

More Board Elections Mean Easier Targets for Icahn

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Billionaire corporate raider Carl Icahn is getting some help from his institutional investor brethren.

As recently as 2000, almost two-thirds of America's biggest companies maintained a controversial policy that discourages hostile takeovers and limit the kinds of investor insurgencies Icahn and others have conducted at dozens of U.S corporations.

The policy -- known as a staggered or classified board -- typically means that every year only a third of the corporation's directors come up for election. Many companies put it in place to block Icahn-types from swooping in and taking over corporations they oversee by having dissident slates of director nominees replace CEO-backed incumbent boards.

However, years of efforts by labor-backed pension funds and other types of money managers has driven up the number of large cap S&P 500 companies who chose to declassify and have their directors elected annually.

Not coincidentally, Icahn's most recent targets -- Forest Laboratories and Clorox, where he is seeking to install himself and 10 other candidates, -- both have declassified boards.

Proxy advisory firm Institutional Shareholder Services reported this month that as of June, less than a third, or 31%, of S&P 500 companies have classified boards. That's down from more than half of S&P 500 companies with classified boards in 2005 and 63% in 2000, according to ISS.

Also, recent shareholder votes on investor proposals to break up classified boards and have directors elected annually have received surprisingly large backing so far in 2011. Shareholder resolutions on this topic averaged 74% support this year, up more than 12 percentage points from 2010, and declassification proposals won majority support at 22 large capitalization companies in 2011, ISS reports.

Francis Byrd, a vice president at governance advisory firm Laurel Hill, said times have changed from the 1990s when there was much less support for declassification proposals and they almost never won the backing of a majority of investors.

Governance observers say the increasingly popular annual election policy is driving a transforming relationship between boards, institutional and activist hedge fund investors.

"With annual election of boards, each director is more susceptible to pressure from investors," said ISS counsel Ted Allen.

Harvard Law School Professor Lucian Bebchuk, a leader in efforts to declassify boards, cites a study he conducted that found classified boards are associated with lower firm valuation.

“The negative view of classified boards is consistent with empirical studies suggesting that classification could be associated with lower firm value and worse corporate decision-making,” he said.

However, proponents say the director election provision is important so that executives can focus on their business without interference and, when faced with hostile buyers, negotiate deals that they believe are in the best interest of shareholders.

“Classified boards give managers and directors the ability to manage companies with some board continuity without worrying about short term risks and having to be elected,” said MacKenzie Partners vice president Paul Schulman. “It is clearly also an anti-takeover device.”

Indeed, some unclassified boards recently have experienced insurgencies and takeover attempts.

Icahn lost a showdown Aug. 18 with pharmaceutical company Forest Labs. Icahn -- a 9.2% investor -- nominated four candidates to the unclassified 10-person board, but didn't receive the backing of ISS. Icahn then on Friday filed with the Securities and Exchange Commission to install himself and 10 other directors to the 11-member Clorox board. Insurgent David Portnoy, a 5.6% holder of Cryo-Cell International Inc., is seeking five seats on the company's declassified board on Thursday.

Institutions take action

Part of the reason why declassification proposals have fared so well lately may be due to a new collaboration taking place between Harvard professor Bebchuk and investors including the Florida State Board of Administration, a public pension fund with \$156 billion in assets.

The Florida fund, working with an organization formed by Bebchuk -- the American Corporate Governance Institute -- received an average of 84% support for declassification proposals at six companies in 2011. That includes 77% at McDonald's Corp. and 91% at Pioneer Natural Resources Co.

In addition, the Florida fund withdrew its proposals at seven other corporations after their boards agreed to put management-backed declassification proposals up for a vote before shareholders. These received an average of 99% support at four of the companies so far. One firm, Biogen Idec Inc. (NASDAQ:BIIB) agreed to immediately declassify their board after their vote.

Laurel Hill's Byrd said Bebchuk's legal and governance expertise is useful for a fund like Florida State that has an interest in declassification but may not have the resources to conduct an investor campaign.

“Being able to team up or outsource activities with an adviser they trust who has a philosophy on governance they believe in can be very helpful,” Byrd said.

Another Florida-fund target, visual computing technologies company NVIDIA Corp., agreed to a staggered declassification of its board over four years, with two directors up for annual election in 2011, three in 2012, six in 2013 and all eight in 2014.

A number of companies have agreed to similar staggered declassification, a delay that governance experts insist is unnecessary.

NVIDIA spokesman Robert Sherbin defended the strategy, arguing it is less disruptive and allows elected directors to serve their full terms. Some investor relations officials insist the approach is necessary to meet Delaware law requirements for existing directors to fulfill their three-year terms.

However, Charles Elson, director of the corporate governance center at the University of Delaware, says if directors consent to an immediate declassification it does not go against Delaware law. He says there is no practical difference in the operation of boards that are declassified and that an annual election is necessary to keep boards accountable.

“There is no benefit to gradual declassification,” he said.

Activist declassifiers

E*Trade Financial Corp. also was the target of both the Florida state fund and hedge fund Citadel LLC. The online brokerage firm struck a deal with the Florida fund in April to put a staggered declassification proposal up for a vote at the company’s 2012 meeting. With that proposal the full board couldn’t be elected annually until 2014, an approach that Citadel insisted indicated the company lacked urgency. In a July 25 letter, the activist company, which was pressing for E*Trade to consider a sale, sought a more immediate board declassification.

“It appears that the board would rather talk about accountability to shareholders than take steps to create it,” said Citadel chief legal officer Adam Cooper.

Citadel relented after E*Trade agreed to make other changes, including hiring Goldman Sachs Group Inc. to look into strategic alternatives.

Nevertheless, declassification proponents say annual director elections are not always about hostile takeovers of boards. Jacob Williams, Governance Manager at the Florida State Board of Administration, says annual elections ensures a more direct a relationship between investors and directors.

“With a classified board, entrenchment can occur,” he said. “The three-year election cycle does create a disconnect between director performance and accountability to share-owners.”

Another major driver of declassification in 2011 so far has been the Nathan Cummings Foundation, which also worked with Bebchuk and the ACGI.

Declassification proposals put forth by the Cummings Foundation were supported overwhelmingly at Western Union Co., C.H. Robinson Worldwide Inc. and Hudson City Bancorp. Inc. After urging from the investor, seven other companies also agreed to put up proposals for staggered declassification.

For Bebchuk, it is a simple concept: “Classification makes the board more insulated from replacement and thus less accountable to shareholders.”