Classification Cancels Corporate Accountability

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In the wake of the corporate scandals of the past several months, ISS often receives inquiries as to our views on the two or three key governance changes that—if adopted by all issuers—would help investors to avoid similar market meltdowns in the future.[1] Unquestionably, the item on our wish list that draws the blankest stares from corporate America is the call for annual elections of all members of corporate boards.

These visceral responses are not surprising given the recent degeneration of the staggered terms versus annual election debate.[2] Few governance issues produce the same "Shareholders Are from Mars, Executives Are from Venus" level of disconnect. Simply put, executives and investors view the board-election timing issue from different perspectives. As is often the case with such genetic-level disagreements, where each group stands is dictated by where its members sit.

Executives favor strong defense. From the vantage of the executive suite, most chief executives (and their legal and investment banking advisers) view classification, first and foremost, as a potent defense against challenges to corporate control.[3] Over the past decade, executives have seen successive

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1. *See, e.g.*, *Bush Speech Leaves Investors Wanting Action: A Wall Street Journal News Roundup*, WALL ST. J., July 10, 2002, at C1 (discussing the Bush Administration's efforts to restore investor confidence and prevent corporate corruption as well as chronicling investor skepticism at proposed new measures).

2. *Compare* Martin Lipton, *Pills, Polls, and Professors Redux*, 69 U. CHI. L. REV 1037, 1057-58 (2002) (stating that "corporate law . . . has long permitted shareholders to enjoy a staggered-board charter that protects against changes in management predicated on short term events," and using Weyerhauser's acquisition of Willamette as "a shining example of how a staggered board . . . operate[s] to the benefit of shareholders"), *with* Charles M. Nathan, *Controlled Convergence*, DAILY DEAL, Aug. 10, 2000 (stating that "institutional investors believe the existence of . . . management-entrenchment devices, such as the staggered board, undermine a policy of shareholder value creation").

3. *See, e.g.*, Lucian Arye Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 785 (2002) (arguing that "because a classified board makes a hostile takeover more difficult, a CEO's power will tend to be greater if the board is classified").

doomsday takeover defenses, including shareholder rights plans (poison pills) and second- and third-generation state statutes, wither in the face of a rising tide of investor activism.[4] In the absence of classified board terms, proxy fights have proven an effective antidote to all but the most toxic (read: dead hand) poison pills. In contrast, staggered terms guarantee a long delay in the bidding process.[5]

Executives argue that classification protects shareholders. Professors Bebchuk, Coates, and Subramanian shatter the shareholder-value-enhancement mythology that some boards have used to justify their staggered structures in recent years.[6] Unlike studies concerning shareholder-rights plans,[7] there is no empirical evidence that classified boards provide tangible economic benefit to shareholders.

Shareholders favor annual terms. Shareholders tend to shun staggered terms. Over the past decade, resolutions to repeal classified boards have appeared on ballots at hundreds of companies.[8] These requests to return to annual elections of the full board typically win significant amounts of support. Since the 2000 proxy season, repeal proposals have averaged support in excess of fifty percent of the votes cast.[9]

The 2002 proxy season was a high watermark.[10] Average voting support for the fifty-six proposals that made it to corporate ballots was a whopping

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4. *See* Mark R. Wingerson & Christopher H. Dorn, *Institutional Investors in the United States and the Repeal of Poison Pills: A Practitioner's Perspective*, 1992 COLUM. BUS. L. REV. 223, 233 (describing 1992 as "the year of the breakthrough for activism," when "investors broaden[ed] their campaign against corporate control defenses"); *see also* Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV 871, 895 (2002) ("[S]hareholders are enjoying significant success in their efforts to get boards to repeal dead-hand features of poison pills.").

5. *See* John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301, 1306 (2001) ("[T]he staggered . . . board . . . (if properly implemented) imposes a year delay on efforts . . . to take control of a target's board.").

6. Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 934 (2002).

7. *Cf.* Coates, *supra* note 5 (questioning the validity of empirical evidence concerning the effectiveness of poison pills).

8. *See* Michael Klausner, *Institutional Shareholders' Split Personality on Corporate Governance: Active in Proxies, Passive in IPOs*, *in* DIRECTORSHIP NEWSLETTER (forthcoming) (John M. Olin Program in Law & Econ., Working Paper No. 225, 2001), *available at* http://papers.ssrn.com/id=292083.

9. Institutional S'holder Servs., Voting Results Database, 2000-2002 (on file with author).

10. *See generally* Gretchen Morgenson, *Pick Up the Proxy, Fill It Out and Exert Some Control*, N.Y. TIMES, Aug. 25, 2002, at 3-1 (providing statistics on proxy voting by individual investors versus large brokerage companies and discussing new rules submitted by the New York Stock Exchange to the SEC in August 2002).

58.1% of the votes cast.[11] Thirty-nine proposals calling for repeal of staggered terms received support from holders of at least a majority of the votes cast at the firms' 2002 annual meetings.[12] A dozen boards witnessed holders of more than half of their companies' shares support the precatory proposals.[13] Defenders of the status quo note that these majority votes fall short of the supermajority vote lock-in requirements—typically two-thirds or eighty percent of the outstanding shares—required for repeal.[14]

This opposition is not a knee-jerk reaction to the obvious chilling impact of classified boards on the market for corporate control. Instead, most shareholders view annual board elections as an essential ingredient in maintaining corporate accountability.[15] Over the years, they have learned firsthand that directors are more likely to act in shareholders' best interests when they know that they may be turned out of office.

Proxy challenges. At the extreme, annual elections allow investors to change control of the board at a single meeting (or even absent one via a consent solicitation if possible).

Replacement of an entire incumbent board may be warranted when a board fails to bargain in good faith with an unquestionably qualified bidder.[16] Even where the vote is an effective referendum on a significant premium-to-market offer, shareholders generally favor dissident nominees only when they are clearly "independent" both from management and the bidder.

More importantly, shareholders must be able to remove directors who fail to oversee management and thus allow for fraud or mismanagement.[17] Forcing

11. Institutional S'holder Servs., *supra* note 9.

12. *Id.*

13. *Id.*

14. DEL. CODE ANN. tit. 8, § 102 (2002) (allowing shareholders to adopt supermajority vote lock-in requirements for shareholder action); John H. Matheson & Jon R. Norberg, *Hostile Share Acquisitions and Corporate Governance: A Framework for Evaluating Antitakeover Activities*, 47 U. PITT. L. REV. 407, 486 (1986) (stating that the "vote required to repeal the [antitakeover] defenses is . . . usually in the range of a sixty-seven to eighty percent affirmative vote").

15. *See* Greg Jefferson, *A Test for Lilly's Board; Upstart Shareholder Challenges 3-Year Terms*, INDIANAPOLIS BUS. J., Mar. 15, 1999, at 1 (quoting a Union of Needletraders, Industrial and Textile Employees (UNITE) officials' resolution: "The staggered board is . . . a shield to protect incumbent directors and management from regular shareholder accountability").

16. *See, e.g.*, Lucian A. Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973, 1031-33 (describing Willamette's directors' 14-month battle against a takeover bid by Weyerhaeuser despite overwhelming shareholder support for the sale and noting that the incumbents opposed the bid primarily due to animosity against the Weyerhaeuser CEO). The article also describes a case in which Circon incumbents' intransigence forced U.S. Surgical to withdraw its bid after a year-long struggle; Circon sold itself for 17% less than Surgical's original bid a few months later. *Id.* at 1033.

17. *See generally* Ige Omotayo Bolodeoku, *A Critique of the Theories Underpinning Proxy Solicitation by the Board*, 2001 J. BUS. L. 377-98 (2001) (explaining proxy solicitation and critiquing relevant theories concerning shareholder apathy, implied

investors to return for two successive meetings to remove a board that may be allowing management to loot the company is nonsensical.

Shortchanging short slates. Full-blown contests for boardroom control are rare. Even long-term poor stock price performance typically is not enough to convince shareholders to hand the keys to the boardroom over to an insurgent group. This "show me the money" mentality has led dissidents in recent seasons to turn to "short slate" proxy fights.

Playing off of the proxy rules' bona fide nominee requirements, dissidents may, in effect, fill out their slates with some of management's nominees. (Technically, the rules require the dissident to indicate the specific nominee(s) that it intends to withhold votes for, since the insurgent cannot include candidates on its slate without their express permission.[18])

Not surprisingly, dissidents often use these new tactics to target underperforming board members. Common targets include employee directors, conflicted outsiders, and truants. Classified board structures frustrate these campaigns by limiting the dissidents' choice in designing a replacement board. In this fashion, the staggered structure actually protects underperforming directors.

Just Vote No campaigns. Most directors have a better chance of being run over by a bus in front of corporate headquarters than facing a challenge to their tenure via a proxy fight—full or short slate. In the modern governance era, shareholders are much more likely to use the election of the board as an opportunity to register their displeasure with the conduct of individual directors.[19] These so-called "Just Vote No" campaigns took place at thousands of annual meetings in 2002.[20]

Unlike political forms of representative democracy, shareholders' contact with their elected representatives is limited at best. Corporate management typically discourages direct communications between shareowners and directors. Few companies, for example, take outside directors on investor road shows or make them available during quarterly earnings calls. As a result, the only real opportunity that most owners have to express their views to board members is via the vote at a shareholder meeting.

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obligation, and market efficiency theories).

18. Securities Exchange Act Rule 14a-8, 17 C.F.R. § 240.14a-8 (1998).

19. *Shareholders "Just Say No" to Company Directors*, BLOOMBERG NEWS, May 1, 1996; *see also* MARK A. SARGENT & DENNIS R. HANABACH, PROXY RULES HANDBOOK § 2.18 (2002) (explaining that the requirement for public disclosure of shareholder results is useful to shareholders who employ Just Vote No campaigns to protest the election of individual directors).

20. ISS recommends votes against board members for a variety of reasons including poor attendance, a lack of adequate independence, and use of abusive governance practices. *See* INSTITUTIONAL S'HOLDER SERVS., ISS PROXY VOTING MANUAL (2002) (on file with author). During the 2002 proxy season, ISS recommended votes against one or more board nominees at more than 2000 companies.

Withholding voting authority from board nominees has emerged as a significant weapon in shareholders' activism arsenals over the past decade.[21] Today, it is common for directors to look at the report of the inspector of elections and to see that holders of twenty percent or more of the company's shares voted against their reelection.

Most of the reasons cited by investors for pursuing these "vote no" campaigns are much less effective when a company has staggered terms.

- Shareholders cannot protest a decision by the board to fail to take action in response to a majority vote on a shareholder proposal.
- They might not be able to protest a director's poor attendance.
- They might not be able to protest a director's conflicts of interest with members of senior management.
- They cannot protest payment of excessive levels of CEO remuneration if all members of the compensation committee are not on the ballot.
- They cannot address inadequate executive succession planning by the full board if all the directors are not standing for reelection.

Fostering accountability. Proclassification executives and commentators chant "stability" and "continuity" to justify staggering directors' terms,[22] but the real goal is to vest final decisionmaking authority on all-important strategic issues with the board and management. Such logic stretches the usual gap between ownership and control into a chasm.

Such paternalism is misplaced. A decade of proxy fight activity has graphically demonstrated that shareholders rarely hand over control of a board to a dissident slate at a single meeting without compelling justification.

The only true role played by a classified board is to obstruct the process. If shareholder protection from "low ball" and discriminatory bids is the goal, other forms of defense, such as fair price provisions or poison pills, are better suited to the task. Interestingly, the one-bite-of-the-apple reform approach suggested by the authors is similar in effect to so-called "chewable" pills.[23] Although their forms vary, these pills typically dissolve if a majority of shareholders approve a "qualified offer" or vote to redeem the pill.

Annual elections of the entire board promote accountability. They also foster communications between investors and their elected representatives,

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21. *See Shareholders "Just Say No" to Company Directors*, *supra* note 19 (stating that the Just Vote No practice emerged in 1993, and has been a successful outlet for frustrated shareholders).

22. See Richard H. Koppes, Lyle G. Ganske & Charles T. Haag, *Corporate Governance Out of Focus: The Debate over Classified Boards*, 54 BUS. LAW. 1023, 1027 (1999) (stating that "the primary effect of classification [is] stability").

23. *See generally* Kate Margolis, *Binding Shareholder Bylaw Amendments: An Antidote for the Poison Pill*, 67 MISS. L.J. 817 (1998) (analyzing the role of shareholder-rights plans in takeovers and discussing shareholder activism in the debate over poison pills). Certain antipill bylaws have been referred to as "chewable poison pills," because they turn the pill into a proshareholder device. *Id.* at 825.

directors. In this post-Enron environment, it is crucial that shareholders have the means to insure that boards are not asleep at the switch.

An easy, real-world test of shareholders' affection for classification is readily available to boards: Put repeal on the proxy ballot for an up or down vote. While executives at the nearly sixty percent of U.S. companies that have staggered boards in place could do so, they will not. The honest ones would admit that they could not win the vote.