Mixed Governance in Corporate Law: The Dialectical Regulation of Rule 14a-8

In broadest terms, my comments today concern the relative place of federal and state authority in corporate governance – More specifically, they posit an alternative regulatory scheme, standing somewhere between the prevailing regime of state charter competition, and the Sarbanes-Oxley-inspired bogeyman of "federal corporate law" – Most narrowly, my comments are an attempt to consider the nature (and briefly, the benefits) of this alternative scheme of "mixed governance," using Rule 14a-8 of the Securities Exchange Act of 1934 as a (forgive the pun) proxy

I hope to tackle this agenda in two parts: First, with a story in the negative, and then one in the affirmative

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Let me begin with the story in the negative:

My interest in the possibility of patterns of "mixed governance" – and particularly what I have termed "dialectical regulation" – in corporate law stems from what I found to be the nearly universal critique of the Sarbanes-Oxley Act for its "federalization" of corporate law – Invoked as it was, SOX's critics seemed to have found in "federalization" a new "F" word

What, I wondered, was behind this response? – What is the real issue, behind the widespread talk of "federalization"?

Contrary to first impressions, I suspect it is not a claim that SOX oversteps some doctrinal bound between "federal securities regulation" and "state corporate law," be it a distinction of public and private, or process and substance

While each of these distinctions has descriptive utility in characterizing the reach of federal securities law and state corporate law, at least as a traditional matter, neither constitutes so <u>sharp</u> a distinction, or so impermeable a barrier, so as to exclude ANY federal role in issues of corporate governance

Neither, I believe, are criticisms of SOX's "federalization" of corporate law about federalism – at least in its purest form – for two reasons:

First, traditional arguments for federalism, grounded in the benefits of local autonomy and of policy diversity, do not distinguish between federal securities law and state corporate law – Rather, if federalism (of this variety) favors devolution of authority to set corporate law rules, it would seem to apply no less to securities law – Yet few of SOX's critics are ready to go this far, perhaps because such a notion would make the rejoinder to SOX an even more radical departure from the status quo than SOX itself

Additionally, both the theory and the empirical reality of regulatory competition in corporate law are difficult to reconcile with federalism goals of local autonomy and policy diversity – State

competition for corporate charters rests on legislative capacity for the rapid incorporation of optimal innovations of other states – The essential premise is not that diverse state rules will capture particular morays – Rather, the premise of the relevant race, whether it be to the top or the bottom, is one of convergence – The empirical reality of Delaware's dominance, of course, bears this out

Perhaps, then, critics of SOX's "federalization" are pressing federalism claims of a second-order variety – federalism arguments in praise of regulatory experimentation and competition

Of course, recent empirical analysis has not been promising on that front – More importantly, however, the presence of regulatory competition is not <u>inherently</u> a question of federal versus state law – Its essential prerequisite, rather, is access to multiple regulating jurisdictions

What <u>allows</u> regulatory experimentation and competition in corporate law to be conceived as a federal-state question is not the adoption of relevant rules by national versus local authorities, then – Rather, it is the traditionally mandatory nature of federal rules, and the enabling nature of state rules – Were federal rules similarly enabling (i.e., were federal incorporation simply an option for public corporations) or were state rules effectively mandatory (i.e., both mandatory (versus enabling) in character, and difficult to escape, as implicit in California's broad outreach statute), the story would change dramatically

SOX's critics have no greater affection for *state* outreach statutes than for *federal* rules of corporate law - The trouble, this suggests, is not <u>jurisdictional</u> - Rather, it is <u>regulatory</u>

Critics of SOX's "federalization" of corporate law undoubtedly do bewail the loss of experimentation and competition attendant to the statute - The sacrificed result of such competition, however, is not efficient <u>regulation</u>, at least as "regulation" is ordinarily conceived - Rather, it is a species of <u>de-regulation</u> - SOX's "federalization," in this view, is questioned not because it gets the rules wrong, <u>but simply because it imposes rules</u>

The preference for default rules is thus not a preference for more efficient rules, but a preference for market control - Of course, the desired market is a "regulatory" market - But a market in state corporate law is no less a market - The motivating force behind regulatory design in a world of default rules, negotiated via regulatory competition, is not (even asserted) public interest, but private incentive - If a given default rule comports with private preferences, it survives market competition; if not, it is waived - To similar effect, if a state's corporate regime (including both its default rules and its "trivial" mandatory rules) advances private interests, it is embraced via incorporation; if not, it is abandoned

In this view, the critique of Sarbanes-Oxley for its "federalization" of corporate law is not about federal regulation versus state regulation, but about the imposition of public regulation, where private incentives have heretofore played out within a market dynamic - At the extreme, it is not federal law to which critics of SOX's "federalization" object; it is law—or at least law in a command-and-control, regulatory sense

Such an argument is rarely articulated - Yet criticism of SOX's "federalization" of corporate law must either rest on a generalized claim of the efficiency of a market dynamic, or mean nothing at all

If criticism of SOX's intervention into state corporate law, and of federal corporate law rules generally, comes down to this, it cannot offer a systemic barrier to such intervention

Of course, in any given case, relevant federal rules may be unwise or unwarranted – But there is nothing to suggest that this is always so – Just as regulatory interventions in products markets generally may (at least occasionally) be efficient, the same holds true where law (whether corporate or otherwise) is the relevant product

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So much, then, for our argument in the negative – Some federal role in corporate law, however limited, cannot be categorically excluded – What about our argument in the affirmative – the positive assertion of utility in a federal role?

If there is a place for both federal and state rules in corporate governance, it might most readily manifest itself in some parsing out of the array of questions faced by corporate law:

Which issues are best suited to the flexible construct of state law and which to the mandatory scheme of federal law? – To cite the obvious, one might argue, in this vein, that anti-takeover rules are best suited to federal governance

Yet I would propose to go a step further, to embrace affirmative <u>overlap</u> in the jurisdictional reach of federal and state authorities in corporate law – Rather than parsing out the realm of corporate governance, to identify those areas best governed by one authority or the other, one might instead pursue a regime of what Professor Robert Cover once termed "jurisdictional redundancy," and I have variously characterized as "mixed governance" or "dialectical regulation"

This is, in some sense, the implicit point of Mark Roe's conceptualization of federal law as "Delaware's Competition," of Bob Thompson's analysis of "collaborative" regulation, and of the general approach taken in work by Renee Jones

But what might such a regime of – let us call it "dialectical regulation" for the moment – actually look like in corporate law?

The regulation of annual proxy solicitations may be as good a place as any to take up this question – Here, if anywhere, dialectical regulation is at work, as federal and state rules intertwine to establish the collective governing regime – Federal rules providing for access to shareholder lists, requiring separate votes on distinct matters, and facilitating selective voting on board candidates, among others, are an intimate part of the proxy rules

In particular, however, I propose to focus on Rule 14a-8, providing for the inclusion of shareholder proposals in companies' proxy materials

In essence, 14a-8 mandates the inclusion of shareholder proposals, assuming certain (relatively non-onerous) procedural requirements are met, AND the relevant proposal does not come within an enumerated set of exceptions – In such circumstances, the relevant proposal must be included in annual mailing

Most important for our purposes are several of the exceptions to the rule:

14a-8(i)(1) permits exclusion where the proposal is "not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization"

14a-8(i)(2) permits exclusion where the proposal, "if implemented, [would] cause the company to violate any state, federal, or foreign law to which it is subject"

14a-8(i)(7) permits exclusion where the proposal "deals with a matter relating to the company's ordinary business operations"

In each of these cases, assessment of the exception turns on an evaluation of relevant state law (i.e., of the state of incorporation) – To date, however, the operationalization of 14a-8 has included little effort to bring state analysis to bear

In the ordinary case, thus, a corporation seeking to exclude a proposal from its proxy solicitation materials, based on one or more of the above grounds, petitions the SEC's Division of Corporation Finance for a no-action letter, which letter the Division either issues or declines to issue – On rare occasions, corporations may go directly to federal court, seeking declaratory relief, upon receipt of an objectionable shareholder proposal, but that's far from the norm

In making its determination, however, the SEC does little to engage with those state actors best-positioned (and authorized) to address the questions presented – In fact, state authorities generally are absent from the analysis

Instead, the SEC does a sort of eyeball of the relevant state law, issuing or not issuing the requested no-action letter, based on a combination of the Division's gut assessment, and the results of a pair of heuristic devices the Division has cut from whole cloth, to lend some appearance of coherence to its analysis – Perhaps unsurprisingly, Division responses, whether in the affirmative or the negative, rarely articulate much by way or rationale or reason

As Brett and Larry have documented in prior work, both explicitly and implicitly, in their contrasting interpretations of Delaware law, it is no easy task to decipher the "proper subjects" for shareholder action under state law, violations of state law, and the scope of "ordinary business operations" under state law – Little surprise, then, that the Division of Corporation Finance has fallen back on easy-to-apply, if difficult-to-justify, heuristic devices in handling no-action requests under Rule 14a-8

First has been a general principle disfavoring mandatory, versus precatory, shareholder proposals, as enshrined in the notes to the Rule – While a relatively effective filter, the latter enjoys no meaningful basis in relevant state law, at least besides the general trope that if a proposal is not mandatory, it cannot possibly violate state law (or impose on ordinary business practices, for that matter)

Second has been the Division's decision to take no position, in the face of ambiguous state law – While understandable on the surface, as Brett has argued, this approach likely condemns relevant proposals to permanent exclusion, given the costs of private solicitation – Where the proposal does not advance, meanwhile, state law remains ambiguous, preserving the status quo

More generally, one might find the natural intuition to favor the opposite result – If relevant state law is unclear, the default policy prescription of Rule 14a-8 would seem to kick in – The proposal ought to be included

Each of these heuristic devices can, at heart, be understood as an avoidance mechanism of sorts, grounded in the Division of Corporation Finance's difficult task of attempting to deconstruct (perhaps inherently) ambiguous state law

Might we find a better way? - What might a regime of "dialectical regulation" or "mixed governance" – appropriate here, if ever – look like under Rule 14a-8?

Brett, of course, offers one potential element in the facilitation of such a regime – In the face of ambiguity in state law, better evidence of humility, as he terms it, might be found in allowing proposals to go forward, not because of any claimed "understanding" of state law, but because of an unabashedly self-evident lack of understanding – In essence, such an approach can be constructed as an effort to allow better qualified, <u>state</u> entities to grapple with the relevant issue

Adding further to our dialectical regime, however, this will not necessarily be the end result, given the potential for resistant corporations to seek not state court adjudication of the permissibility of the relevant bylaw or other change – Nor may they seek clarity from the relevant state legislature - Rather, objecting corporations' next stop may be federal court

In this circumstance again, however, a dialectical approach can offer guidance – As in *International Brotherhood of Teamsters (General Fund) v. Fleming (Cos.)*, federal courts faced with such claims might exercise their discretion to certify the question presented to the Supreme Court of the relevant jurisdiction – In the case of certification particularly, moreover, we find a dialectical regime, given the continued existence of some room for subsequent interpretation and discretionary application by the relevant federal court, following certification

Returning to the SEC itself, one might also imagine a slight shift in the burden of proof, that might more effectively incentivize corporations to seek declaratory relief in state courts, in order to clarify relevant state law – The Division of Corporation Finance might thus impose a heavier burden on corporations seeking to exclude shareholder proposals, demanding that they document <u>clear</u> state law or state jurisprudence that is directly on point, in order to qualify for the relief of a no-action letter

What might be other potential elements of a regime of dialectical regulation under Rule 14a-8?

More directly, the SEC might pursue some pattern of engagement with relevant state authorities – Depending on the relevant jurisdiction, this might include state attorneys general, secretaries of state, or even state securities market officials, where extant

Some mechanism of SEC petition for state judicial guidance, a "certification" of sorts, might also be imagined – A form of declaratory judgment might be sought by the Division of Corporation Finance in appropriate cases - an advisory opinion perhaps more feasible under state law, given lowered standing and ripeness barriers to jurisdiction

Might state legislative engagement also be a possibility? – While case-specific engagement is not easy to envision, systemic interaction is both feasible and perhaps even more likely to bear fruit – Relevant data regarding no-action letter requests from corporations incorporated in a given jurisdiction might be compiled annually or otherwise, perhaps with appropriate Division commentary on the questions its staff has faced in responding to such requests – Testimony before relevant legislative sub-committees might offer opportunities to present such annual reports, with obvious further opportunity for engagement

The latter structure, of course, explicitly highlights the essential back-and-forth pattern of engagement essential to a regime of dialectical regulation – Each of the aforementioned elements might thus be conceived as simply a form SEC delegation (and ensuing deference) to state authorities – But the very point of a regime of jurisdictional redundancy, of mixed governance, of *dialectical* regulation, is the allocation of authority in such a way that neither participant can effectively dictate outcomes – Instead, regulatory outputs arise from an exchange, even an ongoing discourse, among relevant regulators

Yet this is just what we have the potential for, under Rule 14a-8

Consider the overall structural dynamic: As a formal matter, the SEC enjoys near-complete independence from relevant state authorities, be it state legislatures, regulators, or courts – Likewise, the federal courts

Each of the enumerated state authorities, meanwhile, enjoys similar independence from its federal counterparts

As a practical matter, however, the very facts that make dialectical regulation a <u>possibility</u> may also make it <u>unavoidable</u> – Of course, the SEC is free to assert whatever interpretation of state law it wishes in addressing the inclusion or exclusion of shareholder proposals in proxy materials – It can be assured, however, that state courts, as well as state legislatures, are likely to exhibit little hesitation in brushing aside those interpretations

Conversely, however, the very cost of having to recurrently do so, can be expected to effectively incentivize state authorities to seek engagement with relevant federal actors, rather than simply imposing their will

Reason, not power, thus becomes the coin of the realm, in both directions

What, then, to very briefly conclude, can we identify as the utility of such patterns of engagement? – While a number might be suggested, let me highlight two in particular, which might well be conceived as flip sides of a single coin

As the foregoing discussion implicitly suggests, a regime of dialectical regulation under Rule 14a-8 may help to foster useful innovation – State corporate law might be improved by certain changes, but be less likely to undertake such change in isolation – External prompting of the sort I propose, however, might effectively serve as the catalyst of such change

One might imagine certain desirable changes in the rules for shareholder participation, for example, with the rise of institutional investors through the final decades of the 20th century – Such responsive change might well be encouraged and facilitated through state engagement with the SEC

Flipping the coin, if mixed governance's facilitation of innovation offers a story of utility-enhancing improvements, the role of dialectical regulation in overcoming inertia is the negative counterpart – Here, the notion is not one of changes serving to achieve optimality, but of a resistance to change that may be far more widespread in legal regimes that we might like to imagine – Again, however, instability of a sort fostered by forced engagement with regulatory actors external to a given regime may help to break patterns of inertia – Here, changes in the treatment of various forms of anti-takeover protections, as new protections have risen to the fore, might suggest relevant examples

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While this thumbnail sketch necessarily brushes over significant questions of design and application of regimes of mixed governance in corporate law, I hope it begins to suggest the potential for such regimes to play a greater role in corporate governance than they do today