An Unusual Boardroom Battle, in Academia

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By Andrew Ross Sorkin
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A normally academic question about corporate governance has erupted into a nasty, often personal battle among elite professors, regulators and white-shoe lawyers that has raised the suggestion of securities fraud on one side and abuse of authority on the other.

At the heart of the dispute is an academic paper written last month by Daniel M. Gallagher, a member of the Securities and Exchange Commission, and Joseph A. Grundfest, a professor at Stanford Law School and himself a former S.E.C. commissioner, that was titled "Did Harvard Violate Federal Securities Law? The Campaign Against Classified Boards of Directors."

The paper took aim at Lucian A. Bebchuk, a Harvard Law School professor who has long researched corporate governance issues and has been an outspoken advocate for increased democracy in corporate America's boardrooms. Through Harvard's Shareholder Rights Project, a group he created, Mr. Bebchuk, on behalf of public pension funds, has helped wage proxy contests at 129 companies to change policies that prevent shareholders from electing, or overthrowing, an entire board at once.

Many companies have such policies — known as staggered, or classified, boards — which usually mean that only about a third of their directors come up for election in any year.

Advocates for staggered boards say they create continuity and are an effective defense against a rival company — or activist investor — that tries to take over a company through a proxy contest without paying a premium to shareholders. Opponents like Mr. Bebchuk say such a mechanism silences shareholders, entrenches management and makes it less likely that suitors or activists will emerge, depressing valuations.

At the moment, Mr. Bebchuk appears to be winning the argument. Corporations have been dropping their staggered board structure in droves. Only about 60 companies in the Standard & Poor's 500-stock index had staggered boards in 2013, down from 300 in 2000, an 80 percent drop, according to the Gallagher-Grundfest paper.

Mr. Gallagher and Mr. Grundfest suggest that companies are dropping their staggered board structures — and shareholders are voting to eliminate them — based, in part, on faulty research by Harvard's Shareholder Rights Project. Worse, they suggest, Mr. Bebchuk's project committed fraud by not fully disclosing the extent of contradictory research, which they say is a "material omission" by S.E.C. standards.

"It takes some fancy footwork even to argue that the Harvard Proposal, with its glaring omissions, complies with S.E.C. regulations," Mr. Grundfest wrote in a blog post in response to an attack on the paper from a Yale law professor, Jonathan R. Macey.

Harvey Pitt, a former S.E.C. chairman, weighed in over the holidays: "When arguments made by proponents in support of their shareholder proposals rely upon studies and statistical analyses they claim demonstrate the positive attributes of the proposal, it is misleading not to indicate the existence of studies and statistical analyses that reach the opposite conclusion." He continued: "A single violation can seriously harm investors; seven is extreme and reflective of recidivism; and 129 is cause for alarm and effective action."

That's one side of the debate. But before delving into the specifics of that question, there's the fundamental issue of whether a sitting member of the S.E.C. should be writing such an incendiary paper in the first place.

Robert J. Jackson Jr., a professor at Columbia Law School, said he was shocked when he read the paper. "All should agree that it is wildly inappropriate for a sitting S.E.C. commissioner to issue a law review paper accusing a private party of violating federal securities law without any investigation or due process of any kind. This is a striking, and as far as I know unprecedented, departure from longstanding S.E.C. practice," he wrote in an email.

"Imagine if a sitting S.E.C. commissioner wrote a law review article accusing Goldman Sachs of violating federal law without any S.E.C. investigation of the matter — Goldman and their counsel would quite rightly be outraged."

Robert B. Lamm, a securities and corporate governance lawyer, wrote on his blog about Mr. Gallagher: "If he really thinks that there's a violation here, perhaps he should have whispered in the ear of the enforcement division that it might want to look into this. Instead, he's behaving somewhat like a bully."

And then there's Mr. Bebchuk. He's furious for obvious reasons. Perhaps in a nod to the decorum of academia, Mr. Gallagher and Mr. Grundfest never identified Mr. Bebchuk in their paper — they referred only to the Shareholder Rights Project — but their target was clear.

"The paper's spurious allegations are unworthy of a sitting S.E.C. commissioner and a former commissioner," Mr. Bebchuk, who learned about the paper the night before it was published, said in an email. "I was also surprised that the authors chose not give me an opportunity to correct the paper's reckless factual and legal errors."

Mr. Gallagher, through a deputy, said he was unavailable to comment. Mr. Grundfest said his various online postings on the topic speak for themselves.

When I asked Mr. Pitt if he thought it unworthy of Mr. Gallagher to publish the paper, given his job, he said: "Who better than a sitting commissioner — especially one as thoughtful and substantive as Dan Gallagher — to raise the issue." He added, "This has been done from the beginning of the S.E.C.'s existence."

He cited the example of a paper about "going private" transactions during the tenure of the former S.E.C. Chairman Ray Garrett Jr. Another commissioner, Al Sommer, suggested that those engaging in such deals were violating federal securities laws and that the S.E.C. should pursue those who made little in the way of meaningful disclosure.

“Ray wasn’t all that thrilled with Al’s public diatribe against completed going-private transactions,” Mr. Pitt said, “but the S.E.C. nonetheless thereafter adopted rules designed to govern the process of going private by public companies.”

Beyond the debate about Mr. Gallagher’s actions is the question of the paper’s actual merits.

Matt Levine, a writer for Bloomberg View, described it as “loony.” Stephen M. Bainbridge, a law professor at the U.C.L.A. School of Law, wrote on his blog: “My take is that Gallagher and Grundfest went way over the top on this one.” Even Mr. Pitt said he viewed the title “as tongue-in-cheek.”

Those who side with Mr. Bebchuk say it is ridiculous to believe that someone advocating a position could be accused of committing fraud by not fully articulating the opposing side’s argument. And even then, they argue, the opposing research is not conclusive, nor was it all published at the time the proxy material was. (There’s a bit of a technical and legalese argument embedded in the paper, but that’s not worth getting into here.)

On the other side are people like Martin Lipton, the lawyer who founded Wachtell, Lipton, Rosen & Katz and has fought against shareholder activists and hostile bids, suggesting that they are all too often focused on the short term.

“Legalities aside, it is unfortunate and wrong that a major American university has allowed its name to be invoked in a tendentious, unacademic and quasi-political campaign against staggered boards,” Mr. Lipton wrote in a note to clients. “If nothing else, the commissioner’s article makes a persuasive showing that the scholarship claimed to underlie the Harvard campaign is bogus, or at best one-sided.”

There are many opposing views on the paper. But here’s one way to think about it: It was a bad precedent for Mr. Gallagher to involve himself in a paper that raises the possibility of fraud in the field he regulates without the due process of a legal complaint. Mr. Grundfest could have written this provocative paper on his own, though it might not have attracted the same amount of attention within the industry.

As for the paper itself, Mr. Gallagher and Mr. Grundfest may have legitimate complaints about Mr. Bebchuk’s presentation of his scholarship, but it is a technicality at best and unlikely to change the outcome of any of the elections. Still, the paper serves as an important reminder of the need for truthful research and disclosure to shareholders on these complex important issues.

Almost lost as collateral damage is the central question of whether staggered boards benefit or hurt shareholders. It should continue to be pursued as the smoke clears.