Corporate Funding For Shareholder Activism?

Critics Cite Strategic Issues, But Backers See Fairer Game; Judge Offers a Compromise

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Who controls the corporate purse? It is an important question in the debate over whether businesses should subsidize activist shareholders who nominate their own candidates for board seats.

Some governance advocates believe that requiring businesses to reimburse board challengers would level the playing field and make boards more accountable. After all, they note, directors endorsed by management already spend the company's money to finance their candidacies.

But critics fear that subsidizing activists could discourage potential directors and disrupt long-term corporate strategies. Investors at three major U.S. corporations this spring overwhelmingly rejected resolutions that would have made dissident candidates eligible for reimbursement.

Now, a Delaware judge is offering a possible compromise in the Harvard Law Review. Leo Strine Jr. serves as a vice chancellor of the state's Chancery Court, whose rulings are watched in the business community because so many companies incorporate there.

Big Companies, Little Democracy

Shareholders rarely nominate corporate director candidates, particularly at large companies, because proxy campaigns are expensive and challengers don't often win. Below, the number of contested director elections at companies of varying market size between 1996 and 2004, and the results.

MARKET CAPITALIZATION	CHALLENGES	SUCCESSFUL
$0 - $50 million	59	23
$50 - $100	19	7
$100 - $200	13	6
Greater than $200	17	2
Total	108	38

Source: Prof. Lucian Bebchuk, Harvard Law School

In an article in the review's April issue, Mr. Strine suggested subsidies be available for challenging each corporate director once every three years. To qualify for a subsidy covering "reasonable solicitation costs," a challenger would have to be nominated by shareholders owning at least 5% of the company, and win at least 35% of the votes cast.

The proposal would "periodically bolster the ability of stockholders to run a competing slate of directors against an incumbent board they believe is performing poorly," Mr. Strine wrote. Reimbursement would give activists "a fair shot at getting board seats," Mr. Strine said during a recent panel about the topic at the University of Delaware's Alfred Lerner College of Business & Economics.

In the article, Mr. Strine suggests the proposal be enacted through state laws governing corporations. He isn't personally pushing for such laws, however.

Mr. Strine would exclude from the subsidy shareholders seeking a hostile takeover by capturing a majority of board seats. Of those investors, he says in an interview, "If you can't afford to fund a proxy fight, you have no business claiming you have the wallet to buy a public company."

Mr. Strine's proposal aims to address a vexing problem in corporate governance: Many boards are insulated and unresponsive, but it is expensive to run an outside candidate against a director, and few challengers win. As a result, almost no one tries.

Harvard Law School Prof. Lucian Bebchuk counted only 108 challenges for board seats, excluding hostile-takeover attempts, at U.S. companies between 1996 and 2004. Thirty-eight challengers won, but only two at companies with market capitalizations greater than $200 million. For medium-size and large companies, he says, "the risk of removal via the ballot box is practically negligible."

Governance experts favor promoting more board challenges. Reimbursement for activists "would make corporate democracy more real" and could "expand voices in the boardroom," contends Charles Elson, head of the John L. Weinberg Center for Corporate Governance at the University of Delaware's business school.

Proxy fights, which can involve repeated mailings to all of a company's shareholders, can be costly. Walter Hewlett, a dissident director of **Hewlett-Packard** Co., spent about $30 million on an unsuccessful proxy fight to block its acquisition of Compaq Computer Corp. in 2002. A director election likely wouldn't be that expensive, but **Bank of New York** Co. estimated in its latest proxy statement that the cost could "reach six or even seven figures."

The bank was opposing a shareholder resolution sponsored by the American Federation of State, County and Municipal Employees that would have allowed reimbursement for board challengers under certain conditions. AFSCME submitted similar resolutions at **American Express** Co. and **Citigroup** Inc. None got more than 4.5% of the votes.

Richard Ferlauto, the union's director of pension-investment policy, said at the University of Delaware forum that the resolutions sought "access to the corporate treasury, so there's real meaning here when board elections occur."

The other two companies also opposed the AFSCME proposals. "Stockholders should pay their own proxy expenses," Citigroup argued in its proxy. The New York financial-services giant said adoption of the proposal "could impair Citigroup's ability to attract accomplished candidates" as directors, because they wouldn't want to endure bruising proxy-election battles.

Other critics say changes that promote director challenges will inevitably make boards more shortsighted. Even under Mr. Strine's proposal, where reimbursement would be available only to challenge each director once every three years, "everything [directors] think is important would have to be done in a three-year time frame," says corporate lawyer A. Gilchrist Sparks III, a partner at Morris, Nichols, Arsht & Tunnell LLP in Wilmington, Del.

Mr. Ferlauto says the union will reintroduce the reimbursement proposal next year, targeting companies with entrenched boards and weak share prices.

In other contexts, proposals to empower shareholders with corporate funds have gained some support. Harvard's Mr. Bebchuk submitted proposals this year to change the bylaws of **American International Group** Inc. and **Chevron** Corp. so shareholders could be reimbursed for "reasonable" expenses involved in successful shareholder resolutions and bylaw changes. (Bylaws govern a corporation's internal affairs.)

The AIG board approved a variation of Mr. Bebchuk's proposal, eliminating the need for investors to vote on it. At Chevron, the amendment garnered 33% of votes cast at the April 26 annual meeting. The board nominating and governance committee will recommend "what response, if any" the full board should make, a spokesman says.

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