DEAL LAWYERS

Vol. 5, No. 1 January-February 2011

How to Respond to Shareholder Proposals Seeking Board Declassification

By Philip Stamatakos and Joel May of Jones Day[1]

One of the more challenging situations that a public company can face today is to receive a non-binding shareholder proposal for board declassification. Such proposals, usually made by activist shareholders and supported by proxy advisory firms, present companies with a choice between being responsive to shareholders who demand greater accountability from directors[2] and a stronger voice in corporate affairs or maintaining the company's protection against unsolicited takeover bids.

Classified (or staggered) boards[3] have been the focus of many shareholder proposals in recent years,[4] in part, because the combination of a classified board and a shareholder rights plan creates a strong takeover defense.[5] Classified boards force acquirers to wage and win two separate proxy contests for the election of directors one year or more apart in order to gain control of a company's board.[6] Only after winning a majority of board seats in two separate elections can an acquirer rescind a company's shareholder rights

[1] The opinions expressed in this article are those of the authors and not necessarily those of Jones Day or any of its clients.

[2] See, *e.g.,* Glass Lewis, U.S. Proxy Paper Policy Guidelines: An Overview of the Glass Lewis Approach to Proxy Advice for U.S. Companies (2010) (asserting that "staggered boards are less accountable to shareholders than annually elected boards.").

[3] Classified boards are comprised of directors divided into two or more, but typically three, separate classes, usually with each class having an equal or nearly equal number of directors. In contrast with unified boards in which directors are elected annually, only one class of directors of a classified board is elected each year. Classified boards are typically enabled by state corporate statutes and provisions for their existence usually appear in companies' charters, or less commonly, their by-laws. Effective staggered boards (*i.e.,* those which may not be circumvented): (a) are established in a company's charter (not by-laws, which are susceptible to amendment by shareholders), (b) may not be "packed" by shareholders through charter provisions that permit a shareholders to increase the number of board seats and fill the resulting vacancies and (c) have directors who are not vulnerable to removal as a result of state statutes or charter provisions that permit removal without cause.

[4] In 2009, 63 companies were subject to board declassification proposals. RiskMetrics Group Governance Group Flash Update, *U.S. Season Preview: Takeover Defenses* (March 1, 2010). In 2010, 37% of S&P 500 companies had a classified board, down from 63% in 2000. *Id.* Approximately half of all U.S. public companies, 52% of S&P 1500 companies and 63% of S&P 500 companies have unified boards. RiskMetrics Group, *RiskMetrics Group 2010 U.S. Governance Client Conference Powerpoint Presentation* (2010); *cf.* Erik Krusch, *Proxy Disclosure: Boards Stagger to Declassification*, Westlaw Business Center (March 4, 2010) ("[T]he overwhelming trend in corporate governance has been towards the declassification of boards . . .").

[5] Effective staggered boards almost double the odds of a target remaining independent in the face of a hostile tender or exchange offer. Lucian Arye Bebchuk, John C. Coates IV and Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 Stan. L. Rev. 887 (2002).

[6] Because charters and by-laws of public companies commonly prohibit shareholders from calling special meetings or acting by written consent, hostile acquirers are frequently forced to use proxy contests at a company's annual meeting to replace incumbent directors. Also, under many states' laws, unless a company's charter provides otherwise, directors on classified boards may be removed only for cause, a difficult and time-consuming undertaking, so removing a director through a shareholder vote usually is not practical alternative. *See, e.g.,* 8 Del. C. §141(k)(1); *cf. Rohe v. Reliance Training Network, Inc.*, 2000 WL 1038190, at *3, n. 6 (Del. Ch. July 21, 2000) (describing matters constituting "cause"); *cf.* John Mark Zeberkiewicz & Blake Rohrbacher, *Winning the Class Struggle: Acquirer Strategies for Declassifying Classified Boards*, *Corp. Gov. Advisor*, Jan/Feb 2008 (comparing declassification of boards that are classified through their certificates of incorporation and bylaws).

TABLE OF CONTENTS

DealLawyers.com • P.O. Box 21639 • Concord, CA 94521-0639 • (925) 685-5111 • Fax (925) 930-9284 • info@DealLawyers.com
ISSN 1944-7590

plan, approve a merger, sell key assets or replace management. This delay deters hostile acquirers because it is costly to conduct a takeover battle over such a long time, creates uncertainty about whether the takeover will be successful, provides opportunities for other bidders to emerge and introduces a significant element of business risk as the target's operation of the business during the intervening period may reduce its value to the bidder. Institutional investors and shareholder activists also have targeted classified boards based on the argument that the classified board is a mechanism for entrenching management that depresses stock prices and deters potentially profitable takeovers.[7]

Recent declassification proposals have attracted strong shareholder support.[8] Consequently, how a company responds to a declassification proposal can have important repercussions not only on its ability to defend against a hostile bid, but for the company's shareholder relations, including the balance of power between its shareholders and the board.[9] Some boards are unprepared for the resulting drama that unfolds on the public stage. This article provides an overview of considerations for the board of a company that receives such a declassification proposal.

Obtain Information About the Proponent

After receiving a declassification proposal, a company should assess the nature and size of the proponent's shareholdings, as well as the proponent's level of sophistication, financial resources and objectives.[10] It may be advisable to speak with the proponent shortly after receiving the proposal to learn whether he or she is intent on declassification or would be willing to withdraw the proposal in exchange for a concession on another matter. Although such conversations are often fruitless, they do permit a company to better understand the shareholder proponent's concerns and many boards are be eager to understand the proponent's character, tenacity and motives.

Exclude the Proposal Under Rule 14a-8, if Possible

A company should consider whether it can exclude a proposal from its proxy under Rule 14a-8 of the Securities Exchange Act of 1934 (the "Exchange Act"), which sets forth the list of substantive and procedural bases for which such proposals can be excluded.[11] If the proposal otherwise satisfies the procedural requirements discussed below and the company intends to exclude the proposal for one of the substantive reasons, it must seek a no-action letter from the Securities and Exchange Commission no later than 80 calendar days before it files its definitive proxy statement.[12] In most cases, Rule 14a-8 will not provide a basis for excluding a declassification proposal because the majority of shareholder declassification proponents routinely make such proposals and are careful to comply with both the Rule's procedural and substantive requirements. Nevertheless, a company should carefully examine these requirements determine whether there is a basis for exclusion.

Procedural Bases for Exclusion

The procedural requirements of Rule 14a-8 include, that, to be eligible to submit a proposal, a shareholder must (a) have continuously held at least $2,000 in market value or 1% of the company's securities

---

[7] *See, e.g.,* Jolene Dugan, *ISS, 2007 Background Report: Classified Boards of Directors* (April 2007).

[8] The authors' review of declassification proposals in 2008, 2009 and the first quarter of 2010, revealed that declassification proposals received support from a majority of the shares cast approximately 81% of the time and, on average, 73% of shares voting voted in favor of such proposals.

[9] Some have argued that the central problem presented by a classified board is its restriction on the prerogative of shareholders to remove directors (a corporate governance matter relating to the dichotomy between "director primacy" and "shareholder primacy") and the irrevocable nature of classified boards, an issue that implicates the principle-agent relationship between shareholders and the board. *See, e.g.,* Rivka Weill, *Declassifying the Classified*, 31 Del. J. of Corp. L. 891, 899, 900, 906 (2006).

[10] In recent years, a small number of shareholder activists who hold shares in a large number of publicly traded companies have routinely submitted and have been responsible for a majority of all declassification proposals. One activist, Gerald R. Armstrong, was the proponent in 68 declassification proposals in 2008, 2009 and the first quarter of 2010 and accounted for 54% of all such proposals during that period. *Cf., Activist Profile: Gerald R. Armstrong*, August 12, 2008 at www.sharkrepellent.net/pub/rs)20080812.html.

[11] Shareholders typically do not have the authority under state law to submit a charter amendment directly to the shareholders for a vote. To avoid having a proposal excluded for violating state law, shareholder proponents submit precatory or nonbinding shareholder proposals that, if approved, simply recommend that the board take the necessary action to submit to the vote of the shareholders a charter amendment that declassifies the board. A company must include a precatory proposal that complies with Rule 14a-8 (and is not otherwise properly excluded) in its proxy statement at its own expense. If the proposal is approved by shareholders holding a majority of votes cast, it is considered by proxy advisory firms to have been approved even though the vote will not be binding on the company or the board. *See* Rule 14a-8 under the Exchange Act.

[12] Rule 14a-8(l) under the Exchange Act.

entitled to be voted on the proposal for at least one year by the date the proposal is submitted, (b) hold such securities through the date of the meeting, (c) provide the company with a written statement that the shareholder intends to hold such securities through the date of the meeting, (d) submit no more than one proposal to the company for any particular shareholders' meeting, (e) limit the proposal to 500 words, (f) have delivered the proposal to the company before the deadline for delivery of such proposals (usually not less 120 calendar days before the date on which the company's proxy statement was released to shareholders in connection with the previous year's annual meeting) and (g) appear either personally or through a representative at the shareholders' meeting to present the proposal.[13] Before excluding a proposal based on these procedural requirements, a company must notify the proponent of the deficiency (unless the deficiency cannot be cured) and provide the proponent with an opportunity to cure.[14]

Substantive Bases for Exclusion

If the proponent satisfies the procedural requirements, the Commission may agree to take no action against the company if it seeks no-action relief to exclude the proposal for substantive reasons. The most relevant substantive bases for excluding a precatory proposal are that (a) the company has already substantially implemented the proposal,[15] (b) the proposal duplicates a proposal previously submitted by another shareholder for the same meeting, or (c) the proposal is substantially the same as one previously submitted within the preceding five calendar years and such proposal received poor shareholder support.[16]

Evaluate Whether To Oppose Declassification Initially

If the proposal is incapable of being excluded for the reasons described above, the board should evaluate whether to take no action in response to the proposal, oppose the proposal or propose a declassification resolution and submit the matter to a shareholder vote at the upcoming annual shareholders' meeting.[17] Boards commonly seek to initially avoid declassification by including opposition statements in the first proxy statement that contains the declassification proposal and deferring further board action until the results of the initial shareholder vote are known.[18] Institutioinal Shareholder Services ("ISS") and other proxy advisory firms nearly always recommend that shareholders vote in favor of declassification proposals,[19] and while such proposals generally receive strong shareholder support, the effect of any such recommendations will be highly dependent on the constitution and identity of a company's shareholders.

As an initial matter, a board should take steps to understand the composition of its shareholder base and how its shareholders are likely to vote as this information can be critical to making an informed decision and developing a longer term strategy regarding board declassification. Together with its advisers, a company should consider whether to engage directly with shareholders regarding a declassification proposal. Regulation FD and the proxy rules restrict the ability of public companies to selectively disclose material non-public information or to solicit proxies and votes prior to the filing of a definitive proxy statement. Nevertheless, regular and open communication with shareholders, or the implementation of a carefully constructed shareholder engagement plan upon receipt of a declassification proposal, can provide a company with valuable information regarding the governance views of its shareholders in general and any resistance it might face in particular if the board opposes or continues to oppose board declassification.

---

[13] Rule 14a-8 under the Exchange Act.

[14] A company desiring to exclude a proposal must follow the procedural requirements of Rule 14a-8(f) under the Exchange Act. The company will bear the burden of persuading the Commission that it is entitled to exclude a proposal. Rule 14a-8(g) under the Exchange Act.

[15] If both a company and a shareholder have advanced proposals to declassify a board, the Staff typically grants no-action relief for omitting the shareholder's proposal from the company's proxy because the shareholders' proposal will be deemed to be "substantially implemented" by the company. *See, e.g.,* SEC No-Action Letter re: MeadWestvaco Corporation (available Feb. 13, 2006) (the Staff granted relief to omit a shareholders' proposal where a shareholder proposed immediate declassification and the company proposed phased-in declassification).

[16] Rule 14a-8(i) under the Exchange Act.

[17] In the latter case, the company would need to negotiate with the shareholder proponent to have the proposal withdrawn or seek no-action relief from the Commission based on the fact that the proposal has been substantially implemented.

[18] The authors' review of declassification proposals in 2008, 2009 and the first quarter of 2010 revealed that in only 7% of the cases (nine instances), boards made no recommendations, and in 1.5% (two instances) of the cases, boards supported declassification proposals.

[19] Mutual funds usually vote in accordance with ISS recommendations. James Cotter, Alan Plamiter and Randall Thomas, *ISS Recommendations and Mutual Fund Voting on Proxy Proposals*, 55 Vill. L. Rev. 1, 2, 8 (2010) (finding that mutual funds tend to vote in line with ISS recommendations more often than do all shareholders and more often than with management recommendations, but conceding that there is some question about whether proxy advisory firms lead institutional voting or merely follow existing mutual fund voting attitudes).

Assess the Shareholder Vote and Determine the Company's Response

If a declassification proposal does not receive support from a majority of outstanding shares or, if the company's charter requires a supermajority vote for amendment (as is commonly the case for companies with classified boards) and vote tallies fall short of the number of votes that would be needed (if the vote was binding) to amend the charter, the board may elect to take no action and wait to see whether the proponent resubmits a declassification proposal at its next annual shareholders' meeting. The company may wish to use these tools during the period following the vote but prior to the receipt of a subsequent shareholder proposal to canvas the views of its shareholders, to persuade its shareholders to support management's position or to simply demonstrate responsiveness and enhance support generally for management and the board.

In most cases, however, shareholders strongly back non-binding declassification proposals.[20] If a proposal receives the support of a majority of votes cast and the company's board does not submit a declassification proposal to a binding shareholder vote at the next annual meeting (or otherwise take steps to declassify the board), the proponent shareholder can be expected to re-submit the proposal in the next and subsequent proxy seasons.[21] Boards faced with such results typically decide to either take no action in response to the proposal or submit a resolution recommending that the company's shareholders vote at the next annual shareholders' meeting to declassify the board. A board's decision is often informed by (a) its assessment of whether proxy advisors will recommend "withhold votes" against the company's directors and the affect of such a vote, (b) its view of the shortcomings and merits of classified boards, (c) how the company's takeover defense posture would be affected by declassification, and (d) whether the company has plurality or majority voting for the election of directors or provides for cumulative voting. These considerations are discussed below.

Consider the Consequences of "Withhold Votes" and the Erosion of Shareholder Support

If a company's board fails to submit a proposal on declassification at the following annual shareholders' meeting, then one or more proxy advisors may recommend a "withhold vote" against the directors who opposed declassification. ISS' policy is to advocate withhold votes against an entire board (except for new nominees who are considered on a case-by-case basis) if the board fails to propose declassification following a shareholder proposal that receives approval by (a) a majority of the shares outstanding the previous year or (b) a majority of the votes cast for the previous two consecutive years.[22] Although some other proxy advisors for institutional investors do not issue withhold vote recommendations as a matter of policy, it is possible that they may nevertheless recommend withhold votes in a particular circumstance.[23]

If the company's directors are elected by plurality voting, "withhold votes" for any class of directors standing for election will not prohibit their reelection to the board and the board may simply consider whether their effect on shareholder relations weighs in favor of submitting its own proposal for declassification. However, a significant number of "withhold" votes could signify an erosion of shareholder support for the board and the company's management. If the company's directors are elected by majority voting, a "withhold" vote recommendation from proxy advisors could mean that the company's directors incur a significant risk of not receiving the votes necessary for their reelection at the company's next annual

---

[20] *Supra,* note 8.

[21] For example, nine of the companies that reported majority support (based on either shares outstanding or shares cast) for a declassified board proposal in 2009 were the subject of a board declassification proposal for at least two consecutive years. A declassified board proposal appeared in the proxy statement of The Stanley Works every year from 2003 to 2009, Boston Properties Inc. every year from 2004 to 2009 and Pulte Homes Inc. and McGraw-Hill Companies every year from 2006 to 2009. In 2009, board declassification proposals for 35 companies received support of at least a majority of the votes cast. Georgeson, *2009 Annual Corporate Governance Review* (2009).

[22] Based on a sampling of ISS recommendation reports, ISS has followed this policy in all but one case in the 2008 and 2009 and the first quarter of the 2010 proxy seasons. One must question a monolithic "one-size-fits-all" approach to governance in light of recent empirical evidence that reflects that there is no consistent relationship between scores on governance indices and measures of corporate performance. Sanjai Bhagat, Brian Bolton and Roberta Romano, *The Promise and Peril of Corporate Governance Indices*, 108-8 Colum. L. Rev. 1803, 1857 (Dec. 2010) (concluding that, of all the measures of governance quality evaluated in one study, only directors' stock ownership was related to various performance measures, profitability and disciplinary management turnover as a result of poor performance).

[23] Fidelity's FMR Investment Proxy Research and Glass Lewis generally support proposals to repeal classified boards. While it is FMR's policy to vote in favor of incumbent and nominee directors except where they clearly appear to have failed to exercise reasonable judgment, FMR's policy does not specifically address withhold votes for directors based on their failure to act on a shareholder proposal that received majority support. Similarly, Glass Lewis & Co.'s general policy is to vote for the election of directors, but will recommend a withhold vote in a number of specific situations, none of which is failure to act on a shareholder proposal that received majority support in the past.

meeting.[24] This risk is frequently sufficient to induce a board to recommend that shareholders approve declassification.[25]

The board also should consider whether its failure to recommend declassification could induce its shareholders to reject upcoming board proposals on important compensation or operational matters, including proposals to increase the number of authorized shares, approve a stock incentive plan or issue shares in a merger, or, of less concern, cause shareholders to vote "no" on non-binding "say on pay" matters. In addition, the board should consider whether a hedge fund or other insurgent might take advantage of the resulting strained relations between shareholders and the board during the pendency of an unsolicited bid. Finally, the board should consider whether refusing to submit a declassification proposal will induce shareholders to nominate their own directors in a proxy contest.

Understand the Arguments For—and Against—Classified Boards

Opponents of classified boards typically support their position with the following arguments:[26]

- Directors serving on classified boards are less accountable to shareholders. Because classified boards protect the incumbency of current directors, the incumbency of current managers appointed by such directors is also protected.[27] Conversely, the annual election of directors allows shareholders to approve or disapprove of the performance of an individual director or the entire board every year, thus fostering greater accountability.
- Classified boards deter potentially attractive acquisition proposals. Some studies have concluded that, because board classification deters potential acquisitions, classification can lead to lower takeover premia in friendly acquisitions and lower shareholder value, both in the long- and short-term.[28]
- Although some more recent studies contest these conclusions,[29] and other studies have found significant association between classified boards and higher takeover premia, institutional

---

[24] Under a majority voting standard, in an uncontested election, a director must receive a majority of the votes cast in his or her election to be elected. Non-votes and withhold votes are not counted in the election. In a contested election, plurality voting applies. A new director nominee will not be elected in an uncontested election if he or she does not receive the required majority vote. In the case of an incumbent director nominee, if the director does not receive the requisite vote for re-election, a "failed election" occurs, and the director would not be elected to a new term. The incumbent director would continue, however, to serve as a holdover director until his or her successor is elected and qualified. A majority voting standard is typically coupled with a resignation bylaw under which a holdover director would tender a conditional resignation for consideration by the board of directors. Accordingly, this approach ensures that even in a failed election, the board would have the ability to reject the holdover director's tendered resignation and allow that director to continue to serve as a holdover director. Activist shareholders generally support majority voting provisions because directors must actively receive a majority of the votes cast in their election every year, instead of just receiving more votes than other candidates for a seat. Activist shareholders have become increasingly willing to withhold votes for directors to influence the ultimate selection of a director or, at a minimum, to demonstrate displeasure with a board. For this reason, majority voting is more risky for incumbent directors and those nominated by a company than plurality voting.

[25] *See, e.g.,* John F. Olson et. al, *Excerpt from Recent Developments in Federal Securities Regulation of Corporate Finance as of August 30, 2004*, Practicing Law Institute (Nov. 2004) ("the pressure of majority votes on shareholder resolutions [to declassify] played a significant role in getting companies to [declassify in 2004].")

[26] *See generally,* Jolene Dugan, *supra,* note 7.

[27] *But see* Thomas W. Bates, David A. Becher and Michael L. Lemmon, *Board Classification and Managerial Entrenchment: Evidence from the Market for Corporate Control*, Journal of Financial Economics (2008) vol. 87, issue 3, pages 656-677 (citing empirical evidence that classified boards neither entrench managers in the context of a takeover nor facilitate management self-dealing in competing bids) (hereinafter "Bates, Becher and Lemmon").

[28] *Cf.* Lucian A. Bebchuk and Alma Cohen, *The Costs of Entrenched Boards*, J. of Fin. Econ. (Nov. 2005) (presenting evidence that staggered boards reduce firm value); Michael D. Frakes, *Classified Boards and Firm Value*, 32 Del. J. of Corp. Law 113 (2007) (finding evidence of a negative and statistically significant association between classified boards and company value); Morgan J. Rose, *Heterogeneous Impacts of Staggered Boards By Ownership Concentration*, J. Corp. Fin. (Feb. 2009) (concluding that staggered boards have no significant negative effect on market value in firms with a low probability of receiving an unsolicited bid, but are associated with decreases in value as the probability of a hostile bid increases); *but see* Seoungpil Ahn, Vidhan K. Goyal and Keshab Shresthat, *Differential Effects of Classified Boards on Firm Value*, preliminary draft (Apr. 2009) at http://www.business.smu.edu.sg/disciplines/finance/Research%20Seminars/papers/VidhanGoyal_27Apr09.pdf (concluding that classified boards increase firm value for firms that have low monitoring costs and high advising requirements).

[29] *See, e.g.,* Lynn A. Stout, *Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem*, 55 Stan. L. Rev. 845 (2002) (arguing that takeover defenses allow directors to provide extra-contractual benefits to executives and employees who in turn make extra-contractual contributions that benefit shareholders, and arguing that ex post costs of classified boards tell us little about whether takeover defenses are good or bad for target shareholders; ex ante costs and benefits must be considered also); Bates, Becher and Lemmon (concluding that the empirical evidence is inconsistent with the conventional wisdom that board classification is an anti-takeover device that facilitates managerial entrenchment).

investors and their advisors have continued to support board declassification and often view a board's failure to pursue declassification as a sign that the goals of the board are not aligned with those of shareholders.

Supporters of classified boards argue that such boards provide companies and their shareholders with several benefits[30] and they dispute some of the studies and empirical data cited in support of unified boards:[31]

- Classified boards offer stability and continuity to a company's board of directors and allow the board and management to focus on long-term shareholder interests.[32]
- Classified boards provide a degree of "institutional memory" that boosts shareholder value.
- Staggered boards are an important and effective takeover defense if paired with a poison pill and incentivize hostile acquirers to negotiate with the target's board.[33]
- Recent studies have concluded that board classification allows a company's managers to negotiate vigorously with acquirers, thereby increasing the incidence of multi-bid auctions, and resulting in a larger proportional distribution of total bid surplus for target shareholders. This is consistent with studies based on data from the 1990's that show that companies with poison pills receive higher stock price premia in takeovers.
- The evidence does not suggest that managers of companies with classified boards are more likely to engage in self-dealing in connection with takeovers, thus raising doubts about arguments that board classification generally insulates management from accountability.[34]

Evaluate the Company's Takeover Defenses

In considering how to respond to a proposal, a board should understand the effect of declassification on a company's takeover defenses. As discussed above, if the company has an effective classified board and a shareholder rights plan in place (or a "shelf pill" ready for implementation), then its defensive posture is formidable, but declassifying the board will significantly weaken its defenses generally regardless of other takeover defenses at its disposal.[35]

When assessing the company's post-declassification vulnerability, the board may consider, among other things, the takeover activity in the company's peer groups, the prospects, size and strength of the company relative to its competitors, the company's other takeover defenses, the number and nature of credible acquisition overtures the company has received in recent years and whether those overtures might have resulted in a proxy contest if the company had a unified board.

---

[30] *See* generally, Richard H. Koppes, Lyle G. Ganske and Charles T. Haag, *Corporate Governance Out of Focus: The Debate Over Classified Boards*, 54 Bus. Law 1023 (1998-99);

[31] *See, e.g.,* John C. Wilcox, *Two Cheers for Staggered Boards*, Corporate Governance Advisor (Nov./Dec. 2002).

[32] By ensuring that the entire board of directors may not be replaced at a single shareholders' meeting, classification increases the stability of a company's leadership structure and discourages drastic changes based on overreactions to recent or one-time events and pandering to the needs of hedge funds and day-traders for short-term results at the expense of the company's long-term strategic objectives. *But see* Olubunmi Faleye, *Classified Boards, Firm Value and Managerial Entrenchment*, J. of Fin. Econ. (2006) (concluding that classified boards have no significant effect on board turnover, *i.e.,* do not promote board stability, and that classified boards significantly insulate management from market discipline, thus suggesting that the observed reduction in value is due to managerial entrenchment and diminished board accountability).

[33] *See* Bates, Becher and Lemmon at 673 (classified boards, the authors concluded, are effective in deterring hostile bids. Controlling for other factors, the authors concluded that a classified board statistically reduces the likelihood of a takeover bid by 1.0%, which the authors found to be statistically significant given that the average annual takeover bid rate is 3.6% for companies with classified boards. The authors demonstrate that, once a bid has been initiated, targets with classified and unified boards are about equally successful in remaining independent.)

[34] *Id.* (citing evidence that classified boards neither entrench managers in the context of a takeover nor facilitate management self-dealing in competing bids).

[35] Even if the company has other charter and by-law provisions typically characterized as takeover defenses (including, for example, blank check preferred stock, plurality voting in director elections, the board establishes the number of directors and fills vacancies, shareholders may remove directors only for cause, supermajority shareholder vote to remove directors, shareholders cannot call a special meeting, shareholders must provide advance notice of proposed business at shareholders' meetings, shareholders cannot act by written consent, locked-in charter and by-laws (amendment by supermajority shareholder vote), adoption of mergers by supermajority shareholder vote and provisions enabling share repurchases), unless the company can pair a shareholder rights plan with a classified board, such provisions are not likely to prevent a determined bidder from acquiring the company. At most, they will delay a takeover or make a takeover more costly and time-consuming for the acquirer.

Make Declassification Contingent on the Elimination of Cumulative Voting for Directors, if Applicable

When a company with cumulative voting for directors declassifies, it risks magnifying the voice of minority shareholders unless it simultaneously replaces cumulative voting with plurality voting for directors.[36] Under a cumulative voting scheme, shareholders vote a total number of shares equal to the number of their shares multiplied by the number of board seats to be filled, and shares may be aggregated and voted for one director or spread among numerous directors.[37] Thus, cumulative voting makes it easier for minority shareholders, whether individually or as a group, to elect one or more representatives to a board and makes a company considerably more vulnerable to shareholder activism and unsolicited bids.[38]

Declassification increases the number of directors up for election in any given year and therefore permits a minority shareholder to cumulate its votes in favor of one or more directors, effectively increasing the likelihood that a nominee it favors will be elected to the board. Consequently, when the boards of companies with cumulative voting for directors submit a declassification proposal to shareholders, the proposal is often paired with a proposal to eliminate cumulative voting.[39]

Further Thoughts

If a board decides not to declassify, it should be prepared to reassess its decision annually in response to future declassification proposals. Depending on its circumstances, a board may ultimately resolve to declassify when, in its judgment, the costs of maintaining a classified board outweighs the benefits. If the board decides to declassify,[40] it may declassify immediately so that upon the effectiveness of its charter amendment all directors are elected annually, or it may phase-in its declassification over a period of time (*i.e.,* each year, one class would be eliminated).[41]

Conclusion

As discussed above, boards that face a board declassification proposal can pursue a number of different alternatives, including supporting immediate declassification, opposing declassification both before and after a shareholder vote, and initially opposing a declassification proposal and later supporting the proposal if it receives strong shareholder support. The alternative selected by a board will depend on the facts and circumstances faced by the company, including, for example, the nature of the company's shareholder base, its vulnerability to a takeover, whether the company has majority voting for the election of directors and the board's willingness to endure potential withhold vote campaigns in subsequent elections. Many boards initially oppose declassification but, if shareholders approve declassification by a sufficient margin (which many boards assume will be the case), those same boards are willing to support declassification at the company's next annual shareholders' meeting. This approach ensures that the board will be classified for a year after the shareholder vote on the non-binding declassification proposal, and permits a board to be ultimately responsive to its shareholders.

---

[36] Plurality voting is recognized as the safest option for incumbent directors and those nominated by a company because each director needs to receive just enough votes to defeat any challengers (even if such number is fewer than a majority of votes cast), and incumbent directors generally garner strong support from shareholders. In an uncontested election, a nominee needs to obtain only one vote to win the seat.

[37] Cumulative voting represents a significant weakness in a company's takeover defenses because it may facilitate the election of candidates nominated by an insurgent shareholder who, once elected, can exert influence over the remaining directors or generally disrupt the effective operation of the board.

[38] For example, if the company has nine board seats and directors are classified into two classes with three directors each and one class with four directors, in a year when a class of three directors stands for election, a shareholder or group of shareholders must hold more than 25% of the company's shares to ensure that such shareholder or group is able to elect one director to the board. By contrast, if the company had nine board seats and all directors are elected annually, then a shareholder or group of shareholders need only hold more than 10% of the company's shares to ensure that such shareholder or group would be able to elect one director to the board.

[39] *See, e.g.,* Definitive Proxy Statement on Schedule 14A of Qualcomm Inc., filed with the Commission on January 12, 2006 (coupling a declassification proposal with a proposal for plurality voting and making declassification contingent on the replacement of cumulative voting with plurality voting).

[40] *Cf.* Mira Ganor, *Why Do Managers Dismantle Staggered Boards?*, 33 Del. J. Corp. L. 149 (2008) (finding statistically significant evidence that the likelihood of destaggering increases due to precatory shareholder declassification proposals and the number of unvested options held by a company's CEO).

[41] *See* John Mark Zeberkiewicz and Blake Rohrbacher, *Destaggering with Class: A Plan for Potential Targets in Troubled Times*, Deal Lawyers (Nov.-Dec. 2009) (describing a method for declassifying over time so that the incremental takeover protection of a staggered board is preserved for the maximum period possible).