Shareholder challenges to the staggered board

Recent proposals pose new risks and require directors to consider appropriate responses.

BY DOUG RAYMOND

In recent proxy seasons, shareholders have successfully campaigned at many public companies to institute majority voting for the election of directors as a replacement for plurality voting. This concerted movement to eliminate plurality voting in uncontested elections has resulted in nearly 80% of S&P 500 companies adopting majority voting. (Plurality voting allows director nominees that receive the highest number of affirmative votes cast to be elected, in contrast to majority voting, which requires each director to be elected by a majority of the votes cast.) Having been largely successful in the effort to eliminate plurality voting among large cap companies, the same institutional forces are leading shareholder groups increasingly to oppose staggered boards.

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A staggered board, also referred to as a classified board, is a corporate board of directors in which the directors are divided, generally into three classes. Each class of directors serves for a different, but overlapping, multiyear term. As a result, in any year, only some of the directors, generally fewer than a majority, are up for re-election. Proponents of staggered boards point to the continuity they engender. They can also be effective in a hostile takeover, as a proxy contest to replace a sitting board generally has to be successful in two different years to give the dissident (or the acquirer) majority control of the board. And two years is, for many, too long to have to wait to acquire control, which sometimes dissuades a proxy contest in the first place. Because of this aspect of staggered boards, critics argue that they support entrenchment and lessen directors' accountability to shareholders.

So far this year, at almost 50 companies, shareholders have submitted proxy proposals to declassify staggered boards and instead hold an annual election of all directors. The proposals that have gone to vote have been predominantly successful, often passing with significant shareholder support. In addition, most likely in response, at least to some extent, to shareholder pressure, another 65 companies, including 44 companies in the S&P 500, have submitted their own proposals to eliminate staggered boards. Most of the recent management proposals to declassify boards for which results are currently available have not only passed, but in many cases have done so with the overwhelming support of the votes cast.

The elimination of a staggered board, in combination with the change from plurality voting to majority voting, creates an important new dynamic in shareholder elections. Furthermore, since the updated NYSE Rule 452 went into effect in the 2010 proxy season for companies listed on the NYSE or Nasdaq, brokers are no longer permitted in uncontested director elections to vote shares for which no voting instruction has been received from the beneficial owner. This means that the incumbents have lost these votes as a block on which they could count, and which had previously given them a significant advantage in elections. Today, with the amended rule in place, directors at many companies are finding it challenging to reach a majority threshold, as many shareholders, particularly individual investors, often do not bother returning proxy cards in uncontested elections.

Directors who are serving on a board with staggered terms, even if they have not yet received a request to eliminate the different classes, should be considering the appropriate response. In light of the growing prevalence of majority voting, boards should recognize that declassified boards, when coupled with majority voting, can create a recurring risk that the entire board may be voted out in any year, with obvious implications for continuity in the boardroom. The usefulness of a staggered board in defending against a hostile takeover also can be significant and, unlike a shareholder rights plan, or poison pill, which if necessary can be adopted quickly, a classified board generally can only be implemented by a shareholder-approved amendment to the corporation's articles of incorporation.

If the board determines that declassification is advisable (or inevitable), the board may prefer to submit to the shareholders a declassification proposal on terms that are acceptable to the board rather than risk the adoption of a shareholder proposal with less favorable language. Directors may also want to re-assess what other antitakeover devices may be available if a hostile takeover bid is made.

Regardless of whether a company has a staggered board or plurality director elections, boards should remain cognizant that shareholders are giving more attention to the mechanics of electing directors and that this imposes new risks and challenges for which directors should be prepared. ■

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