Declassification: Florida Strikes Back at Entrenched Corporate Boards

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While other shareholder activists have taken on CEO pay not tied to performance and the responsible (or irresponsible) directors who approve it, Florida's state pension fund has quietly made unprecedented progress in making all directors accountable to shareholders on an annual basis. The **Florida State Board of Administration** (FSBA), the $158.9 fund administered by the state for pensions and other purposes, has announced that seven major companies have agreed to eliminate their classified boards.

Instead of electing directors to staggered three-year terms so that only a third of them are put to a vote each year, the companies have agreed to switch to annual election of the entire board. Working with the American Corporate Governance Institute (ACGI), headed by **Harvard Law School** professor **Lucian Bebchuk**, FSBA has withdrawn shareholder proposals in exchange for a promise to switch to annual election at:

- **Biogen Idec** (BIIB)
- **Dean Foods** (DF)
- **E*Trade** (ETFC)
- **Fiserv** (FISV)
- **National Oilwell Varco** (NOV)
- **NVIDIA** (NVDA)
- **Ross Stores** (ROST)

The **Nathan Cummings Foundation** also worked with ACGI to get agreements from six more companies to switch to annual election of directors. It is especially impressive that these companies capitulated even though these were first-time proposals at each of them. Normally, it takes a strong slowing of shareholder support before a company will agree to a significant change.

The Rise and fall of classified boards

Classified boards were widely adopted during the takeover era of the 1970's and 80's, when new categories of bonds made it possible to finance previously unthinkable hostile takeovers by **Gordon Gekko** types. As they began to run their own candidates for the board, companies moved to make sure that it would take at least two years for dissidents to gain a majority.

By 1998, one study found that 59 percent of major companies had directors with staggered terms. Management called classified boards "protection." Shareholders called them "entrenchment."

Supporters argue that they provide continuity and may even protect directors who might worry about being tough on the same CEO who was making the decision to re-nominate them every

year. Some activists found that companies with classified boards were more vulnerable to a proxy contest because nominating candidates for only a minority of the board seats in a given year is an easier sell to other investors.

It was unquestionably easier to get the support of powerful proxy advisory firm **Institutional Shareholder Services**, which looked favorably on proxy contests for a few seats rather than the whole board.

But shareholders do not like them and the academic studies of their impact on shareholder value and effective board oversight bears them out. A 2006 study by **Olubunmi Faleye** of Northeastern University found that classified boards are bad for shareholder value, provide no discernible benefits in director performance, and "significantly insulate top management from market discipline." In 2003, there were 56 shareholder proposals calling for an end to classified boards, gaining as much as 85 percent of the vote.

Companies capitulated, and today, just over ten percent of the S&P 500 have classified boards, including **McDonald's**, **Capital One Financial**, **Dun & Bradstreet**, and **United States Steel**. Florida may be shining some sunlight on them next year.