Dancing Delicately in Delaware:

Wilmington's balancing act continues as corporations and shareholders face off, and examining the merits of outsiders as CEOs.

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Since the 2002 passage of Sarbanes-Oxley, Delaware's courts and legislature have delicately danced between two camps -- critics who claim that the state's law is too tilted toward corporations and Wilmington lawyers who argue that it's fine as is and fear that a more shareholder-friendly regime would drive their clients to other jurisdictions. The balancing act continues in two recent pieces of law, one an amendment to the statute setting out the state's corporate law, the other a case.

Over the past few proxy seasons, shareholder activists have lobbied companies to mandate that would-be directors win at least a majority of shares cast to secure a seat on the board, a change from the Delaware default rule of plurality voting. Led by Pfizer Inc., about 150 companies have adopted policies that would implement the shareholders' wish, but even most of these corporations have steadfastly declined to change their bylaws, in part because of concerns about the mechanics of succession in cases where a director fails to receive a majority.

The state's legislature recently tweaked the statute to assuage those concerns and to provide that a board may not alter or repeal a shareholder-adopted bylaw that provides for majority voting. With the changes, which will become effective Aug. 1, Delaware seems to be following the lead of Pfizer and other companies that view majority voting as inevitable and therefore capitulate rather than battle the shareholder activists.

In client memos, New York's Cleary Gottlieb Steen & Hamilton LLP and Wachtell, Lipton, Rosen & Katz both suggest that the changes in the Delaware law will hasten the adoption of majority voting, a standard with which corporations will be stuck whether they like it or not. Cleary even proposes that a company wishing to avoid a shareholder proposal and accompanying debate on the issue should just propose the bylaw amendment itself.

In Lucian Bebchuk v. CA Inc., Vice Chancellor Stephen Lamb studiously declined to rule on the legality of a bylaw that seeks to limit the CA Inc. board's ability to keep a poison pill in place because shareholders of the Islandia, N.Y., computer products distributor had not yet approved it. CA has resisted putting the proposal on its ballot, claiming that such a bylaw would be illegal under Delaware law. Lamb held that Bebchuk, a Harvard Law School professor and longtime critic of poison pills, could pursue his case before the Securities and Exchange Commission or in the federal courts. The extent to which shareholders may bind a board by passing bylaws has been a key bone of contention between shareholder activists and corporations.

CA and its lawyers at New York's Sullivan & Cromwell LLP and Richards, Layton & Finger PA in Wilmington argued that the Delaware statute on the point clearly gives the board the absolute right to set the terms of a poison pill unless shareholders vote to change the company's charter. Lamb declined to address that point, instead offering a few anodyne comments on the issue that several attorneys said were not of great consequence.

One New York lawyer's terse analysis of Lamb's decision: "Punt-orama."

Last month, we wrote about recent academic research on executive compensation (see "Comp romp," June 12). That consideration of CEO pay perhaps inevitably led to a more basic question: How much do CEOs really matter? After all, the companies they run are large, complex, far-flung bureaucracies whose inhabitants often strive to be impervious to pressures from those above them.

That resistance to change may be why boards and investors have increasingly preferred outsiders to insiders as CEOs. According to a paper by Kevin Murphy and Jan Zabojnik at the University of Southern California, in the 1970s, 14.9% of new CEO appointments at large U.S. public companies were outsiders, a figure that rose to 17.2% in the 1980s and 26.5% in the 1990s. Those figures correspond with the increase in the number of outside directors on boards. In a 1996 paper, Kenneth Borokhovich, Robert Parrino and Teresa Trapini found that the higher the percentage of outsiders on a board choosing a new CEO, the more likely the CEO was to come from outside the company, a trend that Parrino, a professor at the University of Texas, says has continued.

And just as shareholder activists such as Institutional Shareholder Services Inc. have pushed for outside directors, shareholders themselves tilt toward outside CEOs. The market reacts positively when a board replaces an underperforming CEO with an outsider, Parrino says, noting that in another paper he and fellow academics Mark Huson and Paul Malatesta found that the firm's operating performance tends to improve.

The trio didn't attempt to measure the performance of such firms' stock under the new CEOs in their 2004 paper because of the inconclusiveness of such data, given the changes that outside CEOs often implement at troubled companies. "I wouldn't bet anything on the sort of numbers you get when you do that analysis," Parrino says. "It's very difficult to measure those effects accurately." And thus to conclude how much value an outside CEO should be expected to add to his new firm.

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