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One Man's Junk Mail Is Another Man's Treasure: Proxy Contests and Corporate Governance

Erica Laudano

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I. Introduction

Proxy contests traditionally have been viewed as the least efficient means of corporate governance. During the 1960s, such contests were opined to be "the most expensive, the most uncertain, and the least used of the various techniques" available to discipline management and transfer corporate control.[1] This attitude persisted through the 1980s when the cash tender offer dominated the wave of hostile takeovers and acquisitions of publicly held companies. In fact, during the period from 1981 to 1984, there were over 250 tender offers for publicly held U.S. corporations as compared to only some 100 proxy contests.[2] In effect, the ready availability of cash coupled with the relatively short timetables afforded by the Williams Act rendered the tender offer a quicker, more certain alternative to the proxy contest.[3]

In the 1990s, these negative attitudes towards proxy contests changed. With the widespread adoption of poison pills, the proliferation of state anti-takeover laws, and the relative unavailability of financing for financially motivated hostile takeovers, proxy contests became an important tool by which potential acquirers could facilitate hostile takeovers. Moreover, proxy contests became noteworthy for their less drastic uses. For instance, proxy initiatives were used

[1] Henry Mann, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).
[2] John Pound, *Proxy Contests and the Efficiency of Shareholder Oversight*, 20 J. FIN. ECON. 237 (1988).
[3] Michael W. Goroff & Guy W. Winters, *Recent Developments in Proxy Contests*, 711 PLI 347, 349 (1995).

to reverse corporate policies, change payout levels, replace directors and managers, and propose alternative long-range strategies for the firm.[4]

This paper examines the source of this changed outlook by focusing on the efficacy of proxy contests as a tool for maximizing firm efficiency. The cumulative research on proxy contests supports the contention that such contests are an effective tool for disciplining inefficient managers and implementing corporate change. Proxy campaigns generally are waged by skilled individuals who seek to persuade shareholders that they possess the skills necessary to run the firm efficiently. Throughout the contest, these individuals highlight their strengths as well as current management's inequities. As a result of these claims, the firm often experiences significant changes in both its management and its policy. Furthermore, proxy contests increase shareholder wealth regardless of their outcome.

The next section outlines the mechanics of proxy voting and proxy contests. Section III reviews the federal proxy rules and their objectives. Section IV examines the qualifications of individuals who instigate proxy contests, while Section V analyzes the publicized rationale behind such contests. Further, Section VI considers the effects of proxy contests on current management and Section VII examines their effects on the target firm itself. Section VIII analyzes the research on the wealth maximizing effects of proxy contests. Finally, Section IX presents a discussion of proxy reform along with my conclusions.

II. The Proxy Voting System

Owning a share of stock conveys three basic rights: the right to receive a return on the investment, the right to receive a proportionate interest in net assets on liquidation, and the right

[4] Ronald J. Gilson, Lilli A. Gordon & John Pound, *How the Proxy Rules Discourage Constructive Engagement: Regulatory Barriers to Electing a Minority of Directors*, 17 J. CORP. L. 29, 31 (1991).

to vote.[5] Although state law once required shareholders to attend the annual shareholders' meeting in order to exercise their voting rights, the development of large, widely held corporations rendered this requirement problematic. Consequently, firms implemented the proxy system by which management mails each shareholder a proxy form together with a proxy statement and an annual report. While the proxy form authorizes the proxy-holder to represent the shareholder and vote in a certain manner, the shareholder commonly grants the proxy-holder authority to vote according to his own preference.

A proxy contest typically begins several months prior to the firm's annual shareholder meeting. During the contest, shareholders are asked to select between two opposing sets of nominees for board seats. The outside group, the dissidents, initiates a campaign in opposition to incumbent management and solicits votes from shareholders for its alternate slate of director nominees. Both dissidents and incumbents forward proxy solicitation materials to shareholders, who sign and return the proxy form of the preferred group, thus authorizing the agents nominated in the form to vote the shares. The agents for each group accumulate votes via the returned proxies and cast these votes at the shareholders' meeting. The group obtaining a majority of the votes will generally elect a majority of the directors. Nonetheless, the specific allocation of director positions between incumbents and dissidents depends upon the method of voting. The two methods used in the United States are straight voting and cumulative voting.[6]

Straight voting typically serves as a hindrance to the election of dissident directors. In straight voting system, each director position is treated as a separate election. Proxy-holders are entitled to cast votes, equal to the number of shares for which proxies are held, for each director

[5] Jayne Elizabeth Zanglein, *Pensions, Proxies, and Power: Recent Developments in the Use of Proxy Voting to Influence Corporate Governance*, 7 LAB. LAW. 771, 791 (1991).
[6] The actual method used by the firm is determined by the corporate law for the state in which it is incorporated in conjunction with its own by-laws or articles of incorporation.

position. However, no share may be voted more than once for any given candidate. Consequently, the successful nominee for each position is the one attracting the majority of votes.

Cumulative voting, in contrast, enhances the ability of dissident interests to elect a minority of directors.[7] In a cumulative voting system, a proxy-holder is allowed to cumulate or aggregate his votes in favor of fewer candidates than there are slots available, including the extreme case where all votes are cast in favor of one candidate. Then, the nominees from both the incumbents and the dissidents are ranked in descending order according to the number of votes received, and the required number of directors is elected from this ranking.

III. Federal Regulation of the Proxy System

Given the import of shareholder voting as well as the potential for abuse of the proxy system,[8] the federal government developed an extensive system of rules and regulations governing the solicitation of proxies. The Securities and Exchange Commission (SEC) bases its power to promulgate regulations governing the solicitation of proxies on the Securities Exchange Act of 1934.[9] Specifically, § 14(a) of the Act authorizes the SEC to make rules governing the solicitation of proxies "as necessary or appropriate in the public interest or for the protection of investors" and provides that the solicitation of proxies in contravention of these rules is

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[7] *See* FRANK H. EASTERBROOK & DANIEL R. FISCEHL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 86 (1991) (stating that despite this advantage, cumulative voting is rare in publicly traded firms and most state statutes contain a presumption against it because it creates a holdup power that makes negotiation difficult)

[8] Congress addressed the potential for abuse of the proxy system as far back as 1939. *See* H.R. Rep. No. 1383. 73d Cong., 2d Sess. 13-14 (1934) ("Managements of properties owned by the investing public should not be permitted to perpetuate themselves by the misuse of corporate proxies. Insiders having little or no substantial interest in the properties they manage have often retained their control without an adequate disclosure of their interest and without an adequate explanation of the management policies they intend to pursue. Insiders have at times solicited proxies without fairly informing the stockholders of the purposes for which the proxies are to be used and have used such proxies to take from the stockholders for their own selfish advantage valuable property rights.").

[9] 15 U.S.C.A. § 78a-78kk (2003).

unlawful.[10] Exercising this rule-making power, the SEC has established a proxy voting system composed of three main components: disclosure requirements, shareholder communication rules, and an antifraud provision.

The SEC's proxy rules contain general disclosure provisions designed to keep shareholders informed. In particular, Rule 14a-3 requires anyone soliciting a proxy to furnish the shareholder with a written proxy statement prior to or concurrent with the solicitation.[11] Furthermore, Rule 14a-6 requires that a proxy statement be pre-filed with the SEC even before it is used to solicit proxies.[12]

The federal proxy rules also contain disclosure regulations intended to protect the shareholder's ability to oppose management's board nominees. Rule 14a-7 provides any shareholder who wishes to solicit in opposition to management with the right either to obtain a list of shareholders from management or to have management mail the dissident's proxy materials to the shareholders.[13] In both cases, the shareholder must pay the cost of the mailing and reasonably prompt methods of distribution must be used.[14]

Furthermore, the proxy rules contain a provision allowing shareholders to communicate with each other by placing proposals in the proxy materials. Designed to ensure shareholder

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[10] 15 U.S.C.A. § 78n(a) (2003). As the statutory language indicates, the SEC is only authorized to regulate proxy solicitation with respect to securities registered pursuant to § 12. 15 U.S.C.A. 78l (2003). Under §12, all companies whose securities are listed on a national exchange or that have assets in excess of $1 million and more than 500 security holders of record, are subject to the requirements of §14. 15 U.S.C.A. § 78l(a) & (g) (2003).

[11] 17 C.F.R. § 240.14a-3 (2003). The proxy statement must include a description of the person or entity making the solicitation, a list of the parties interested in the solicitation, a description of the subject of solicitation, and an explanation of the rules and procedures governing the proxy process. Schedule 14A, 17 C.F.R. §240.14a-101 (2003).

[12] Specifically, Rule 14a-6 provides for a ten day waiting period after the proxy statement is filed before the statement may be distributed to shareholders. 17 C.F.R. § 240.14a-6 (2003). However, all oral solicitations by persons who do not seek proxy authority and who do not have an interest in the subject of the solicitation are exempt from both the filing and the pre-filing requirements. In addition, written solicitations under similar circumstances are exempt from filing, except that beneficial owners of more than five million dollars of the issuer's securities must submit copies of written solicitations contemporaneously to the SEC. 17 C.F.R. § 240.14a-2(b)(1) (2003).

[13] 17 C.F.R. § 240.14a-7 (2003).

[14] *Id.*

access to the ballot, Rule 14a-8 gives the shareholder who meets certain threshold requirements the right to require management to include his or her proposal in management's proxy materials.[15] In addition, the proposal itself must meet several requirements, including a five-hundred word limit.[16] Nevertheless, after receiving an eligible proposal from a qualified shareholder, management may still exclude it from the proxy materials it will send to shareholders.[17]

Lastly, Rule 14a-9 is a general antifraud provision devised to promote the integrity of proxy disclosure. Specifically, Rule 14a-9 bars the use of false or misleading statements in connection with the solicitation of a proxy.[18] This provision applies to all communications, oral and written, as well as to affirmative misstatements and omissions.[19] The federal courts have implied a private right of action under Rule 14a-9, and thus, most litigation under the federal proxy rules is based on this provision.

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[15] Rule 14a-8 is commonly referred to as the "shareholder proposal rule." It states that to be eligible to submit a proposal, a shareholder either must have continuously held at least $2,000 in market value or 1% of the company's securities for at least one year, or be a registered holder. In both circumstances, the shareholder must continue to hold those securities through the date of the annual meeting. 17 C.F.R. § 240.14a-8 (2003).

[16] *Id.*

[17] According to Rule 14a-8, management may properly exclude a shareholder proposal if: (1) the proposal is improper under state law; (2) the proposal, if implemented, would cause the company to violate any state, federal, or foreign law to which it is subject; (3) the proposal or supporting statement is contrary to any of the SEC's proxy rules; (4) the proposal relates to the redress of a personal claim or grievance against the company or any other person, or if it is designed to result in a benefit to you, or to further a personal interest, which is not shared by the other shareholders at large; (5) the proposal relates to operations which account for less than 5% of the company's total assets at the end of its most recent fiscal year, and for less than 5% of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the company's business; (6) the company would lack the power or authority to implement the proposal; (7) the proposal deals with a matter relating to the company's ordinary business operations; (8) the proposal relates to an election for membership on the company's board of directors; (9) the proposal directly conflicts with one of the company's own proposals to be submitted to shareholders at the same meeting; (10) the proposal has already been substantially implemented by the company; (11) the proposal substantially duplicates another proposal previously submitted to the company by another proponent that will be included in the company's proxy materials for the same meeting; (12) the proposal deals with substantially the same subject matter as another proposal that has been previously included in the company's proxy materials within the preceding five calendar years, unless the earlier proposal received a sufficiently large vote; or (13) the proposal relates to specific amounts of cash or stock dividends. 17 C.F.R. § 240.14a-8 (2003).

[18] This provision is limited to material misstatements or omissions. 17 C.F.R. § 240.14a-9 (2003). *See* TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976) (explaining that an omitted fact is "material" if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote).

[19] 17 C.F.R. § 240.14a-9a (2003).

IV. Dissident Qualifications

Proxy contests differ from other methods of corporate takeover in that voting shareholders must be convinced of dissidents' ability to identify and implement profitable policies. Therefore, it is beneficial for dissidents to emphasize traits that make them appear superior to incumbent management. In particular, shareholders consider a dissident's target company expertise, target industry expertise, manufacturing expertise, real estate expertise, and alleged corporate raider status as key determinants of managerial ability.

Shareholders view the target company expertise of dissidents as an indicator of dissidents' ability to maximize the efficiency of the firm. In fact, proxy contests are frequently waged by insiders. In a sample of ninety-six proxy contests for seats on the boards of exchange-listed firms ranging from 1962 to 1978, forty-one contests were waged by dissidents who were former board members, former high-ranking officials of the firm,[20] or both.[21] Furthermore, in a survey of sixty proxy contests for board seats of exchange-listed firms from 1978 to 1985, nineteen contests were waged by former employees of the target firm or members of its board.[22] Typically, these individuals leave the firm after a policy dispute with incumbent directors, and actually initiate the proxy contest.[23] Shareholders view inside information about a target firm's operations and policies as highly valuable and persuasive in evaluating whether a firm is

[20] A high ranking official is one having the title of president, vice president, executive vice president, senior vice president, or president of a subsidiary.
[21] Peter Dodd & Jerold B. Warner, *On Corporate Governance: A Study of Proxy Contests*, 11 J. FIN. ECON. 401, 410 (1983) (using published reports in the *Wall Street Journal* to evaluate characteristics of the dissidents). Dodd and Warner further provided proof for the linkage between target company expertise and successful dissidents. Specifically, they found that in 29 of the 37 control contests involving insiders, dissidents won seats on the board, whereas non-insider dissidents only won seats in 7 of 23 control contests.
[22] Harry DeAngelo & Linda DeAngelo, *Proxy Contests and the Governance of Publicly Held Corporations*, 23 J. FIN. ECON. 29, 36 (1989) (using information provided in the proxy statement itself as well as *Wall Street Journal* articles).
[23] *Id.*

maximizing its profits. Thus, shareholders view firm insiders as both knowledgeable of firm inefficiencies and capable of correcting them.

Shareholders consider the target industry expertise of dissidents as another gauge of their ability to identify poorly managed firms and thereby increase the value of the target firm. In evaluating dissidents' target industry expertise, shareholders evaluate the credentials of both the dissident leader as well as other members of the dissident party. In twenty-nine of the sixty sample contests, twenty-nine dissident leaders had prior experience in the target's line of business.[24] Further, other members of the dissident party had industry experience in twenty-three of the sample cases.[25]

Shareholders also regard managerial expertise as valuable to improving firm efficiency. In six of the sample contests, the dissident leader had general experience in manufacturing.[26] Moreover, in an additional six contests, the dissident leader had experience in real estate.[27] Thus, shareholders view such expertise as helpful in managing the target's resources as well as in implementing value-increasing changes in corporate policy.

Furthermore, shareholders consider a dissident's reputation as a corporate raider[28] to be a favorable trait. In eleven of the sample contests, dissident leaders had general capital market reputations as corporate raiders.[29] This inclination towards "corporate raiders" suggests that proxy contests are influenced by more than pure managerial or technological expertise: proxy fight participation is determined at least in part by dissidents' ability to force a sale of the firm or other material policy shifts.

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[24] *Id.*
[25] *Id.*
[26] *Id.*
[27] *Id.*
[28] Parties classified as such for the purposes of the study included the Belzberg brothers, Coniston partners, Asher Edelman, Clyde Engle, Sir James Goldsmith, Carl Icahn, Leucadia National Corporation, and Harold Simmons. *Id.* at 37.
[29] *Id.* at 36.

Dissidents who possess and publicize the previously mentioned expertise and traits will be more likely to convince the target firm's voting shareholders that they can run the firm more efficiently. However, dissidents may not actually be able to increase firm profitability. Despite their expertise, dissidents still may not be superior to incumbent management. Moreover, shareholders may overvalue skills that are not necessarily indicative of good managers while at the same time undervaluing skills that are present in superior managers. Nevertheless, it is significant that shareholders are not voting to replace incumbent management with dissidents who possess no skills whatsoever. At the very least, shareholders are conducting an evaluation of potential directors and selecting those with skills that appear relevant to the successful management of a firm. Therefore, even if shareholders elect an inferior board, the firm is still being managed by a board with some technical and/or managerial expertise.

V. Publicized Rationale Behind Proxy Contest

To obtain the necessary support, dissidents also must persuade other shareholders that a change in the board of directors is likely to increase the value of the firm and thus the value of their shares. Consequently, dissidents typically publicize facts that raise doubts about incumbents' performance and suggest a change in board composition to remedy the situation.

While the specific combination of criticisms varies across campaigns, dissidents most frequently argue that incumbents have done a poor job of managing the firm's current operations. In a study of sixty proxy contests for seats on the boards of exchange-listed firms from 1978 to 1985, 68.3% of the dissidents claimed that incumbents' operating performance was substandard.[30] To support this claim, dissidents cited a variety of performance indicators,

[30] DeAngelo & DeAngelo, *supra* note 22, at 33-34 (compiling information from all dissident proxy statements available from Disclosure as well as the *Wall Street Journal* reports about sample contests).

including low or declining earnings, a recent string of accounting losses, a low return on equity, a low-market-to-book ratio, and/or a decline in the firm's stock price.[31]

Dissidents also commonly assert that the overall investment policy set by the incumbents is unsatisfactory. In 46.7% of the sample contests, dissidents argued that incumbent management should consider a sale or liquidation of the firm because either of these transactions would create greater value for shareholders than continued operation under the direction of incumbent management.[32] In an additional 26.7% of the contests, less radical dissidents maintained that managers should consider changes in the firm's asset structure, including a partial divestiture of corporate assets, initiation of an acquisition program, or adjustments to certain divisional operations or product lines.[33]

Furthermore, dissidents regularly argue that the firm's inappropriate financial policies and ownership structure are both the cause and the result of incumbents' poor operating performance. In 28.3% of the sample contests, dissidents criticized the firm's dividend policy.[34] In particular, dissidents pointed to dividend omissions or cuts as evidence that the incumbents were not generating adequate returns for shareholders and/or that the firm's financial situation was more precarious than current management would admit.[35] Moreover, in 28.3% of the contests, dissidents claimed that managers owned too little stock in the target firm and thus lacked proper incentives to maximize the value of the firm.[36] Further, in 8.3% of the contests, dissidents claimed that incumbents had over-leveraged the firm, hence reducing its earnings and/or limiting the cash dividends available for stockholders.[37]

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[31] *See id.* at 34.
[32] *Id.*
[33] *Id.*
[34] *Id.* at 34-35.
[35] *See id.* at 35.
[36] *Id.* at 34-35.
[37] *Id.*

Finally, dissidents frequently question incumbents' integrity and general competence by citing publicly visible managerial decisions that suggest self-dealing or conflicts of interest. In 50% of the sample contests, dissidents challenged incumbent-initiated takeover defenses that allegedly decreased the likelihood that shareholders would receive a premium for their shares.[38] Contrasting incumbents' "generous" compensation with the "inadequate" earnings or dividends paid to shareholders, dissidents claimed that the incumbents awarded themselves excessively in 35% of the contests.[39] Moreover, in 23.3% of the contests, dissidents argued that incumbents were simply incompetent or unreliable since they had not delivered on past promises and/or their forecasts were repeatedly proven to be biased.[40]

In sum, dissidents seek to publicly create a sweeping image of managerial inefficiency in order to gain support for their campaigns. Shareholders are given a number of bases upon which to find incumbent management inefficient to bolster support for dissidents' campaigns. Thus, incumbent management is forced to account for their actions in order to be re-elected.

It is not clear, however, whether dissident criticisms are properly founded or simply contrived in order to portray incumbents in a negative light. In some cases, management may be behaving inefficiently simply by addressing unfounded dissident criticisms. Moreover, given the difficulties in identifying superior managerial talent, dissident criticisms are not necessarily indicative of actual managerial inefficiency. Nevertheless, there is value to this function of proxy contests in that incumbent management should be readily capable of explaining their decisions to others, especially shareholders. Furthermore, in cases where these criticisms are substantiated, they can lend support to the argument that incumbent management actually was inefficient.

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[38] *Id.*
[39] *Id.*
[40] *Id.*

VI. Impact of Proxy Contests on Management

One factor that lends support to the validity of dissident criticisms, and thus the efficiency of proxy contests, is the managerial impact of dissidents' proxy challenges. Despite the fact that dissidents who wage proxy contests rarely win majority control of the board,[41] more than half the firms in which dissidents do not obtain board control experience resignations in top management either during or shortly after the contest.[42] In a study of thirty-nine proxy contests for seats on the boards of exchange-listed firms where dissidents did not obtain board control during 1978-1985, twenty firms experienced resignations by individuals holding top management positions either during the proxy contest itself or within three years of the contest outcome.[43] In these twenty firms, a total of twenty-three individuals resigned thirty-eight managerial positions, including seventeen CEO positions, eleven board chairmanships, and ten presidencies.[44]

These resignations cannot be explained by mere retirement. Despite a "normal" retirement age of 65, the median age of those who resigned was 59.[45] In fact, the only two individuals who resigned close to the "normal" retirement age had been subjected to scathing attacks by dissidents.[46] Consequently, it appears that a more plausible explanation for these untimely resignations is the challenge brought by the dissidents.

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[41] *See* Dodd & Warner, *supra* note 21, at 409 (dissidents successfully obtain a board majority only ~~20~~ 25.4% of the time). *See also* DeAngelo & DeAngelo, *supra* note 22, at 30 (dissidents win a board majority approximately 33% of the time).

[42] Top management includes chief executive officers (CEOs), chairmen, and/or presidents.

[43] DeAngelo & DeAngelo, *supra* note 22, at 46 (analyzing the *Wall Street Journal* for evidence of changes in CEO, chairman and/or president around the time of the proxy contest).

[44] *Id.*

[45] "The age distribution at resignation is as follows: less than 50 years old, three individuals; between 50 and 59, nine individuals; between 60 and 63, six individuals; 65 or 66, two individuals; 69 or older, three individuals." *Id.* at 46 n.16.

[46] *See Id.* at 54 (The case of Condec Corporation: There, the dissident leader, William Farley, alleged that Condec management, led by Norman I. Schafler (age 65), was 'weak', 'confused', and had compiled a 'miserable track record' by running the company 'carelessly and without strategy'. Furthermore, he said that Condec was not a

Incumbent management resignations are also inconsistent with simple managerial turnover. Grouped in time around the election campaign, "fifteen of the twenty resignations occurred either during the contest itself or within one year of the outcome."[47] Moreover, this 38% resignation rate is much greater than rates typically found in empirical studies of top management changes.[48] Rather, the resignation frequency for the sample appeared more in line with the management change rates previously documented for other significant corporate events. For instance, the rate was comparable to the 33% management change rate for firms experiencing financial distress, the 27% change rate for firms whose managers pay greenmail to deflect a possible takeover, and the 25% change rate for firms that are acquired by another public corporation.[49] Therefore, the timing and frequency of incumbent management resignations appear to be related to the dissidents' efforts to influence managerial change.

Although public sources rarely disclose the "true" reasons for a management change,[50] information from financial press reports about the firm-specific circumstances surrounding each resignation links these resignations to dissidents' proxy challenges. In particular, financial press reports provide evidence of the identity of the replacement as well as the circumstances and conflicts surrounding the resignation. In light of this evidence, the managerial resignations at

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Schafler family heirloom to be handed down from father to son' [Mr. Schafler's 33-year-old son was vice president-operations]. Within one year, Mr. Schafler resigned and "would have no further connection with the company.").

[47] *Id*. at 47.

[48] Jerold B. Warner, Ross L. Watts & Karen H. Wruck, *Stock Prices and Top Management Changes*, 20 J. FIN. ECON. 461 (1988) (documenting an average annualized rate of 11.5% for arrivals or departures by top management, including retirements from the CEO, chairman, or president positions, reported in the *Wall Street Journal*); Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 431(1988) (documenting an average rate for CEO departures, excluding retirements, of 4.8% for NYSE-listed firms); and Anne T. Coughlan & Ronald M. Schmidt, *Executive Compensation, Management Turnover, and Firm Performance: An Empirical Investigation*, 7 J. ACCT. & ECON. 43 (1985) (documenting an average CEO departure rate of 8.0% for CEOs younger than 63 and of 12.7% for all firms listed in the *Forbes* compensation survey).

[49] DeAngelo & DeAngelo, *supra* note 22, at 48 (citing respectively, Stuart C. Gilson, *Management-Borne Costs of Financial Distress* (1988) (unpublished manuscript on file with the University of Rochester); April Klein & James Rosenfeld, *Targeted Share Repurchases and Top Management Changes*, 20 J. FIN. ECON. 493 (1988); and James P. Walsh, *Top Management Turnover Following Mergers and Acquisitions*, 9 STRAT. MGMT. J. 173 (1988)).

[50] Warner, Watts & Wruck, *supra* note 48, at 461.

75% of the sample firms were reasonably tied to the dissidents' efforts to unseat incumbent management.[51]

The identity of the replacement together with the circumstances surrounding the resignation provides strong evidence of the importance of the dissidents' challenge. In six of the fifteen sample firms, the resigning manager was replaced by a dissident or blockholder to whom the incumbents had sold shares in a "friendly hands" placement in order to diminish dissidents' voting power.[52] Further, the case studies of these firms provided convincing evidence of conflicts between the particular manager who resigned and the dissident or new blockholder whose alliance with the incumbent management ended shortly after the contest.[53]

The visibility of these often heated clashes between dissidents and incumbent management provides further corroborative evidence of dissidents' influence. In an additional five cases, the managerial resignation occurred during hostilities between the incumbents and dissidents, with three resignations taking place after the contest had apparently ended, but amid visible signs of renewed conflict with dissidents who had obtained board representation.[54] In fact, in four of the five cases, financial press reports indicated that the particular individual who resigned had experienced direct personal conflicts with the dissidents.[55] Moreover, in another

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[51] DeAngelo & DeAngelo, *supra* note 22, at 49.
[52] *Id.*
[53] *See, e.g.*, the case of Pantry Pride. There incumbent management issued shares and transferred effective control of the company to MacAndrews & Forbes in order to get a concentration of shares in the hands of a single party and thus prevent future proxy bids. When the issuance was announced, Pantry Pride claimed that Grant C. Gentry, the company's chairman and CEO, would continue to run the company. However, Mr. Gentry resigned three months later and was succeeded by Ronald O. Perelman, the CEO of MacAndrews & Forbes.
[54] DeAngelo & DeAngelo, *supra* note 22, at 49.
[55] *See, e.g.*, the case of Canal Randolph Corporation. Following a compromise agreement, the dissident leader, Asher Edelman, characterized the chairman of the executive committee, Sir Walter Salomon, as a '76-year-old chairman' who ran the company far too conservatively and as a 'foreign resident who spends little time in the U.S.' Sir Walter resigned unexpectedly from the position of chairman and from the executive committee. Sir Walter's stated reason for his resignation was: "It's time to entrust the future of the company to the younger generation."

case, a manager resigned within six months of the dissidents' failure to obtain any seats, following a campaign emphasizing his alleged incompetence.[56]

In less than one-fifth of the entire sample, the same incumbent management team remained in control of the still publicly held target firm three years after the contest outcome.[57] Thus, even where dissident shareholders fail to obtain a board majority, their efforts frequently play a significant role in effecting a change in corporate top management. While there is insufficient evidence to infer that the dissidents' efforts were the single critical factor in management resignations, circumstances surrounding most of these resignations suggest that the dissidents' efforts were important in effecting the management changes.[58]

However, these resignations once again raise a question as to whether inferior managers are removed. Because resources are expended in proxy solicitations when there are no material information costs for outsiders to identify the superior management team, some dissident challenges may actually focus on, and ultimately remove, incumbent managers who are in fact better at operating the firm. In contrast, material information costs may enable relatively inefficient incumbents to survive a dissident challenge.[59] Consequently, some firms may become less efficient because of these resignations. Nevertheless, these resignations may allow the firm's board to be more efficient overall. While individual directors may be less efficient than those they have replaced, the dissident-represented board in its entirety may function more

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[56] *See, e.g.*, the case of Pullman, Inc. There, the dissidents alleged that Samuel B. Casey, the firm's CEO and president, had mismanaged the company and sought to have him fired. According to *Wall Street Journal* reports, the dissidents 'are betting that even if they can't unseat Mr. Casey by a proxy contest, the questions they are raising will stir up enough adverse publicity to force him out of office.' Despite dissidents' failure to obtain board representation, Mr. Casey resigned six months later amid both dissident and shareholder questions 'about his perquisites and the company.'

[57] DeAngelo & DeAngelo, *supra* note 22, at 49. The incumbent team is treated as having survived intact as of a given date if (1) the dissidents fail to obtain board control through the proxy contest, (2) there are no top management resignations, and (3) the firm is not sold or liquidated.

[58] *Id.*

[59] *Id.*

efficiently than the previous incumbent board. For example, the individuals who resigned may have been overbearing and stifled views contrary to their own. The removal of these individuals will allow remaining members to speak freely and suggest policies that may maximize firm value. Therefore, the firm may still increase its efficiency despite the apparent loss of these "superior" managers.

VII. Impact of Proxy Contests on the Firm

Another factor that supports dissidents' claims of inefficient management is the impact of their challenges on target firms. Many firms experience major corporate policy shifts that can be linked directly to dissident activity. Specifically, empirical evidence supports a relation between dissident challenges and the decision to sell the target firm. In a study of sixty proxy contests for seats on the boards of exchange-listed firms during 1978-1985, seventeen firms were sold or liquidated either during the proxy campaign or shortly thereafter.[60] In fourteen of these seventeen cases, the sale or liquidation was announced within one year of the contest outcome.[61]

The sale or liquidation of target firms is directly connected to dissidents' proxy challenges. In six of the fifteen firms in which sale or liquidation was announced within two years of the contest, the dissidents themselves acquired the firms.[62] Moreover, the dissidents' campaign placed major emphasis on selling the firm in five cases, while acquisition by a third party effectively ended the contest in three cases.[63] Finally, in one case the firm was acquired by a party with which managers had privately placed shares to defeat the dissidents.[64]

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[60] Id. at 43 (finding that 15 firms were sold and 2 firms were liquidated.)
[61] *Id.*
[62] *Id.* (finding that all 15 of the proposed transactions were eventually completed).
[63] *Id.*
[64] DeAngelo & DeAngelo, *supra* note 22, at 44 (finding that the median overall shareholder return in the 15 firms where sale of the target firm was linked to dissident activity was 21.96% as compared to the 45 firms where there was no evidence that any sale of target firm was linked to dissident activity was 5.18%).

Nonetheless, dissidents' need not control the target firm in order to effect change. In seven of the fifteen firms whose sale or liquidation was directly connected to dissidents' proxy challenges, dissidents merely gained a minority position on the target's board.[65] Thus, minority representation can help dissident shareholders force the sale or liquidation of the target firm when incumbents are reluctant to take the necessary steps.

Proxy challenges influence the policies of target firms. Regardless of whether dissidents achieve control of the target firm, proxy contests can cause target firms to re-evaluate their policies and perhaps prompt a sale or liquidation. Although other factors also may have contributed to these policy changes, empirical evidence confirms the significant role proxy contests play in effecting change. Despite confirming dissidents' claims, there is still a question as to whether these sales and liquidations actually increase the efficiency of the firm. Nevertheless, the fifteen aforementioned firms experienced an average wealth gain of 15.16% over the full period of dissident activity, while the forty-five firms with no evidence that any sale of the target firm was linked to dissident activity experienced an average wealth gain of only 2.90%.[66] Given these returns, it appears that dissidents are identifying inefficiencies and are, in fact, increasing shareholder wealth.

VIII. Wealth Effects of Dissident Activity

The effect of proxy contests on share value also defends the proxy contest as an efficient tool of corporate governance. Despite recent opinions to the contrary, the traditional objective of firm management is to maximize shareholder wealth.[67] Irrespective of contest outcome, dissident activity typically generates gains for target shareholders. This finding has been

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[65] *Id.*
[66] *Id.*
[67] *See* Jill E. Fisch, *From Legitimacy to Logic: Reconstructing Proxy Regulation*, 46 VAND. L. REV. 1129, 1150 (1993) (stating that some shareholders feel that social responsibility is a legitimate corporate concern, and corporations should act responsibly rather than merely emphasizing accumulation of profits).

supported by several empirical studies, including the following studies conducted by Peter Dodd and Jerold B. Warner as well as Harry DeAngelo and Linda DeAngelo.[68]

A. Dodd and Warner

In an analysis of ninety-six proxy contests for board seats on exchange-listed firms with elections held between July 1, 1962 and January 31, 1978, Peter Dodd and Jerold B. Warner found that positive and statistically significant performance is associated with proxy contests.[69] Specifically, Dodd and Warner documented a positive abnormal performance around the time of the proxy contest.[70] In the forty day period prior to and including the day of initial public contest announcement, the estimated magnitude of the average abnormal performance was 0.105.[71] Furthermore, for many of the sample firms, virtually all of the positive abnormal performance occurred in the ten to twenty day period prior to the time of contest announcement.[72] After finding that the excess returns could not be attributed to alternative sources, Dodd and Warner concluded that these findings were "consistent with the standard economic analysis of proxy contests, in which the challenges benefit shareholders by transferring resources to higher valued uses."[73]

Furthermore, Dodd and Warner found that the presence of positive stock price performance around the time of proxy contests is independent of outcome. Stock price activity

[68] Regardless of the wealth increases caused by proxy contests, dissidents may still launch contests based on hubris. Given the high incidence of former insiders in dissident parties, it is plausible that these individuals would want to see the policies they favored implemented simply to thwart incumbent management.
[69] Dodd and Warner based their data on logbooks of proxy contests maintained independently by the staff of the New York Stock Exchange ("NYSE") and by Georgeson and Company, a proxy solicitation firm with additional information being taken from *Wall Street Journal* articles. The sample itself consisted of 57 contests for firms listed on the NYSE and 39 contests of firms listed on the American Stock Exchange ("AMEX").
[70] Dodd & Warner, *supra* note 21, at 416.
[71] *Id*. at 420. (Asserting that this positive abnormal performance is a sample wide phenomenon; 77% of the 60-day cumulative residuals were positive).
[72] *Id*. at 423, 434 (explaining that the period before the announcement is relevant because there is reason to believe that dissident activity had been underway for some time, and that any contest related excess returns could precede the actual announcement).
[73] *Id*. at 416, 424 (concluding that merger activity and unexpectedly good earnings could not explain the results).

for contests where dissidents failed to win any seats, where dissidents won some seats, and where dissidents won a majority of seats, all experienced the same positive abnormal returns. [74] Therefore, Dodd and Warner concluded that increases in share value do not require dissidents to gain a majority or even a positive number of board seats.[75]

Notwithstanding the uniformity of behavior for the various outcome categories, Dodd and Warner found that the outcome of the contest is relevant to the share price of a firm. They noted that small share price adjustments took place at the time the election outcome announcement actually appeared in the *Wall Street Journal*, and in a manner somewhat related to contest outcome. In particular, they noted that in contests where the dissidents won seats, there was a positive abnormal performance. In contrast, contests where dissidents failed to win seats showed a negative abnormal return.[76] Thus, Dodd and Warner concluded that a slight positive price adjustment is associated with the actual winning of a contest, while a negative adjustment is associated with the failure to win seats or control.[77]

B. DeAngelo and DeAngelo

Analyzing sixty proxy contests for seats on the boards of exchange-listed firms during 1978-1985, Harry DeAngelo and Linda DeAngelo further substantiated Dodd and Warner's findings.[78] Specifically, DeAngelo and DeAngelo found that dissident activity typically generates gains for target shareholders. In fact, shareholders in their sample incurred an average abnormal wealth increase of 4.85% for the two day period including the day before and the day

[74] For contests where dissidents won seats, the mean cumulative residual from the 59th day prior to the contest announcement through the day of the election outcome announcement was 0.081. For contests where dissidents won no seats, the mean cumulative residual was 0.082; while for contests where dissidents won a majority it was 0.128.
[75] Dodd & Warner, *supra* note 21, at 416.
[76] *Id.* at 418 (stating that for contests where dissidents won seats the mean cumulative residual for the two-day period prior to and including the day of the outcome announcement in *Wall Street Journal* was 0.011 as compared to –0.014 where they failed to win any seats).
[77] *Id.*
[78] DeAngelo and DeAngelo's sample included 40 NYSE-listed firms and 20 AMEX firms.

of the first *Wall Street Journal* report of dissident activity and of 18.76% for the forty trading days prior to and including the first report.[79] Furthermore, they found that over the full period from forty days prior to initiation through contest outcome, the average abnormal shareholder wealth increase was 6.02%.[80]

DeAngelo and DeAngelo also found that shareholder wealth increases materially and by roughly the same amount at the initiation of dissident activity regardless of the immediate outcome of the proxy contest.[81] DeAngelo and DeAngelo, like Dodd and Warner, suggested that these findings were explained by the theory that "an external challenge to managerial policies increases the likelihood that corporate resources will be re-allocated to higher-valued uses."[82]

Like Dodd and Warner, DeAngelo and DeAngelo found that shareholders experience negative price adjustments in contests where incumbents successfully deflect dissidents. In their sample, shareholders experienced average wealth losses of 5.45% in the two days surrounding contest outcome for the twenty-three contests in which incumbents defeated the dissidents' challenge.[83] Further examining the rationale behind this finding, DeAngelo and DeAngelo concluded that shareholders were not harming themselves by choosing to retain incumbent management because they played no direct role in the resolution of most contests. In fact, a shareholder vote determined the outcome in only seven of the twenty-three contests where

[79] DeAngelo & DeAngelo, *supra* note 22, at 40.
[80] *Id.*
[81] DeAngelo & DeAngelo, *supra* note 22, at 42 (stating that firms in which dissidents obtained control experienced a mean return from 40 days prior to the initiation of dissident activity of 17.68% as compared to 16.47% in firms where dissidents won some seats and 21.35% for firms where dissidents failed to win any seats).
[82] *Id.*
[83] *Id.*

incumbents prevailed.[84] Furthermore, in these seven cases, the adverse price effect was insignificant.[85]

In cases where incumbents prevail, DeAngelo and DeAngelo found that incumbent managers' defensive actions play an integral role in explaining the significant shareholder losses. In sixteen of the twenty-three contests where incumbents prevailed, incumbent managers' defensive actions ended the contest.[86] These contests included eleven cases settled by negotiations in which incumbents used corporate resources to induce the dissidents to abandon their takeover attempt, three cases where the dissidents withdrew because the courts upheld the validity of defensive restructurings announced by incumbents, and two cases where the dissidents dropped their takeover attempt because the incumbents agreed to an acquisition by another party.[87] In these contests, the average shareholder return at the outcome announcement was a significant 7.19% decrease.[88] Consequently, DeAngelo and DeAngelo concluded that "the stock price decline at the defeat of dissidents' challenge should not be attributed to voting stockholders' naiveté in distinguishing the superior management team."[89]

Also like Dodd and Warner, DeAngelo and DeAngelo found that shareholders experience positive price adjustments when dissidents win seats on the target firm's board. The 16 contests in which the dissidents obtained a minority of the directorships incurred a large overall wealth gain. Specifically, shareholders experienced significant overall returns of 30.12% in contests in which dissidents obtained a minority of directors.[90] DeAngelo and DeAngelo hypothesized that

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[84] *Id.*
[85] *Id.* (Finding that for the seven contests where a shareholder vote resulted in incumbent re-election the average return at announcement of contest outcome was –1.73%).
[86] *Id.*
[87] *Id.*
[88] *Id.*
[89] *Id.*
[90] *Id* at 43.

"one possible explanation is that dissident board representation leads to improved monitoring of managerial decisions, hence to the implementation of higher-valued corporate policies."[91]

IX. Implications and Conclusions

Proxy contests are an efficient tool of corporate governance. Such contests are an effective means of disciplining inefficient managers and implementing corporate change. Proxy campaigns are waged and won by experienced individuals who convince other shareholders that they possess the skills necessary to run the firm efficiently. These dissidents highlight both their strengths and current management's inequities throughout the entire contest. As a result of these claims, the firm experiences wealth-maximizing resignations from its top management as well as lucrative policy changes, such as sales and liquidations.[92] Furthermore, as expected of a transfer of resources to higher valued uses, proxy contests increase shareholder wealth regardless of their outcome.

Nonetheless, critics maintain that proxy contests are futile and inefficient. They argue that the proxy system requires significant reformation before it can become an effective method of corporate governance. Specifically, critics have suggested three general reforms: (1) increased disclosure, (2) increased shareholder access to the proxy machinery, and (3) increased regulation of institutional investors.[93]

A. Increased Disclosure

Proxy critics contend that additional disclosure is necessary to increase the efficiency of proxy contests. Citing low levels of shareholder participation, proxy critics argue that the proxy system does not provide shareholders with the essential information to vote intelligently.

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[91] *Id.*
[92] Top management includes chief executive officers (CEOs), chairmen, and presidents. *See* DeAngelo & DeAngelo, *supra* note 22, at 46.
[93] EASTERBROOK & FISCHEL, *supra* note 7, at 86.

Consequently, they assert that the firm should be required to disclose more information about its activities and the qualifications of its management.[94]

Increased disclosure, however, suffers from significant drawbacks. Specifically, it translates into increased costs, and thus, decreased profits for the firm. Moreover, there is no indication that shareholders desire additional information and no proof that increased disclosure will, in fact, increase shareholder voting. Furthermore, even if shareholder voting increases, there is no evidence that shareholders will make more efficient decisions for the firm. Additional shareholder participation could result in an increase in irrational voting, which in turn could cause further declines in firm efficiency. Under the present system, participating shareholders are making rational, informed decisions that result in positive adjustments to the value of their shares. They are able to assess and evaluate both the credentials of dissidents and the reforms they are suggesting. Thus, it appears that the optimal number of shareholders is currently participating.

Finally, increased disclosure could deter the firm itself from implementing programs that would increase profit-maximizing behavior. According to Easterbrook and Fischel:

> Requiring firms to disclose their policies with respect to compliance with environmental laws, violations of regulatory statutes, or questionable foreign or domestic payments, all may affect the willingness of the firm to undertake the conduct at issue. Due to a fear of litigation, adverse publicity, or regulatory intervention, managers may simply decide that the costs of disclosure may exceed the expected benefits from the activity.[95]

In sum, This contributes to the risk that will result in decreased efficiency and decreased firm value.

B. <u>Increased Shareholder Access to the Proxy Machinery</u>

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[94] *Id.*
[95] *Id.* at 87.

Once again citing shareholders disinterest in corporate decision-making, proxy critics argue that shareholders lack the ability to participate meaningfully in the electoral process.[96] Alluding to the low success rates of dissidents, critics note that incumbent board nominees are routinely elected by shareholders.[97] Accordingly, they suggest a wide range of reforms, including reimbursing dissident expenses,[98] reforming the record date rule,[99] and prohibiting street name ownership.[100]

However, increased access reforms suffer from many of the same shortcomings as the aforementioned increased disclosure reforms. For instance, increased shareholder access reforms are costly and reduce shareholder value. Moreover, there is no proof that shareholders desire these changes or that increased access would result in increased participation. Once again, even if participation increases, the firm could suffer losses as a result of increases in irrational decision-making. Furthermore, these reforms could decrease the profitability of a firm by forcing it to subsidize campaigns from various social activists and cranks. The firm's profits

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[96] *Id.*

[97] *See* Dodd & Warner, supra note 21, at 418 (dissidents successfully obtain a board majority only 20-25% of the time). *See also* DeAngelo & DeAngelo, *supra* note 22, at 46 (dissidents win a board majority approximately 33% of the time).

[98] *See* Rosenfeld v. Fairchild Engine & Airplane Corporation, 309 N.Y. 168 (1955) (stating that in an unsuccessful bid, dissident campaign expenses are not reimbursed by the firm; however, in a successful bid, the board can vote to reimburse dissident expenses). *See also* Levin v. Metro-Goldwyn-Mayer, Inc., 264 F. Supp. 797 (S.D.N.Y. 1967) (stating the firm must pay incumbent expenses whether they win or lose provided these expenses are not excessive or illegal).

[99] The record date rule is a state law convention providing that only shareholders who hold shares as of the record date may vote in proxy contests. Typically, the record date is set several weeks before the vote occurs and is often open to the discretion of management. Consequently, a problem arises when shares are transferred after this date. Generally, votes may only be transferred after the record date if shares are accompanied by an irrevocable proxy. However, obtaining such a proxy is costly and thus many firms experience a separation of shares from votes during the solicitation period. *See* Pound, supra note 2, at 229 (discussing the record date rule as one of the state laws that make it difficult to determine who possess the right to vote at any given time).

[100] Street name ownership is also a state law convention. Stock held in street name is registered to a brokerage house, bank, depository corporation, or other intermediary, which administers the transfer of shares among its clients. Street name ownership is beneficial in that it is convenient and affords shareholders some anonymity. However, street name ownership is problematic because votes must be solicited through the nominee who may be less than forthright in contacting shareholders. *See* Pound, *supra* note 2, at 239 (discussing the effects of street name ownership on proxy contests). *See also* J. Robert Brown, Jr., *The Shareholder Communication Rules and the Securities and Exchange Commission: An Exercise in Regulatory Utility or Futility*, 13 J. CORP. L. 683, 686 (1988) (discussing street name ownership and its general implications for corporations).

would be subject to repeated attacks from small shareholders seeking to impose their morals and/or complaining about frivolous matters. The current constraints on lodging a proxy contest are necessary to ensure that only shareholders who actually seek to improve firm efficiency incite proxy campaigns. Therefore, reforms increasing shareholder access to the proxy machinery will only decrease shareholder value.

C. Increased Involvement by Institutional Investors

Arguing that financial institutions are the largest shareholders of many corporations, proxy critics assert that increased institutional investor involvement is necessary in proxy contests.[101] Specifically, they contend that institutional investors simply vote "street rules"[102] and suffer from conflict of interest problems.[103] Consequently, proxy critics maintain that institutional investors invest insufficient resources in deciding how to vote.[104] Therefore, they have suggested requiring institutions to establish voting criteria and to disclose their voting policies to beneficiaries or to pass the vote through to the beneficiaries themselves.[105]

Increased institutional involvement does not appear necessary as it would only result in increased firm costs and decreased firm efficiency. Professional money managers work in a competitive environment where their performance is easily assessed. Managers that "do not make sound decisions regarding the costs of establishing more elaborate voting procedures in

[101] *See* Zanglein, *supra* note 5, at 771 (stating that, in 1988, institutional investors owned more than 80% of General Motors and Amoco, more than 70% of Citicorp, Mobil, and Eli Lilly and more than 60% of Philip Morris, Minnesota Mining, Johnson & Johnson, American Express, Dun & Bradstreet, Digital Equipment, Boeing, and Pfizer).
[102] Street rules, or the Wall Street Rule, refers to the institutional investor inclination to abstain from voting and sell their shares rather than vote against management.
[103] *See* Pound, *supra* note 2, at 242-243 (citing conflicts of interest such as strategic alliances with incumbent management and existing business relationships with incumbent management).
[104] EASTERBROOK & FISCHEL, *supra* note 7, at 88.
[105] Myron P. Curzan & Mark L. Pelesh, *Revitalizing Corporate Democracy: Control of Investment Managers' Voting on Social Responsibility Proxy Issues*, 93 HARV. L. REV. 670, 694 (1980).

relation to the benefit of such procedures" will lose investors and eventually their jobs.[106] Thus, managers have a strong incentive to invest in voting procedures.

Moreover, the aforementioned empirical evidence indicates that institutional investors are not only participating in the proxy process but also evaluating dissidents' credentials and claims. Hence, when institutional investors vote to re-elect incumbent management, they have determined that incumbent management is in a better position to maximize shareholder wealth. Furthermore, this determination indicates that institutional investors have done a cost-benefit analysis and established voting procedures that are optimal for their firm.

Lastly, pass through voting would only increase firm costs and would suffer from the same shortcomings as the increased disclosure reforms, including the inability to ascertain whether shareholders themselves desire such reforms. In fact, pass through voting could decrease shareholder participation even further as individual investors would fail to properly value their votes. Most individual investors feel their votes are insignificant when they are voting on issues specific to the firm in which they have chosen to invest. Therefore, these investors as well as others may fail to see the import in voting on issues regarding the investments of their investment. In sum, institutional investor reform would only result in increased firm costs and decreased firm efficiency.

In conclusion, proxy contests are an efficient means of corporate governance. As such, any reforms to the proxy process will result in decreased firm efficiency. Consequently, no further reforms are necessary at the present time.

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[106] EASTERBROOK & FISCHEL, *supra* note 7, at 88.