1971

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Recommended Citation
Liberalizing SEC Rule 14a-8 Through the Use of Advisory Proposals, 80 Yale L.J. (1971).
Available at: http://digitalcommons.law.yale.edu/ylj/vol80/iss4/4

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Liberalizing SEC Rule 14a-8 Through the Use of Advisory Proposals

The recent attempt of shareholder groups to use Securities and Exchange Commission (SEC) Rule 14a-8, the so-called shareholder proposal rule, as a vehicle for advancing the "public interest" has spawned debate about the proper dimensions of the provision. The rule is part of the proxy machinery which the SEC has created pursuant to its authority under Section 14(a) of the 1934 Securities Exchange Act. It establishes a procedure through which shareholders can force management to include in its proxy materials their own proposals and one hundred word statements in support of such proposals. Under the rule's three basic tests, management may omit proposals which: (1) are not proper subjects for shareholder action under the law of the issuer's domicile; (2) are submitted primarily for the purpose of promoting a general social, economic or political cause; or (3) relate to the ordinary business operations of the issuer. The rule places the burden of proof on management; and, if management seeks to omit the

2. The term "public interest" proposal is used in this Note simply as a shorthand for proposals which seek to make business more conscious of its social role and implies no judgment about the merits of individual proposals. The most widely publicized effort to use the shareholder proposal rule involved the attempt of Campaign GM to include nine proposals in GM's proxy. See pp. 863-64 infra. A recent decision of the D.C. Circuit also has generated considerable interest in the shareholder proposal rule. Medical Committee for Human Rights v. SEC, 432 F.2d 659 (D.C. Cir. 1970). For a summary of the Medical Committee case, see pp. 862-63 infra.
5. Rule 14a-8(c)(1) allows for omission "If the proposal as submitted is, under the laws of the issuer's domicile, not a proper subject for action by security holders." Rule 14a-8(1)(1), 17 C.F.R. § 240.14a-8(c)(1) (1970).
6. Rule 14a-8(c)(2) allows for omission "If it clearly appears that the proposal is submitted by the security holder primarily for the purpose of enforcing a personal claim or redressing a personal grievance against the issuer or its management, or primarily for the purpose of promoting general economic, political, racial, religious, social or similar causes." Rule 14a-8(c)(2), 17 C.F.R. § 240.14a-8(c)(2) (1970).
7. Rule 14a-8(c)(5) allows for omission "If the proposal consists of a recommendation or request that the management take action with respect to a matter relating to the conduct of the ordinary business operations of the issuer." Rule 14a-8(c)(5), 17 C.F.R. § 240.14a-8(c)(5) (1970).
This Note maintains that the legislative policies of the 1934 Act require liberalization of the shareholder proposal rule. As presently administered, the rule does not permit the full exercise of shareholder rights envisioned by the Act. Recent commentaries have effectively criticized the existing shareholder proposal rule, and two in particular have attempted to formulate alternatives. But the proposed alternatives continue to rely upon drawing a distinction between the conduct of ordinary business, a management function, and the setting of policy, a shareholder function. Since that distinction cannot now be drawn according to meaningful criteria, these proposed alternatives, in effect, provide no workable formula for determining what subjects are proper for shareholder action under Rule 14a-8. They are thus susceptible to the restrictive interpretation of shareholder rights which characterizes the present rule. In contrast, this Note seeks to minimize the significance of the difficult line-drawing task by permitting shareholders to include in management's proxy advisory proposals which are not evaluated according to the distinction between ordinary business and corporate policy.

This Note will examine the legislative policy which the shareholder proposal rule was designed to implement, as evidenced by legislative history and early SEC interpretations, and explore the reasons the present rule fails to serve that policy. The Note will then suggest new guidelines which comport with the original congressional policy.
I. The Function of Advisory Proposals

Sec. 14(a) of the 1934 Act was passed at a time when the multiplication and dispersion of shareholdings had made attendance at corporate annual meetings an impractical burden for most shareholders. While the proxy was a seemingly workable alternative, state proxy regulation was in some jurisdictions nonexistent and in others chaotic. But rather than enact specific measures to deal with the problem of proxy regulation by explicit substitution of federal for state law, Congress allowed the SEC maximum flexibility under Sec. 14(a) in promulgating rules or regulations “necessary or appropriate in the public interest or for the protection of investors.”

In exercising its Sec. 14(a) rulemaking power, the SEC must, of course, be guided by the goals of the legislation. The legislative history of the 1934 Act, however, provides only broad indication of the policies Congress intended to serve by enacting Sec. 14(a). The Act was aimed at curbing the unchecked power wielded by the managers of publicly-held corporations. As the House Report indicated:

Even those who in former days managed great corporations were by reason of their personal contacts with their shareholders constantly aware of their responsibilities. But as management became divorced from ownership and came under the control of banking groups, men forgot that they were dealing with the savings of men and the making of profits became an impersonal thing. When men do not know the victims of their aggression they are not always conscious of their wrongs.

Although much of the legislative debates focused on problems of proper disclosure, the hearings also evinced Congress's concern with guaranteeing the shareholder “fair suffrage.” The debates, however,
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The shareholder proposal rule itself developed as an adjunct to the SEC's disclosure requirements. Early formulations of the proxy rules required management to disclose matters shareholders intended to raise at the annual meeting if it were informed of them in advance, but the effectiveness of these rules depended on management's willingness to acknowledge the contemplated action of shareholders. Therefore, in 1942, the Commission imposed a positive duty on management to include in its proxy materials all shareholder proposals which were "proper subjects of security holder action" and the shareholder's one hundred word statement in support of each proposal. According to Chairman Purcell, the SEC sought to guarantee the rights shareholders traditionally held at the annual meeting. This accorded with and gave substance to the legislative intent to ensure fair suffrage because it was at the annual meeting that shareholders had traditionally exercised their voting powers. The SEC recognized that the dispersion of shareholdings had transformed the proxy mechanism into the functional equivalent of the annual meeting for most shareholders.

In fashioning guidelines as to proper subjects for shareholder action under the new rule, the SEC originally looked to state incorporation statutes and court interpretations as sources of law. It is unclear whether the SEC viewed adherence to the potentially inconsistent laws of the various states as mandated by Sec. 14(a) or as an administrative guide. While some commentators have taken the position that adherence is mandated, this Note interprets that section more ex-
pansionly as ensuring fair suffrage within a model of the corporation drawing upon the generality of modern state incorporation laws.\(^\text{24}\) Such an interpretation gives content to the rights shareholders traditionally held at the annual meeting without catering to the idiosyncracies of particular state laws where they derogate from shareholder functions.\(^\text{25}\)

In general, state law as to the proper subjects for shareholder action at the annual meeting reflects the division of powers between the board of directors and the shareholders under modern incorporation statutes. Those statutes vest in the directors authority to manage the corporation, but mandate an annual meeting as a forum for shareholders to scrutinize the management of their investment. The shareholders appear to exercise three functions at the annual meeting: (1) they vote on those items which under state law, the corporate charter, and corporate bylaws require shareholder approval;\(^\text{26}\) (2) they submit their own binding res-

corporate organs, so revolutionary a federal intervention would presumably have been more clearly expressed." 2 L. Loss, supra note 8, at 902-03. However, as another commentator has pointed out, "The stockholder's right to require that his proposal be put before the other stockholders by the company arises only by virtue of the Commission's proxy rules, and in determining the nature and extent of that right the court should take into account the basic congressional policy enunciated in the Securities Exchange Act. Minority stockholders, whose rights Congress was endeavoring to restore by legislation, would have a hard task indeed if they had to rely merely on the requirements of state law: in fact, it was the very inadequacy of such remedies that led to federal action in this field." Friedman, SEC Regulation of Corporate Proxies, 63 HARV. L. REV. 796, 804 (1950). Moreover, the Commission, by adopting a federal standard, would not be reallocating functions but would be guaranteeing the shareholder's role in corporate affairs which the 1934 Act sought to preserve. One can question just how "revolutionary" such action would be in view of the pervasive impact which the Exchange Act has had on corporate affairs. See Kaplan, Foreign Corporations and Local Corporate Policy, 21 Vand. L. REV. 433, 476-77 (1968); Fleischer, "Federal Corporation Law": An Assessment, 78 HARV. L. REV. 1146 (1965). The issue of whether the SEC is bound to a state law test under the 1934 Act has never been directly faced by the courts. However, in SEC v. Transamerica Corp., 163 F.2d 511 (2d Cir. 1947), cert. denied, 332 U.S. 847 (1948), the court, in refusing to apply the restrictive notice requirement of a corporate bylaw, broadly construed the authority granted to the Commission under the 1934 Act. The Third Circuit stated: "If this minor provision may be employed as Transamerica seeks to employ it, it will serve to circumvent the intent of Congress in enacting the Securities Exchange Act of 1934. It was the intent of Congress to require fair opportunity for the operation of corporate suffrage. The control of great corporations by a very few persons was the abuse at which Congress struck in enacting Section 14(a),... The power conferred upon the Commission cannot be frustrated by a corporate by-law." 163 F.2d at 518. Where state law has frustrated the Congressional purpose of Sec. 14(a), the courts have upheld the supremacy of federal law. J.I. Case v. Borak, 377 U.S. 426 (1964); McClure v. Borne Chemical Co., 292 F.2d 824 (3d Cir. 1961); Miller v. Steinbach, 263 F. Supp. 255 (S.D.N.Y. 1967).

24. Modern corporation statutes in the United States date back to the 1915 Delaware Corporation Act. Most states soon followed Delaware's lead. These statutes have been termed "enabling acts" because they establish only a general framework for corporate organization and do not impose the specific restrictions which characterized earlier corporation laws. W. CARY, CASES AND MATERIALS ON CORPORATIONS 9-10 (4th ed. unabridged 1969).

25. The corporate model developed in this Note generally accords with present state law. But see the recent amendment to Sec. 122(12) of the Delaware Corporation Statute, note 43 infra, and Carter v. Portland General Electric Company, note 36 infra.

26. See, e.g., DEL. CODE ANN., title 8, § 251(c) (Supp. 1965). § 251(c) provides that
olutions on matters of corporate policy:27 and (3) they question and advise management regarding its handling of corporate affairs.28 Management must trigger the first function. It is the right to perform the other two functions that the SEC presumably sought to guarantee under the shareholder proposal rule.

The shareholder's power to submit binding resolutions for corporate action is limited by several doctrines of state law. First, the resolution must call for corporate action which is within the corporation's permissible scope of activity. After the demise of the *ultra vires* doctrine,29 the only limitation which state law appears to place on the scope of corporate activity is the requirement that the activity not violate the vaguely defined profit norm.30 Recent cases involving corporate charitable contributions illustrate the flexible nature of the profit norm.31 The courts appear to be applying a standard of financial reasonableness to define the limits of corporate non-profit activity, and in none of the reported cases has a court ruled that expenditures have exceeded the limit.

The second limitation imposed by state law on binding resolutions is the requirement that the requested activity not violate the business management statutes. These statutes reflect the view that the managers

merger or consolidation agreements must be approved by the shareholders at an annual or special meeting.

27. See pp. 851-52 infra.
28. See note 96 infra.
29. This doctrine once limited the range of corporate activity; however, the broad purpose provisions of modern corporation statutes, which permit incorporation for any lawful purpose, have virtually extinguished the applicability of this doctrine in its original sense. W. Casey, supra note 24, at 50-62.
30. The profit norm question appears to have arisen only in the context of managerial decisions. State law does not seem to impose a strict duty on the directors of the corporation to maximize profits. The business judgment rule vests directors with substantial discretion in corporate matters. "In the absence of a showing of bad faith on the part of directors or a gross abuse of discretion, the business judgment of the directors will not be interfered with by the courts." Warshaw v. Calhoun, 221 A.2d 487, 492-93 (Del. Ch. 1966). If a strict profit maximization is not applied to decisions of directors, who are fiduciaries for the shareholders, it can hardly be applied to decisions of the shareholders themselves.
31. For a comprehensive analysis of the evolution of corporate giving, see Blumberg, *Corporate Responsibility and The Social Crisis*, 50 B.U. L. Rev. 157 (1970). Whereas the common law originally permitted charitable contributions only when it could be demonstrated that the ostensibly charitable gift produced a direct financial benefit to the corporation, recent decisions have upheld charitable contributions on the basis of the corporation's responsibility to society. See, e.g., A.P. Smith Mfg. Co. v. Barlow, 13 N.J. 145, 98 A.2d 581, appeal dismissed, 346 U.S. 861 (1953); Union Pac. R.R. Co. v. Trustees, Inc., 8 Utah 2d 101, 329 P.2d 398 (1958); Kelly v. Bell, 254 A.2d 62 (Del. Ch. 1969); Theodora Holding Corp. v. Henderson, 257 A.2d 398 (Del. Ch. 1969). In the landmark *Smith* decision, the court justified a $1,500 gift to Princeton University by recognizing that "modern conditions require that corporations acknowledge and discharge social as well as private responsibilities as members of the communities within which they operate." 13 N.J. at 154, 98 A.2d at 586.
of the corporation are in the best position to handle the day-to-day business matters; they therefore delegate final authority over "ordinary business matters" to the managers of the corporation, leaving to shareholders binding power over policy. A simple view of the distinction between policy and ordinary business could be conceptualized which would separate the relatively general decisions (policy) from the relatively specific ones (ordinary business). While the line can be conceptualized, the practical difficulties of drawing the line are enormous—the relevant legal standard is extremely vague and the case law is exceedingly sparse. The case law provides no meaningful guidelines for determining, for example, whether the decision as to what product to produce or the decisions as to how much the corporation's factories will be permitted to pollute the air or the decision as to what position the corporation will take with respect to safety legislation is a matter of policy or a matter of ordinary business.

A recent case illustrates the difficulty. A shareholder of Standard Oil (N.J.) submitted to management for inclusion in management's proxy materials a proposal that the corporation intensify its efforts to encourage exploration of petroleum reserves beneath the continental shelves and that it encourage the development of a stable international regime with jurisdiction over undersea areas to protect this investment. To the untutored eye, the resolution appears to be closer to policy than to ordinary business because it is phrased in general terms, allowing management considerable discretion as to implementation. The SEC, however, concluded that the proposal related to ordinary business, and the reviewing court upheld that determination in a perfunctory opinion.

But the difficulty of drawing the line between policy and ordinary business is more complex than even the foregoing analysis suggests. All policy decisions interfere with the conduct of ordinary business. For

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32. See, e.g., DEL. CODE ANN., title 8, § 141(a) (Supp. 1969). "The business of every corporation organized under the provisions of this chapter shall be managed by a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation." See H. BALLANTINE, CORPORATIONS (Rev. ed. 1946) 119-23.

33. Brooks v. Standard Oil Co. 308 F. Supp. 810 (S.D.N.Y. 1969). The resolution in full is as follows: "Resolved that the Standard Oil Company of New Jersey continue and intensify its efforts to encourage the exploration and development of petroleum reserves beneath the world's continental shelves, continental slopes and deep ocean bottoms; that the Company in order to insure the protection of capital investment in these undersea areas, encourage the creation of a stable international regime having jurisdiction over the petroleum and other mineral resources of undersea areas beyond the limits of national jurisdiction." Id. at 811. The court, in applying the state law test, used two old New Jersey cases which construed broadly ordinary business operations and upheld the SEC's determination.
example, the "policy decision" not to pollute rivers might well be interpreted to preclude the decision to manufacture paper. To focus on this interference as the reason for invalidating binding shareholder proposals, as the courts seem to have done in the few adjudicated cases,34 is to deny that there can be a policy decision. By construing all binding shareholder proposals which may interfere with managerial discretion as relating to ordinary business, the courts have avoided the difficult task of developing meaningful criteria for separating management from shareholder decisions.

In contrast to their limited authority to set corporate policy by passing binding resolutions, shareholders have a broad opportunity at the annual meeting to communicate with fellow shareholders and management on all matters of lawful corporate action. The annual meeting "... is the one time that all stockholders are given an opportunity to come together and to ask questions of the management regarding all phases of the business."35 The shareholder exercises this function both by submitting advisory resolutions and by addressing questions to management from the floor of the meeting. The practical necessity of fostering good shareholder relations and the little state law which exists in this area seems to impel management to respect the shareholder's advisory function.36 In this fashion, the annual meeting permits a broad

34. Court decisions in this area are rare. 2 L. Loss, supra note 8, at 906. But see Automatic Self-Cleansing Filter Syndicate Co. v. Cuninghame, [1906] 2 Ch. 34; Charlestown Boot & Co. v. Dunsmore, 69 N.H. 85 (1880).
36. The corporation statutes require management to hold an annual meeting but generally are vague with respect to the conduct of the meeting. See, e.g., DEL. CODE ANN. title 8, § 212 (Supp. 1968). Of the leading commercial states, New York has developed the most case law; and N.Y. courts have consistently recognized the shareholder's advisory role. Continental Securities Co. v. Belmont, 206 N.Y. 7, 16-17, 99 N.E. 138, 141 (1912); Miller v. Vanderlip, 285 N.Y. 116, 121, 33 N.E.2d 51, 54 (1941); In re Auer v. Dressel, 306 N.Y. 427, 118 N.E.2d 590 (1954). In Dressel the court not only acknowledged the shareholder's advisory function but went a step further by compelling management to include at the annual meeting an advisory resolution endorsing the regime of the corporation's former President. The Delaware District Court, in interpreting Delaware corporation law, recently endorsed the shareholder's advisory function at the annual meeting. Jacobs v. Tenney, 316 F. Supp. 151 (D. Del. 1970). The court held that an annual meeting convened by a shareholder with 90% of the corporation's stock was of sufficient importance to an alleged violation of the federal securities laws to establish venue under section 27 of the 1934 Act. The court rejected the defendant's argument that his 90% control block rendered the meeting a mere formality and noted that the annual meeting provides an important forum for minority shareholders to challenge the wisdom and conduct of the controlling directors. Id. at 159. In contrast to the case law of the leading commercial states, see Carter v. Portland General Electric Company, 227 Ore. 401, 362 P.2d 766 (1961). The court refused to compel the management of a corporation exempt from the federal securities law to submit an advisory resolution in opposition to the construction of a dam. The court rejected the shareholder's argument that it should apply the SEC's proxy rules to exempt corporations primarily on the ground that there was no administrative agency on the state level capable of enforcing these kinds of

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interchange of ideas between management and shareholder.

The shareholder's right to initiate binding action in policy matters, however truncated, can easily be duplicated in the proxy by requiring management to list the proposal. The second kind of basic shareholder function, the right to question and advise management, although more difficult to duplicate, can be simulated. The shareholder who attends the annual meeting has more than the mere right to propound his own questions or recommendations to management. He also has the opportunity to communicate his views on corporate matters to other shareholders and to hear their suggestions. It is this interchange at the annual meeting which encourages a good faith response on the part of management and provides the shareholder's advisory function with real significance. In addition, under the leading case of In re Auer v. Dressel, the shareholder may submit and obtain a shareholder vote on advisory resolutions.

A shareholder proposal rule which incorporates an expanded provision for advisory proposals is the best practical step which can be taken to guarantee the shareholder's right to communicate his views to management and his fellow shareholders. From management's perspective, a proxy which permits wide latitude for advisory proposals will involve only the cost of printing longer proxy statements and the inconvenience of replying to shareholders' suggestions. These factors suggest that there should be a system for weeding out frivolous proposals, but that the costs of a broad shareholder proposal rule to management and the corporation are not so substantial as to warrant any additional curtailment of the shareholder's right to oversee his investment.

II. The Present Test of Proper Subjects for Shareholder Action

While the SEC's secretive decision-making process makes it difficult to evaluate the precise nature and effect of the shareholder proposal rule, the available evidence suggests that the present rule is ill-adapted
to guaranteeing the shareholder functions of making policy and advising directors. The SEC's experience prior to the addition of the ordinary business and general cause exclusions indicates that the state law test could be interpreted to permit the full exercise of both shareholder functions unless it were the sole test under the shareholder law test. The SEC's experience prior to the addition of the broad power to advise and question management at the annual meeting, the Commission adopted a more liberal policy toward advisory resolutions. Resolutions which related to measures within the permissible scope of corporate activity under state law but infringed the business management statutes were permitted if phrased in advisory form. 

Heller, *Stockholder Proposals*, 4 VA. LAW WEEKLY DICTA COMPILATION 72, 74 (1952-53). 44. An amendment to the Delaware Corporation Statute in July, 1969 indicates the danger of pre-emption which is inherent in a state law standard. Although the change was not accompanied by any legislative history, it was enacted shortly after the Medical Committee controversy began. Sec. 122(12) formerly providing that "In time of war or other national emergency, [corporations are permitted] to do any lawful business in aid thereof, notwithstanding the business or purposes set forth in its certificate of incorporation at the request of direction of any apparently authorized governmental authority" was amended to permit corporations to "transact any lawful business which the corporation's board of directors shall find to be in aid of governmental authority." Del. Code Ann., title 8, § 122(12), 2 P-H CORP., at Del. Corp. 421 (July 1, 1969), formerly Del. Code Ann., title 8, § 122(12) (Supp. 1968). The amendment appears to be an attempt by the Delaware legislature to avoid a recurrence of a challenge like that of the Medical Committee.

44. The Harvard Note recommends that the SEC delete the ordinary business and general cause exclusions and revert to a pure state law test. Note, *Proxy Rule 14a-8: Omission of Shareholder Proposals*, 84 Harv. L. Rev. 760, 714-28 (1971). The core of the state law test is alleged to be the allocation of the policy-making function to the shareholders and the ordinary business function to management. But despite the understated
The SEC’s interpretation of the state law test has been obscured by the addition of the general cause and ordinary business exclusions. The general cause exclusion permits management to omit proposals “submitted primarily for the purpose of promoting a general social, economic, or political cause.” Under one interpretation, this test measures subjective purpose: the SEC can and does permit omission of proposals which are otherwise proper subjects when it devines that the shareholder’s “primary” purpose is improper. It selects the “primary” from concession that “a clear state rule is frequently unavailable to guide the decision” (Id. 715) and the criticism of the SEC for “its failure to articulate reasoned and consistent principles” (Id. 717), the Note itself fails to formulate useful guidelines. The Note’s only specific offering is an attempt to deal with the problem of “general causes” by identifying and dealing with those “proposals which relate to the normal business of the corporation, but which inject into the decision-making process moral, political, social, or religious issues.” Id. 725. While continual invocation of nonexistent “state law” clouds the analysis, the suggestion is seemingly that as to ordinary business decisions, the SEC should require inclusion of shareholder proposals with moral, etc. connotations but only where management has “injected” such factors. Id. 727. While the rule is nicely crafted to enclose the Medical Committee case—Dow’s management was so rash as to acknowledge publicly that napalm was produced for political reasons in spite of its unprofitability—it is but a rule for one season. To make shareholder rights depend upon continued management ineptitude is to give management a veto over those rights. Nor can such a distinction be supported in the face of the elementary recognition that consciously or subconsciously, directly or indirectly, all corporate decisions involve moral, political, social or religious factors—such factors need not be “injected;” they are already there.

45. This exclusion developed from SEC Securities Exchange Act of 1934 Release No. 3638 (Jan. 3, 1945). The Release was prompted by a shareholder resolution proposing that: (1) dividends paid to shareholders not be subject to federal income taxes where the income from which such dividends are paid already has been subject to corporate income taxes; (2) the antitrust laws and the enforcement thereof be revised; (3) all federal legislation thereafter enacted for workers and farmers be made to apply equally to investors, and other unspecified resolutions of a similar nature. The SEC supported management’s decision to omit the proposals and the release stated:

Speaking generally, it is the purpose of Rule X-14a-7 [subsequently redesignated 14a-8] to place stockholders in a position to bring before their fellow stockholders matters of concern to them as stockholders in such corporation; that is, such matter relating to the affairs of the company concerned as are proper subjects for stockholders’ action under the laws of the state under which it is organized. It was not the intent of Rule X-14a-7 to permit stockholders to obtain the consent of other stockholders with respect to matters of a general, political, social or economic nature. Other forums exist for the presentation of such views.

Thus, in its initial form, the exclusion reiterated the state law test and excluded proposals which did not specify corporate action. In one of the few court cases involving the shareholder proposal rule, this release was used to justify the omission from Greyhound’s proxy of a proposal recommending that management consider the advisability of abolishing the segregated seating system in the South. Peck v. Greyhound Corp., 97 F. Supp. 679, 680 (S.D.N.Y. 1951). The court, relying primarily on the shareholder’s failure to exhaust his administrative remedies, denied a request for a temporary injunction to enjoin the company’s solicitation. The Commission’s exclusion of this ambiguous proposal added little clarification to the 1945 release. As the Court of Appeals pointed out in the Medical Committee decision, the shareholder’s proposal in Peck “was ambiguous with respect to whether it was limited solely to company policy rather than attacking all segregated seating, and . . . quite likely would have brought the company into violation of state laws then assumed to be valid.” Medical Committee for Human Rights v. SEC, 432 F.2d 659, 678 (D.C. Cir. 1970).

46. Heller, supra note 41, at 74. The D.C. Circuit criticized the general cause and ordinary business exclusions for permitting the omission of “practically any shareholder proposal” on the grounds that it is either “too general” or “too specific,” and criticized the
among the many purposes causing the shareholder to act and does so
without psychological expertise and often without more evidence than
papers drafted by the shareholder's lawyer. Thus interpreted, the test
derogates from shareholder functions—a subjective test of purpose,
especially one administered by so clumsy a mechanism, gives the SEC
wide discretion to make arbitrary rulings.47

Under a competing interpretation, the test is one of "objective"
motive: that is, proposals may be omitted because purpose will be
presumed if the primary effect of their passage would be to promote
a general social, economic, or political cause.48 Although the administra-
tive task imposed by this interpretation is arguably somewhat lighter,
the difficulty of deciding whether the effect on the corporation of
engaging in proposed activity or the effect on the cause which the
proposal would promote is "primary" suggests that the inquiry itself
is misdirected. Corporate activities inevitably have a social, economic,
or political effect; under the present test, shareholders are improperly
deprived of their policy-making and advisory functions as to those
activities.

The ordinary business test is similarly in derogation of basic share-
holder functions. The test permits exclusion of a "recommendation or
request" relating to ordinary business matters—the use of the ambigu-
ous phrase "recommendation or request" makes it unclear whether
the exclusion was intended merely to reiterate state law's delegation of
final authority as to ordinary business matters to the board of directors
or was intended to limit advisory proposals as well.49 At least some

SEC for not choosing between the "potentially conflicting arguments" in evaluating the
Medical Committee's proposal. Medical Committee for Human Rights v. SEC, 432 F.2d
659, 679 (D.C. Cir. 1970). The two exclusions, however, are not inconsistent on their face.
The SEC could find that the shareholder was actuated by an improper motive (general
cause) and that the proposal related to ordinary business.
47. Thus, as the D.C. Circuit suggested in dictum, "[E]ven accepting Dow's characteriza-
tion of the purpose and intent of the Medical Committee's proposal, there is a strong
argument that permitting the company to exclude it would contravene the purpose of
section 14(a)." Medical Committee for Human Rights v. SEC, 432 F.2d 659, 681 (D.C. Cir.
1970).
49. Former SEC Chairman J. Sinclair Armstrong endorsed the former approach. 1957
Hearings, supra note 42, at 118. Quoting from the same hearings, the Court of Appeals in
Medical Committee reached the same conclusion. Medical Committee for Human Rights
v. SEC, 432 F.2d 659, 678 (D.C. Cir. 1970). Clusserath, supra note 8, at 34-36, discusses
several SEC determinations which follow this approach. However, a decision shortly after
the adoption of the ordinary business exclusion indicated that it would be used to limit
1954), the court upheld the SEC's exclusion of an advisory proposal regarding pension
benefits which the Commission had included in prior years. The Commission still appears
confused over the correct interpretation of the exclusion. For example, in 1964, the
Commission split 2-2 on the acceptability of a shareholder proposal which recommended

members of the SEC subscribe to the latter view, and that view seems to have influenced SEC determinations. To the extent that this interpretation is influential, the ordinary business test undercuts the shareholders' advisory function by subjecting advisory proposals to the broad ambit of the ordinary business test.\footnote{50}

III. Amending the Shareholder Proposal Rule

To facilitate the exercise of the shareholder's distinctive policy-making and advisory functions as to corporate actions and to guarantee that shareholders may introduce certain procedural proposals fundamental to those functions, the SEC should promulgate new rules to replace the state law, ordinary business and general cause exclusions of the shareholder proposal rule. The primary thrust of the proposed rules is to expand the shareholder's opportunity to force management to include advisory proposals by removing the ordinary business limita-

a divided payment; and each Commissioner's vote was grounded in a different interpretation of the rule. W. Case, supra note 24, at 327-33.

\footnote{50} In his recent article, Professor Schwartz suggests that the SEC delete the general cause exclusion. Schwartz, supra note 3, at 520-28. Because he proposes retaining the ordinary business test, thus denying shareholders even an advisory role in ordinary business decisions, maintenance of shareholder rights must depend upon a clear articulation of the distinction between ordinary business and policy. The article does not, however, attempt to develop a systematic typology of business decisions and criteria for distinguishing "types", although it acknowledges that the specific proposals advanced by Campaign GM regarding crash test specifications, warranties, pollution standards, and minority group employment were properly excluded under the ordinary business exclusion whether phrased in advisory or binding form. Id. 460.

Professor Schwartz, however, recommends an expansion of proxy statements as "information-disseminating devices." Id. 525. Shareholders would be permitted to propound questions "directed to the range of company activities, or to activities that the company could carry on . . ." Id. 527. Questions would be included in the proxy statement, but the answers would be presented at the annual meeting and sent to shareholders in the form of a post meeting report. Professor Schwartz, however, does not illustrate the kinds of questions his recommended rule would permit. Almost any declaratory statement can be turned into a question. It is not clear whether the suggested rule would permit shareholders to rephrase an excluded proposal in the form of a question—e.g., why doesn't GM produce a vehicle which meets X pollution standards? A narrow interpretation of the Schwartz rule would suggest that the SEC should permit exclusion of such proposals as being primarily argumentative rather than informational.

Moreover, even if Professor Schwartz is suggesting a broad "shareholder question rule" in order to circumvent the requirements of the shareholder proposal rule, his alternative does not promote effectively the basic rationale of the "public interests" proposal as he conceives it. Campaign GM was aimed primarily at the public at large and at the constituencies of institutional investors, including students, alumni, and faculty of universities, beneficiaries of pension funds, and policy holders of insurance companies. Id. 485. A proposal, unlike a question, necessitates a response by the shareholder and thus compels universities, foundations, churches, and other institutional investors to defend a position. It is this aspect of the shareholder proposal rule which engenders vigorous discussion and debate. Although Professor Schwartz's suggestion would probably result in the availability of more information regarding the social implications of corporate behavior, it would not serve effectively the professed goals of the "public interest" proposal.
tion as to those proposals. In the recognition that the 1934 Act was not a general "federal incorporation law," the proposed rules employ federal standards only to the extent necessary to guarantee the shareholder functions envisioned in the 1934 Act.51

A. *Advisory Proposals for Corporate Action*

In particular, the shareholder proposal rule should provide that management may omit an advisory proposal if the proposed action is beyond the power of the corporation under state law. Under the suggested rule, the permissible scope of corporate activity will be governed by state law. Because the "fair suffrage" requirement of Sec. 14(a) was concerned only with guaranteeing certain *shareholder functions within the corporation*, it should not be interpreted as authorizing corporations to take external action beyond that permitted under state law. However, the only limitation that state law appears to impose on external corporate action, as noted above, is the requirement that the corporation adhere to the vaguely defined profit norm. But because an advisory proposal does not commit the corporation to a course of action—only if management subsequently acts does the corporation become committed—it cannot of itself entail a violation of the profit norm. If the shareholder's advisory function is to be as broad when exercised through the proxy machinery as it has been at the annual meeting, the SEC should include advisory proposals unless management can bear the burden of proving that the proposal could not conceivably be implemented without violating the profit norm.52

The suggested rule does not exclude advisory proposals because they relate to ordinary business. The 1934 Act guarantees the shareholder's right to scrutinize management's performance and to suggest new directions for the corporation. While shareholder proposals may well

51. See note 23 *supra*. While federal standards are offered to provide a uniform basis for guaranteeing the shareholder functions envisioned in the 1934 Act, the proposed rules generally are consistent with present state law. See note 25 *supra*.

52. The present rule places the production burden on management by requiring it to submit an opinion of counsel justifying the omission of a shareholder's proposal. The guidelines in this Note leave management's production burden unchanged, but add a persuasion burden as to the factual issue of whether the proposed action violates the profit norm. As noted above, the state law profit norm is flexible. See note 31 *supra*. In attempting to meet its burden of proof as to advisory proposals, management will presumably present projected revenue and cost data, expert economic testimony, market studies and the like. However, where the shareholder's advisory proposal is a quite general one, the burden will be difficult to meet because management will have to investigate all possible means of implementing the shareholder's proposal and demonstrate that each would violate the profit norm.
persuade management to adopt a new course of conduct, management retains ultimate control over ordinary business decisions.

Because the burden of proof will rest on management to demonstrate that implementation of an advisory proposal would necessarily entail a violation of the flexible profit norm, the number of advisory proposals should increase significantly under the proposed rule. This result would be a practical accommodation of shareholder and management functions.\(^\text{53}\)

### B. Binding Proposals for Corporate Action

The rule should provide that management may omit a binding proposal that the corporation take action if (i) the proposed action is beyond the power of the corporation under state law; or (ii) the proposed action relates to the conduct of the ordinary business operations.

\(^{53}\) A proposal need not be adopted or binding on the corporation in order to have a significant impact. As one former SEC official indicated:

> But most important is the fact that it places in the management the obligation to justify itself to the body of shareholders. Management of course has the right to explain its opposition to the shareholder's resolution at such length as it sees fit. It also theoretically has the right to say nothing in opposition. But practically it must give grounds for its position ... The right to ask a question publicly and to require a public answer may serve a purpose even if the resolution does not carry. Freeman, supra note 18, at 554-55.

Even though the proposals in Campaign GM received a small percentage of the total vote, note 59 infra, the corporation has responded favorably. In September, GM announced the formation of a five member public policy committee consisting of four outside and one inside directors to advise it on matters which affect the general public. N.Y. Times, Sept. 1, 1970, at J, col. 3. Several members of Campaign GM criticized the corporation for limiting the Committee's membership to existing board members. Id. However, in January, GM appointed Dr. Leon Howard Sullivan, a Black minister from Philadelphia, to its board of directors. N.Y. Times, Jan. 5, 1971, at 49, col. 5. The appointment of Dr. Sullivan, who is well-known for his organization of a nationwide employment training program for Blacks, was lauded by a spokesman for Campaign GM. Id.

While the shareholder proposals in Campaign GM fostered substantial publicity and public discussion, a narrow interpretation of the proxy rules governing solicitation could undermine future efforts to use the shareholder proposal rule to stimulate public discussion. See generally Schwartz, supra note 3, at 488-91. A solicitation is broadly defined under Rule 14a-1 to include any communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy. Rule 14a-1(f)(iii), 17 C.F.R. § 240.14a-1(f)(iii) (1970). If a shareholder's communications with the public fall within this broad definition, the shareholder must file a detailed information statement and a proxy with the SEC and send a proxy to every shareholder. Rule 14a-3(a), 17 C.F.R. § 240.14a-3(a) (1970). Only parties who seek control of the corporation are likely to incur this substantial expense. The shareholder proposal rule was designed to provide the shareholder with a means of communicating with management and fellow shareholders which did not entail this expense. This Note therefore endorses Professor Schwartz's recommended change in Rule 14a-3 which would exclude from its provisions statements pursuant to a shareholder proposal under Rule 14a-8 made in a public manner, not addressed exclusively to shareholders. The exclusion would apply unless the proponents of the proposal or the persons making the communications are participants in an election contest or affiliated with parties to or opponents of a merger, consolidation, acquisition, or similar matter. Schwartz, supra note 3, at 528.
of the corporation. For reasons noted above, the profit norm will be used to determine whether the proposed action accords with the permissible scope of corporate activity under state law. Because management has greater expertise and greater familiarity with the prospects of the corporation, final judgment on the costs and benefits of such action is properly a function of management except in clear cases. Consequently, in determining whether a binding shareholder proposal is consistent with the profit norm, the SEC should place the burden of proof on the shareholder.\textsuperscript{54}

The suggested rule would also permit management to omit binding proposals which relate to the conduct of ordinary business operations. Under the view of the corporate decision-making structure sketched above, management must retain final authority over ordinary business decisions.\textsuperscript{65} But in determining whether a proposal relates to ordinary business, the SEC has substantial freedom. The determinations under state law and previous versions of the shareholder proposal rule are few in number and are in any event not binding on the SEC. The courts, the commentators and the SEC have notably failed either to develop criteria for distinguishing ordinary business from policy decisions or even to recognize that a satisfactory approach cannot emerge so long as the SEC and the courts continue to classify as an ordinary business decision every decision which has ordinary business ramifications. Of course one cannot expect sophisticated criteria to be developed from so little cumulative experience with shareholder proposals and corporate decision-making. But as the expanded rule for advisory proposals yields a greater number of such proposals, the SEC can gain a better understanding of the kinds of proposals shareholders wish to submit and can explore the interrelationships of those proposals with other corporate decisions. Eventually, then, the SEC can begin to make case-by-case decisions as to binding proposals and can ultimately hope to develop criteria to distinguish policy decisions from ordinary business decisions.

\textsuperscript{54} In attempting to meet its burden of proof as to binding proposals, shareholders will submit the same sorts of studies as management will submit to meet its burden as to advisory proposals. See note 52 \textit{supra}. The shareholder must show that there is some way in which the proposal can be implemented which would not violate the profit norm. Only SEC experience with a number of shareholder proposals can make this standard more specific.

\textsuperscript{55} See p. 851 \textit{supra}. 
C. Proposals Regarding Corporate Organization and Procedures

Finally, the rule should permit management to omit a proposal relating to the organization of the corporation or its procedures if (i) the proposal is not proper under state law; and (ii) it is not on a list of standardized proposals which the SEC deems to be essential to exercise of the shareholder's function under the 1934 Act. To implement this rule, the SEC should establish such a list, drawing on its past adjudications under the shareholder proposal rule. The list should include, at a minimum, proposals as to the place of the annual meeting, the election of independent auditors, and the right of shareholders to receive reports of the annual meeting. Proposals of this sort enable the shareholder better to fulfill his supervisory functions by providing him with information and access to management and to his fellow shareholders. The thrust of the suggested rule as to organizational or procedural proposals is to leave most questions to be decided by reference to state law, but to create an independent federal standard for those matters which go to the essence of the 1934 Act's effort to protect shareholders. Binding and advisory proposals should be accorded the same treatment to provide maximum flexibility.

D. Frivolous Proposals

Under the proposed guidelines, literally any advisory proposal calling for some action by the corporation would be a proper subject if not so

56. Binding resolutions pertaining to these items in the past have been incorporated under the federal "common law" of proper subjects. See note 41 supra. The federal standard should apply only to those matters deemed essential under the 1934 Act. Devices, like cumulative voting, which are of only arguable benefit to the shareholder would not be included when state law does not permit them.

57. The three proposals of Campaign GM Round II may be used to illustrate the effect of the rule regarding corporate organization. See Proxy Statement Campaign GM Round II, November 19, 1970. Proposal one provides for a new bylaw which details a procedure whereby 100 shareholders of record or holders of 1,500 shares of the corporation could nominate candidates for vacancies on the board of directors. Proposal two provides for a new bylaw which establishes a procedure whereby employees, consumers, and dealers would each be entitled to elect one member to the board of directors, subject to shareholder ratification. Proposal three seeks to amend the bylaw governing the annual report to require disclosure of specific corporate efforts in the areas of pollution control, minority hiring, mass transit, and the details of any vehicle recall campaigns. Under the independent federal test, the three proposals would be included in GM's proxy materials. All three proposals are basic to the shareholder functions preserved by the 1934 Act and are consistent with past adjudications under the shareholder proposal rule. See note 56 supra. The election of directors is clearly one of the most basic, if not the most basic, shareholder functions. Proposal three is consistent with the disclosure rationale of the 1964 Act and the SEC's recognition of the shareholder's right to submit proposals regarding the election of independent public auditors and the right to receive reports of the annual meeting.
specific and expensive as to violate the profit norm. It is conceivable that shareholders would submit a large number of frivolous proposals and thus waste time and money. In that eventuality, rather than attempt to weed out frivolous proposals by regulating the content of the proposals in the manner of the general cause exclusion, the SEC could require that inclusion be supported by shareholders whose holdings total at least a certain percentage (e.g., 1/20 of 1%) of the shares of the corporation. This approach would let the shareholders themselves determine whether a proposal was serious and deserved consideration. For shareholder groups with serious proposals, the percentage requirement would not constitute a significant obstacle: foundations, churches, or universities could easily supply enough votes to have the proposals included in the proxy materials. Because the suggested rules regarding binding and organizational and procedural proposals are similar in substance to existing rules under which frivolous proposals have not been a problem, a percentage requirement need apply only to advisory proposals.

IV. The New Rule as Applied to Recent Cases

Two recent determinations involving the shareholder proposal rule may be used to illustrate the effect of the new rule. In Medical Committee for Human Rights v. SEC, the SEC excluded an advisory pro-

58. This figure is offered only as a rough approximation. The SEC should experiment with various figures in an attempt to reach the lowest percentage figure which still excludes the bulk of frivolous proposals. If the percentage approach is too burdensome for shareholders, the SEC might provide an alternate method for gaining access to the ballot. The SEC could permit a minimum number of shareholders, fifteen for example, to petition for inclusion of an advisory proposal in management's proxy statement.

59. This figure should be easy to obtain in view of the fact that Campaign GM received approximately 2.5% of the votes for each of its two public interest proposals, N.Y. Times, May 23, 1970, at 15, col. 1. Moreover, it is reasonable to expect that universities and large foundations, which are dedicated to free speech and open discussion, would vote in favor of including a resolution on the ballot even if it were opposed to its merits. Recently, an ecumenical panel of the Episcopal Church, the United Church of Christ, the American Baptist Convention, the United Presbyterian Church, the United Methodist Church, and the Lutheran Church expressed interest in the shareholder proposal rule. They are attempting to include a shareholder proposal which would delay a Puerto Rican copper mining project by two United States companies. The churches are alleging that the project would injure Puerto Rico economically, socially, and politically. N.Y. Times, Feb. 11, 1971, at 31, col. 1.

60. 432 F.2d 659 (D.C. Cir. 1970). The court held that a Commission determination under the shareholder proposal rule constitutes a reviewable order under Sec. 25(a) of the 1934 Exchange Act and remanded the determination for sufficiently detailed findings to permit effective judicial review. The court went on, however, in sweeping dictum, to criticize the SEC's administration of the shareholder proposal rule. The court appeared to suggest that the general cause exclusion was not consistent with the Congressional purpose underlying Sec. 14(a) of the Exchange Act. Id. at 680.
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A proposal recommending an amendment to the bylaws of Dow Chemical which would prohibit the sale of napalm unless assurances were provided that it not be used against human beings. This advisory proposal would be a proper subject for shareholder action. It requests lawful corporate action and does not clearly violate the profit norm. Management could omit the proposal only if it could prove that the recommended action violates the profit norm. However, if the proposal were phrased as a binding resolution, the burden of proof regarding the profit norm would be shifted to the shareholder. The Medical Committee probably could meet this burden.61 However, the Medical Committee would also have to demonstrate that the decision not to produce napalm would not be an ordinary business matter. Although the shareholder could argue with some force that napalm is not an ordinary product because of its symbolic association with the Vietnam war, it is nevertheless a product; and specific product decisions are arguably decisions relating to ordinary business operations. Even though the Medical Committee might not succeed in forcing a vote on the proposal as a binding resolution, the proxy mechanism would maintain the shareholder's rights at the annual meeting. Binding shareholder action might be limited, but the shareholder's right to question and advise management would be preserved.

The other case involved the effort of a shareholder group called Campaign GM to force the management of General Motors to include in its proxy materials resolutions regarding crash test specifications, vehicle pollution standards, automobile warranties, mass transit, and minority group employment.62 While management was compelled to include other proposals, the SEC permitted management to exclude these resolutions.63 Under the proposed rule, both the profit norm and the ordinary business limitation would apply because the resolutions were in binding form. Campaign GM might well have some difficulty demonstrating that the profit norm would not be violated. Even if Campaign GM prevailed on this issue, the proposals could probably be

61. See note 54 supra. The Medical Committee's task was eased by management's public acknowledgement that napalm was manufactured for political reasons and in spite of its unprofitability. Medical Committee for Human Rights v. SEC, 452 F.2d 659, 631 (D.C. Cir. 1970).


63. The SEC required GM to include a proposal to expand the size of the board of directors to permit the addition of three public interest directors and a proposal to establish a Shareholder Committee for Corporate Responsibility to assess the impact of GM on society. The reasons for excluding the other resolutions were not given. See Minutes of the Securities and Exchange Commission Meeting of March 18, 1970, released April 14, 1970.
excluded under the ordinary business limitation. However, Campaign GM could force management to include the proposals if they were phrased in advisory form. The ordinary business limitation would not be applicable, and management would bear the burden of proving that the proposed action could not conceivably be implemented without violating the profit norm. The specific nature of the proposals might enable management to meet this burden by presenting detailed market studies and expert economic testimony. The shareholder would then be forced to phrase the recommendation in more general terms—e.g., a recommendation that GM attempt to produce a pollution-free vehicle by 1975. Thus, minority shareholders and creditors would be protected from binding corporate action which would have a detrimental effect on the corporation. Shareholders, however, would have an opportunity to raise fundamental questions regarding the management of their investment.

As the Medical Committee and Campaign GM efforts suggest, public debate about the corporation's proper role is intensifying. Campaign GM has indicated its intention to submit another round of resolutions. An amended shareholder proposal rule would encourage a more serious discussion of the corporation's role in society and would force the management of large publicly-held corporations to defend publicly corporate decisions which, for better or worse, affect the public interest.

64. See note 57 supra.