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GOVERNANCE

Board Primacy Under Attack

Financial Meltdown Gives Impetus to Shareholder Activism

By Stephen M. Honig

Say-on-pay. Independent lead directors. Dissident access to corporate proxy machinery. Majority voting for board seats. Declassification of boards of directors. What do all these modern hallmarks of "good corporate governance" have in common?

First, they arise in reaction to several unfortunate chapters in recent business history, including corporate failures like Enron and WorldCom, questions about the ground rules by which CEOs of Disney and the New York Stock Exchange out-earn other highly paid executives by simply walking out the door, outright fraud in stock options dating, and growing media awareness that the perp walk for people in suits can be as juicy as drug binges by movie actresses.

More fundamentally, these elements of good governance represent an attack on board control that may remake how we think about corporate management.

The pressure on board autonomy can only intensify given the current financial melt down. Public outrage at traditional management and compensation-setting practices, congressional scrutiny of governance, and federal involvement in banks and other entities the taxpayers are bailing out all add the weight of government to the pressures that are changing how we manage. This is a very large camel whose nose is poking deep into the tent of corporate governance.

BROAD COALITION

A coalition of academics, led by Professor Lucien Bebchuk of the Harvard Corporate Governance Project, and shareholder activists who perceive a need to assert shareholder rights against mismanagement, are pressing the management supremacy of boards of directors on many fronts. Some shareholders have very personal goals, such as short-term return on an investment or seizure of corporate control. Others see breaking the board's power monopoly as fundamental to achieving corporate democracy or to ending some particular corporate evil, such as executive over-compensation or insensitivity to the environment.

The coalition that is attacking boards is remarkably broad. It includes outraged individual investors, institutional investors, rating agencies, the SEC, the self-regulatory agencies such as the exchanges, the U.S. Congress and President-

elect Obama (who has endorsed advisory stockholder votes on public company executive compensation). These constituencies are knit together both by modern communications and prestigious academic cachet.

Board defense is spearheaded by America's leading corporate attorney, Martin Lipton. He denies that the board's sole loyalty is to the stockholders who own the corporation. He sees the directors owing duty to a varied constituency, including management, employees, creditors, regulators, vendors and consumers.

Lipton's view, often reflected in decisions by the Delaware courts, is that the attack on boards destroys board collegiality, distracts from the primary mission of providing strategic guidance, and discourages good people from serving.

MANY FLASH POINTS

Stockholder activists want to separate the CEO from the role of board chair. Naming an independent director as chair, or taking the intermediate step of naming an independent so-called "lead director," is designed to break the perceived tight embrace between management and a subservient board, and to open lines of communication with shareholders. Numerous exchange-traded companies already have decoupled the chairmanship or instituted a lead director.

Another flash point is "proxy access." Entrenched management is seen as controlling nominations for directorships and promoting the management slate by proxy solicitations prepared and paid for by the company. One early effort to foster broader proxy access came in the SEC's proposed 2003 regulation to compel inclusion within the company's proxy materials of up to three independent directors nominated by dissidents, provided there had occurred a "triggering event" evidencing shareholder dissatisfaction (such as substantial withheld votes from management candidates for the board). The proposal was complex, and it was roundly criticized by management and board advocates. It never was revised or proposed again.

The attack by stockholder activists then shifted to other strategies, including by-law reforms to permit stockholder nominations. For example, in July of 2008, one such proposal, designed by Professor Bebchuk, was offered for inclusion in the CA, Inc. proxy statement. The SEC referred the legality of the proposal to the Delaware Supreme Court, which ruled (on arguably narrow grounds limited to CA's charter) that the new by-law, requiring reimbursement of dissident expenses in running a successful proxy fight, violated Delaware law.

SOME POLITICAL OBSERVERS PREDICT THAT THE NEXT CONGRESS WILL REQUIRE SAY-ON-PAY VOTES FOR ALL PUBLIC COMPANIES.

Since the Court opined that as a general matter shareholders had a right to propose proxy access by-laws, the proxy access issue surely is not dead at this juncture.

Another attack proceeds under the general rubric of "majority voting." Although it comes in various flavors, majority voting's basic idea is that someone cannot be elected to the board unless he or she gains an absolute majority of votes cast (or shares outstanding). Variants including declaring such candidate, typically a management-proposed incumbent, either not elected or subject to removal by board action. The SEC typically requires the inclusion in proxy statements of shareholder proposals for majority voting, even though the votes are advisory and non-binding under state law.

Some boards, under pressure from shareholders because of poor corporate performance, have embraced majority voting to head off efforts to replace specific directors – the Merrill Lynch board, for example. How majority voting, or any of the shareholder issues discussed in this article, may be impacted if the federal government ends up as a significant equity player as a result of its bail-out efforts, is an intriguing question.

Another attack is "say-on-pay," the movement for a non-binding shareholder vote on pay for senior executives. The 2008 proxy season saw about a 50 percent increase in such proposals, and many major companies adopted say-on-pay votes, notably Aflac, Blockbuster, Ingersoll Rand, Motorola and Verizon.

Some political observers predict that the next Congress will require say-on-pay votes for all public companies. Then-Senator Obama introduced the Senate's say-on-pay bill last session. One version already cleared the House. Representative Waxman's House Committee on Oversight and Government Reform has held many hearings critical of executive compensation practices.

In December 2007, the Committee discovered evidence of pro-management bias in board compensation consultants. In March 2008, the Committee grilled CEOs from Merrill Lynch, Countryside and Citigroup deemed

unworthy of high compensation. The parade of excoriated executives continued as the financial meltdown deepened.

With a lack of consensus on whether enhanced 1934 Act executive comp reporting requirements (imposed in 2006 to increase transparency) have had any success in reining in executive compensation, say-on-pay will have political legs.

A final significant point of attack on board primacy is the movement to declassify public boards. A classified board typically has one-third of its members elected each year, so shareholders attempting to control the company, or compel its sale, must prevail in two consecutive annual elections to achieve board majority. Combined with institution by the board of a "poison pill," a defensive device by which a company issues additional shares in defending against an attempted takeover, boards have been able to resist even premium-priced takeovers, and preserve their controlling positions against angry shareholders.

Recent substantial scholarship, again at Harvard, suggests a strong economic argument in favor of declassification, at least from the stockholder perspective. Professor Bebchuk, who holds degrees in both law and economics, cites research showing that successfully resisting an unsolicited favorable bid reduces shareholder return five years later by as much as twenty percent; that a staggered board does not result in higher bid prices by would-be acquirers; and staggered boards create lower firm values.

Declassification gained some traction in the 2008 proxy season and fostered a variety of compromise models: retain the stagger but all poison pills expire after one year unless a super-majority of the board renews; allow shareholders to remove directors without cause in a proxy fight; and eliminate the stagger if there is a premium acquisition offer.

Current economic conditions, the growth of foreign capital markets and acceptance of their accounting and management practices, combined with outrage against perceived avarice on the part of entrenched management, mean that curtailment of board domination of management is becoming increasingly plausible.

If the pendulum doesn't swing back in support of board-driven management, the corporation of tomorrow is going to look much different than today's. We don't know what impact that difference will have on executive compensation, social responsibility, and the broadly presumed entitlement of shareholders to the biggest piece of the corporate pie.

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