

# Lying in corporate elections

*When it comes to proxy contests, the truth matters, and without an urgent overhaul of the current system, shareholders will continue to influence the outcome of corporate votes in underhanded ways*

WORDS BY  
**Kai Haakon E. Liekefett**  
PARTNER, SIDLEY AUSTIN LLP



We live in polarising times. The current political and cultural environment is arguably the most heated and controversial in decades. One of the most prominent victims of our era: the truth. As Mark Twain famously said; “A lie can travel half way around the world while the truth is putting on its shoes.” Political election campaigns, in particular, are riddled with misleading statements, half-truths and outright lies. Our fragmented media ecosystem and the pervasive influence of social media make it easier than ever to distribute falsehoods to a vast audience near-instantaneously, compromising the integrity of political elections.

While not as extreme as with political discourse, similar issues have emerged in corporate elections. In recent years, it seems there have been more half-truths and outright lies in proxy contests than perhaps ever before. During proxy season, hardly a day goes by without a press release, shareholder letter or investor presentation containing questionable statements.

Public companies, as securities issuers, face heavy scrutiny of their disclosures under areas of federal securities law beyond the proxy rules. A company simply cannot make recklessly optimistic statements about its future prospects without exposing itself to liability.

Dissident shareholders like activist funds, on the other hand, generally escape similar levels of scrutiny. There are rules designed to protect the integrity of corporate elections – the federal proxy rules under the US Securities Exchange Act of 1934. Unfortunately, however, these proxy rules – many of which were adopted decades ago and long before the

advent of the digital age – are increasingly under stress. In fact, many activists repeatedly violate the proxy rules, yet apparently face no repercussions.

## Constraints on misstatements

Rule 14a-9 under the US Securities Exchange Act of 1934 prohibits false and misleading statements in a proxy contest. The rule also prohibits the omission of material facts when such omission would make statements false or misleading. The rule provides examples as to potentially misleading statements, including:

- › predicting future market values;
- › making disparaging claims without sufficient facts;
- › obfuscating who is disseminating the proxy solicitation materials in question, and;
- › making claims prior to a shareholder meeting regarding the results of a solicitation.

While helpful on its face, rule 14a-9 leaves substantial leeway for interpretation of a statement. The application of these rules has often failed to rein in even clearly problematic behaviour in proxy contests.

For example, the legality of statements about proxy tallies prior to the closing of the polls remains an unresolved issue. As noted above, rule 14a-9 lists ‘claims made prior to a meeting regarding the results of a solicitation’ as an example of a misleading statement. On that basis, several courts have ruled that such disclosures can spoil the fairness of the voting process by creating a ‘bandwagon effect.’ This is the phenomenon that many shareholders may vote for the purported likely winner in the belief that the outcome has become a ‘foregone conclusion.’

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**MISLEADING STATEMENTS, HALF-TRUTHS AND OUTRIGHT LIES UNDERCUT THE IDEALS OF CORPORATE DEMOCRACY**  
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Yet, many courts have been reluctant to intervene even in seemingly clear cases. For instance, in one court case, an activist announced preliminary proxy voting results several weeks prior to the shareholder meeting, claiming that it was clearly leading with 80 percent of the shares voted. These numbers turned out to be false. However, the court declined to issue a preliminary injunction, and the dissident proceeded to succeed in its proxy contest. This explains why we still see leaks of alleged or actual preliminary vote tallies pre-meeting on a regular basis, including in a recent high-profile proxy fight.

## SEC review

In the past, the SEC staff in the Division of Corporation Finance, through the comment letter process, strove to enhance compliance with these proxy rules. Whenever a party overstepped boundaries, the other party would send a private and confidential letter to the SEC, noting the violations. To the extent its staff agreed, the SEC would often react promptly to those letters by issuing comments to the offending party. This process ensured that the rhetoric in proxy contests remained significantly less heated and more truthful than in political elections.

In recent years, practitioners have observed a decline in the number and breadth of SEC comments in proxy contests. This surprising trend contrasts with the SEC’s ex-

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**WE BELIEVE IT IS TIME FOR CONGRESS TO LEVEL THE PLAYING FIELD**  
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attention towards other pressing matters.

Moreover, the SEC’s authority under the proxy rules has always been limited. The Division of Corporation Finance can only provide comments. If proxy rule violators do not comply with those comments, their staff can only refer a matter to the SEC’s Division of Enforcement. However, we are not aware of any enforcement action prior to a shareholder meeting in recent years.

## Litigation in federal court

Companies waiting for SEC action can instead bring suit against proxy rule violators in federal court. However, litigation poses significant risks for a company.

As an initial matter, lawsuits are not inexpensive. While there is often insurance when companies are the defendants in a lawsuit, there is typically no insurance available for companies to pursue litigation as plaintiffs. Moreover, proxy advisory firms and investors frequently criticise companies for initiating litigation against shareholders. This is certainly an important consideration in a proxy contest where a company needs to weigh any

potential win in court against a loss at the ballot box.

More substantively, there is also the reality of condensed proxy fight timelines and the burden of proof. Proxy contests are fast-paced and shareholder meetings are typically only a few weeks away. Therefore, a litigant needs to move for expedited proceedings and file for a preliminary injunction to have any hope for a ruling prior to election day. The burden of proof for the issuance of a preliminary injunction, however, is greater than that required in regular proceedings. A preliminary injunction is an extraordinary remedy that generally will be granted only in limited circumstances.

This type of remedy is available generally only when the plaintiff establishes that: 1) there is a likelihood of success on the merits; 2) there is irreparable harm if the injunction is denied; 3) the balance of the equities tips in the plaintiff’s favour; and 4) the public interest favours the requested relief.

This standard requires plaintiffs to clear a high bar – a challenging proposition in the midst of a proxy contest.

A further complicating factor is that many federal judges are not familiar with the intricacies of proxy contests because such cases are relatively rare. As a result, the case law originating from the federal courts has been uneven and inconsistent.

For example, a court last year ruled that certain disclosure claims can be ‘mooted’ by

the defendants by merely filing the complaint with the SEC and stating that they disagree with the lawsuit. This holding is antithetical to the purpose of the securities laws, which focus on accurate disclosure. This ruling has become yet another potential obstacle to enforcing disclosure claims in federal court.

## A call for action

It is time to protect the integrity of corporate elections and the shareholder vote. Misleading statements, half-truths and outright lies undercut corporate democracy. We believe it is time for Congress to level the playing field. The SEC should receive more resources to monitor proxy contests. In addition, the proxy rules should be tightened and provide the SEC with more authority to sanction violations. For instance, the SEC should have the right to require proxy rule violators to publicly withdraw false statements. The SEC should also be authorised to enjoin proxy contests and

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impose severe sanctions on repeat violators (freeze-out periods, for example). Lastly, it should be clarified that the mere filing of a complaint with the SEC is insufficient to ‘moot’ a lawsuit over misstatements in a proxy contest.

These changes would correct a fundamental imbalance in our current system between companies and activist shareholders. Simply put, both companies and investors should be held to the same standard. Some may argue that in our free market system, investors should engage in their own research before voting, rather than relying on a government regulatory agency to police proxy contests. However, in fast-moving proxy fights, even institutional investors do not have the time, resources, or manpower to fact check all statements. Proxy advisory firms like ISS and Glass Lewis, who influence significant portions of the vote, are similarly ill positioned to combat misinformation. Retail shareholders, a major focus of the SEC’s mandate, are even more vulnerable to disinformation in proxy fights. For these reasons, the investor community cannot solve this issue on its own.

Given current trends, it’s already past time for Congress to step in. The SEC takes a leading role to combat misleading or untruthful statements in other contexts – and Congress should enable it to do the same in proxy contests. Lying with impunity should not become a norm in our corporate elections. ■

