Securities Regulation Daily Wrap Up, PROXIES—Commissioner Gallagher offers blueprint for challenging Harvard's destaggered board proposals, (Dec. 11, 2014)

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By Anne Sherry, J.D.

A provocative paper co-authored by SEC Commissioner Daniel Gallagher describes how companies can seek to exclude shareholder proposals by the Harvard Shareholder Rights Project calling for destaggering (declassifying) boards of directors. The paper argues that the Harvard proposal cherry-picks from the academic research on classified boards and can be excluded as materially false or misleading under Exchange Act Rules 14a-8 and 14a-9.

The paper, whose other author is Joseph A. Grundfest of the Rock Center for Corporate Governance at Stanford Law School, goes on to warn that the SEC could bring enforcement proceedings against Harvard for violations of Rule 14a-9 under the doctrine of *respondeat superior*. The courts also recognize a private right of action under Section 14(a) for a violation of Rule 14a-9. The views expressed in the paper by Commissioner Gallagher are his own and do not necessarily reflect the views of the SEC or of his fellow commissioners.

Harvard proposal. Lucian Bebchuk's Shareholder Rights Project (SRP) has taken aim at classified boards, which force hostile bidders to engage in multiple proxy contests by staggering director reelections so that only one-third of board seats are up for election in any year. Bebchuk maintains that staggered boards "are associated with lower returns to shareholders in the event of an unsolicited offer, are more likely to make acquisitions that decrease shareholder value, tend to provide executives with pay that is less correlated with performance, and exhibit lower association between chief executive replacement and performance." The SRP submitted declassification proposals to 31 large-cap companies for voting in 2014 and expects that these proposals, added to its 2012 and 2013 efforts, will result in about 100 board declassifications by S&P 500 and Fortune 500 companies.

The Gallagher-Grundfest paper challenges the SRP proposal's presentation of the empirical evidence on staggered boards. One-third of the proposal's total word count (which, by SEC rule, is limited to 500 words) describes the empirical literature. According to the Rock Center paper, the body of academic research contradicting the proposal is far more substantial than the one opposing study that SRP cites: "The opposing research concludes that studies relied on by the Harvard Proposal are in error because of flawed analytic techniques. This research also documents heterogeneous effects indicating that classified boards are more likely to be beneficial for identifiable categories of corporations."

Omissions in shareholder proposals. Rule 14a-9 prohibits solicitation via a proxy containing any materially false or misleading statement or omission. Rule 14a-8 permits a company to exclude a shareholder proposal that violates Rule 14a-9. According to Gallagher and Grundfest, "the test for the materiality of an omission in a voting context is whether there is 'a substantial likelihood that a reasonable shareholder would consider the information important in deciding how to vote.'" The authors posit that the significance of the academic research on whether declassification improves a corporation's financial performance is clear, and is underscored by the amount of space the SRP devotes to the research in its proposal.

Prospective strategies. There are two prospective mechanisms available to corporations seeking to exclude the proposal from their proxy statement, according to the paper: they can apply for no-action relief from the SEC's staff or can file a federal lawsuit seeking a declaratory judgment that excluding the proposal will not violate Rule 14a-8. "Simply establishing that the Harvard Proposal omits material information should be sufficient to cause the Commission's staff to grant no-action requests," the paper suggests, although it notes that the staff takes a narrow view regarding no-action requests seeking omission of shareholder proposals on the basis of misrepresentations or omissions. "Similarly, a simple showing that the omitted literature is material should be sufficient to support a grant of declaratory relief."

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Securities law violations. In addition to the prospective relieve, the authors warn that Harvard University itself could be liable in SEC enforcement proceedings and private actions alleging Rule 14a-9 violations. Even if the Supreme Court's decision in *Janus* restricting Rule 10b-5 liability to the "maker" of a fraudulent statement extends to Rule 14a-9, the paper maintains, the SRP clearly holds "ultimate authority" over the proposal and thus qualifies as its maker. Going a step further, principles of *respondeat superior* should impute liability for the SRP's actions to the university itself. Gallagher and Grundfest note that the SRP could publish its analysis of the empirical research in an academic journal without risking legal liability, but by availing itself of SEC rules to influence corporate governance, "the scholars voluntarily subject themselves to standards of legal liability that do not apply in other venues."

Private plaintiffs may also bring their own action for a Rule 14a-9 violation, the paper continues, with the additional hurdle of demonstrating causation. Under the circumstances, establishing causation by showing that the misleading statement "had a significant propensity to affect the voting process" may be made easier by the SRP's own description of the role that the clinic and its declassification proposal have played in causing the destaggering of boards at approximately 100 large corporations.

Finally, the authors cite cases in which courts have invalidated shareholder votes and undone charter amendments resulting from materially misleading proxies. Managements that have already destaggered in response to the proposal could petition a court for an order invalidating the votes in favor of, and actually implementing, the destaggering.

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