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What Investment Managers Need to Know About Charters and Bylaws

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Corporate law firms have developed a bread-and-butter business advising public corporations on how they can make themselves less vulnerable to hostile takeover bids. One product of this takeover defense industry is model charters (also called certificates of incorporation) and bylaws that minimize shareholders' ability to change the board of directors or to accept a takeover bid opposed by the board. These are the corporate documents that companies typically seek to adopt when they do an IPO.

By repeatedly voting against poison pills and staggered boards, institutional investors have shown that they want shareholders to have a greater voice in strategic decisions. They might be expected to demand charters and bylaws that reflect this philosophy when they invest in an IPO. But investment managers seem to pay little attention to the company's charter and bylaws when deciding whether to buy stock in an IPO. As a result, these documents — drafted by company counsel and vetted by the underwriters — typically reflect management's views on corporate governance. Key charter provisions such as a staggered board that often encounter shareholder resistance regularly appear in the corporate documents of companies whose shares are sold to the public.

Investment managers are likely to regret their inattention to these matters if the company experiences financial difficulties or becomes the target of a takeover bid opposed by management. At times like these shareholders want to maximize their influence over company policy, but they find that the charter and bylaws they inattentively accepted when they bought the company's stock are formidable obstacles to any effort by shareholders to elect new directors or to impose policy changes on the existing board. If investors paid more attention to the key corporate governance provisions when companies make their IPOs, they would have more influence over corporate policy in times of crisis.

Staggered Board

The most important issue by far in drafting the organizational documents of a public company is whether the corporation should have a staggered board. All the directors of a corporation are elected annually unless the certificate of incorporation — or in some states the bylaws — create a classified board.

A staggered board affects more than the number of directors elected at each annual meeting. Under the corporation laws of Delaware and many other states, shareholders have the right by majority vote to remove the directors with or without cause unless the company has a staggered board. With a staggered board directors can only be removed for cause, which excludes removing the directors over a policy dispute like whether the company should be sold.

The most dramatic effect of a staggered board is its impact on a takeover bid opposed by management and the board. Today any public company can successfully resist a takeover offer by employing a poison pill, which makes the tender offer prohibitively expensive for the bidder. The only way for the bidder to proceed in the face of board opposition is to solicit proxies or consents to replace the existing board with directors who approve the offer. A staggered board prevents a bidder from using this tactic because it requires the bidder to elect an opposition slate at two annual meetings to change control of the board.

Organizations that represent the corporate governance views of institutional investors generally oppose staggered boards. There is some evidence that investors understand that such board structures are not in their best interests. Although about one-half of public companies have annual director elections, management rarely seeks a shareholder vote to adopt one because of the risk that the proposal would not be approved. But in the take-it-or-leave-it environment of an IPO, investors routinely buy stock in companies with staggered boards, thereby undercutting their ability to determine corporate strategy in case of a conflict with management.

Increasing Board Size

It is sometimes possible for shareholders to circumvent a staggered board by amending the bylaws to increase the size of the board and filling vacancies with directors selected by shareholders. The courts have upheld the legality of this maneuver, which has been used by hostile bidders or insurgent shareholders seeking to elect a new board majority in companies that have staggered boards.

However, the lawyers drafting the certificate of incorporation can easily block this maneuver. All they have to do is cap the size of the board or give the board exclusive

control over the number of directors in the certificate of incorporation. Because shareholders cannot unilaterally amend the certificate of incorporation, as they can the bylaws, they are unable to increase the size of the board in this case. When the company's lawyers have taken this precaution, investors must resist the staggered board head-on if they are to retain the ability to replace a board majority in a short period of time.

Action Between Annual Meetings

The right of shareholders to replace the board is far more meaningful if there is a mechanism for shareholders to act between annual meetings. Without such a mechanism, shareholders are likely to face severe practical difficulties in seeking to accept an acquisition proposal by electing a board that supports the proposal.

A prospective bidder for a company is likely to be turned off unless it believes it has a good chance of tying up the acquisition within six months after the proposal is made. Bidders cannot use the election of a new board at the annual meeting to meet this timetable unless the annual meeting happens to occur during a short window period following the bidder's decision to acquire the company. If the meeting is to be held in less than three months, the deadline for making board nominations under the company's bylaws will probably have passed by the time the bidder is ready to make an offer. If the meeting is more than six months away, the meeting may not happen soon enough to meet the bidder's requirements. Moreover, a bidder cannot count on the board to schedule an annual meeting at the same time as the previous year's meeting. If the board sees a hostile bidder approaching, it may test the bidder's patience by delaying the annual meeting well beyond its usual date.

These problems are eliminated if shareholders have a mechanism for acting between annual meetings. In that case, assuming that the board is not staggered, the bidder can move immediately to get shareholders to remove the existing directors and replace them with a board that supports its offer.

There are two ways for shareholders to act between annual meetings: by written consent or at a special meeting. Under Delaware law, shareholders have a statutory right to act by written consent unless the certificate of incorporation denies them this right. Many companies that went public in the past failed to deny shareholders this right, but companies doing an IPO today will almost always have a charter provision excluding the right to act by written consent unless investor pressure keeps this out of the charter.

If there is no right to act by written consent, a special shareholder meeting is the only way for shareholders to act between annual meetings. Shareholders are not entitled to call a special meeting, however, unless that right is granted in the certificate of incorporation or bylaws. Companies that give shareholders this right typically require that

owners of a specified percentage of the stock (typically ranging from ten percent to 50 percent) join in calling the meeting.

The justification for denying shareholders the right to act by written consent is that a consent solicitation would stampede shareholders into taking imprudent action before they have had a chance to consider what they are doing. Investors influenced by this argument may consider a right for shareholders to call a special meeting to be a reasonable compromise. While there is certainly value to being able to call a special meeting, it is a slow and expensive process. Unless the shareholder-proponent owns sufficient stock to call a meeting on its own, it must go through two separate shareholder solicitations to achieve its goal: first getting enough votes to call the meeting and then getting enough votes to take action at the meeting. Assuming management opposition (a reasonable assumption in the context of a contest for control), the total process is likely to consume at least 120 days and several hundreds of thousands of dollars.

When the proponent is a hostile bidder, these costs and delays may not seem unreasonable, given the shareholders' interest in allowing the board a sufficient period of time to find a competing bidder or alternative transaction. However, if the company's larger shareholders must bear the cost of the proxy solicitation — as they do in circumstances where the bidder takes the position that it will only engage in a "friendly" transaction — the cost of running two proxy contests is a serious impediment to shareholder action. Provisions in the typical poison pill that treat shareholders who work together as a single shareholder effectively prevent shareholders from spreading the cost of a solicitation among the owners of more than 15 or 20 percent of the stock, depending on the company's poison pill threshold.

If shareholders retain the right to act by written consent, the proponent of shareholder action only needs to go through a single successful shareholder solicitation to achieve its objective. Even so, there is hardly a risk that shareholders will be stampeded into consenting to something that is not in their interests. The process of clearing solicitation materials with the SEC and obtaining consents from the requisite number of shareholder typically consumes 60 to 90 days — ample time for the company to make a case to shareholders. The board's ability to adopt bylaws giving the board the power to set the record date for any consent solicitation provides further protection against precipitous shareholder action. Finally, if shareholders believe the board should have more time to find an alternative transaction, they can always withhold their consents until the requisite time period has passed.

Power to Amend the Bylaws

The power to amend the bylaws can be an important tool for shareholders in gaining control of corporate policy on takeovers and other strategic decisions.

In recent years, Guy Wyser-Pratte, the State of Wisconsin Investment Board, and other shareholder governance advocates have won shareholder votes to adopt bylaws that give shareholders a say in the board's use of poison pills. While these mandatory bylaws may or may not be legally enforceable, other bylaws of unquestioned legality can have a major impact on shareholders' ability to influence a company's governance practices. For example, shareholders' ability to exercise their statutory right to remove directors by written consent can be thwarted by a bylaw that prevents shareholders from using the consent to fill the resulting vacancies. Bylaws also determine whether directors have discretion to set the date of the annual meeting within the broad boundaries established by the state corporation laws.

State corporation laws typically grant shareholders the right to amend the bylaws and allow the certificate of incorporation to grant bylaw amendment powers to the board as well. Public companies almost invariably opt for the concurrent system in which both shareholders and the board can amend the bylaws. While this arrangement has the appearance of evenhandedness, in fact it gives the board much greater control over the contents of the bylaws. If shareholders adopt a bylaw that is not to the board's liking, the board can simply repeal it. For shareholders to reinstate the bylaw requires a long and expensive consent or proxy solicitation.

Some states solve this problem by subordinating bylaws adopted by the board to bylaws adopted by shareholders, but Delaware, the principal state of incorporation, does not have such a provision. Therefore, if shareholders are to have the superior power over the bylaws, there must be a statement to that effect in the charter or the bylaws themselves. Investors may also want this clause to bar the board from requiring a shareholder vote greater than 50 percent to amend the bylaws. While a board-adopted, supermajority vote requirement for shareholders to amend the bylaws would be legally controversial, there is language in the corporation laws that can be read to allow the board to take such a step.

Perspective

Investment managers do not buy stock in a public company with the idea of participating in a battle for control between shareholders and the board. However, a good investment manager pays attention to downside risks as well as extraordinary opportunities. If the company gets into difficulties or has a chance to be acquired at a large premium, shareholders — who, after all, are the owners of the company — may want the power to make basic strategic decisions for the company. Whether they are in a position to exercise this authority will depend on the corporate governance system that is established when the company makes its IPO.