

# Governance Issues for IPO Companies

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The corporate governance structure of a long-established public company is likely to be a product of its history. If the company proposed anti-takeover charter amendments during the period before 1990, when shareholders generally followed management's lead on corporate governance issues, it is likely to have a classified or "staggered" board of directors and restrictions on shareholder action by written consent. Otherwise, management probably lacks these protections. Shareholders, particularly institutional shareholders, have grown wary in the 1990s of adopting measures that permit the board to block takeovers without shareholder consent.

Directors, accustomed to these realities of corporate governance, might expect companies doing IPOs in the current market to have a governance structure that gives shareholders a high level of direct control over company changes of control and other important decisions. All investors have to do is refuse to buy stock in an IPO, and they should be able to get a corporate governance structure that is more to their liking.

However, a study of charters and bylaws of companies among a list of the top IPOs priced during a recent period suggests that shareholder empowerment is not a high priority for IPO investors. Among the companies covered by the study, almost 70 percent went public with staggered boards, which prevent shareholders from replacing a majority of the board in less than two annual meetings. Most companies without staggered boards had majority shareholders, who probably did not feel the need for a staggered board to protect their position.

The bylaws of some IPO companies permit shareholders to elect a new board majority at a single annual meeting, despite the existence of a staggered board. Yet this appears to be an inadvertent loophole rather than a corporate governance power intentionally conferred on shareholders.

The IPO companies have shown more diversity on other corporate governance issues, such as the rights of a majority of the shareholders to act by written consent, call a special meeting or amend the bylaws. Still, these shareholder rights overall were denied more often than they were granted.

## **Staggered boards**

The most important question about an IPO company's corporate governance structure is whether it creates a staggered board. All the directors of a corporation are elected for one-year terms unless the certificate of incorporation creates a classified or "staggered" board. In the

typical staggered board, directors have three-year terms so one-third of the directors come up for re-election each year. As a result, it takes two annual meetings for shareholders to elect a new board majority.

A staggered board affects more than just 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. This blocks removal of the directors over policy disputes, like whether the company should be sold.

Debate over the merits of the staggered boards is sometimes conducted on a high plane of abstraction. Supporters of the staggered board march under the banner of *stability* and opponents wave the flag of *accountability*. However, the reason board classification is such an important corporate governance issue is that the staggered board is a powerful anti-takeover device.

If a company goes public with a staggered board, the board's ability to prevent a company sale is greatly enhanced. Combined with poison pills, the staggered board gives directors a virtual veto power over any bid to acquire the company -- even one supported by the company's shareholders.

The poison pill stops a bidder from acquiring control through a tender offer or other share acquisition. The staggered board then prevents the bidder from conducting a proxy contest to replace directors with a board that will support the offer. If the company has a staggered board, the bidder would require at least two annual meetings to change control of the board. Most bidders will not attempt a hostile acquisition that takes over a year to be completed.

Defenders of the staggered board argue that its strength as an anti-takeover device actually benefits shareholders. They contend that it enhances the board's power to bargain for a better deal when selling the company to a potentially hostile bidder. However, in the 1990s shareholders have tended to see the staggered board less as a bargaining tool than as a management entrenchment device. Since management tends not to propose a staggered board unless it expects the proposal to be adopted, there have been relatively few staggered board proposals in recent years; and last year at least three were actually defeated.

Also, staggered board repeal proposals have become a favored tactic of investors seeking to send a shareholder dissatisfaction message to the board. Proposals at such well known companies as Eastman Kodak, Bristol-Myers Squibb and Federated Department Stores received over 70 percent of the vote.

Despite investors' negative view of the staggered board, it appears that the marketplace does not impose enough of a penalty to deter IPO companies from adopting them. In a sampling of 44 IPO companies, 30 went public with a staggered board. Among the other 14, eight had principal shareholders who held a majority of the voting power.

In such companies, this principal shareholder rather than management and the outside directors is likely to call the shots, and may choose not to have a staggered board for several reasons. It does not have to worry about a hostile takeover; and has sufficient voting power through the board to amend the certificate of incorporation if it wants a staggered board at a later time. Finally, the major holder's interests as a stockholder may outweigh its commitment to maintaining management and the board in their present positions.

In any case, companies with principal shareholders who have a majority of the voting power are not really comparable to companies whose ownership is dispersed after they go public. Among the latter group, based on the sample of IPO companies, the staggered board is definitely the predominant corporate governance arrangement.

Why is this the case? There is no reason to think that IPO investors differ from other investors in their preference for a non-staggered board. However, this preference may be a weak one. The events that make a staggered board a serious threat to investor interests, such as a hostile takeover bid or a bankruptcy, may seem remote at the time a company goes public. Therefore, investors may not greatly penalize a company for having a staggered board.

Directors and top management, on the other hand, are likely to care very much about the protections that a staggered board provides. When owners of a private company take it public, they and their managers are putting at risk the control they previously held over the company. A staggered board eases that risk by blocking a change in control except gradually.

### **Circumventing the staggered board**

It is sometimes possible for a hostile bidder to get around a staggered board through a technique called "board packing." The bidder solicits proxies from shareholders to amend the bylaws to increase the size of the board. The vacancies are then filled with enough directors to constitute a new board majority. 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 IPO company's certificate of incorporation can easily plug this loophole. All they have to do is cap the size of the board or give the board exclusive rights to fill newly created directorships in the certificate of incorporation. Since shareholders cannot unilaterally amend the certificate of incorporation, as they can the bylaws, they are unable to increase the size of the board.

You would expect IPO companies with staggered boards to routinely include provisions that prevent a hostile bidder from circumventing the staggered board. Oddly enough, most of the staggered board companies in the IPO sample did not take this precaution.

There were 21 staggered board companies that provided enough information to determine whether their charters and bylaws plugged the loophole. Seven of these lacked protections

needed to prevent a hostile bidder from circumventing the staggered board by a majority shareholder vote. Two others allowed circumvention by a two-thirds shareholder vote.

The most common loophole was to place a cap on the size of the board or the board's exclusive right to fill board vacancies in the bylaws, which could be amended by a shareholder vote.

Does this mean that those companies intentionally adopted a more open corporate governance structure? Did they give management the protection of a staggered board, while providing shareholders with a circuitous method for electing a new board majority despite the staggered board?

This hardly seems likely. Why should a company hide its relatively open corporate governance from investors, who might give the company credit for it, while revealing its vulnerability to arbitrageurs and hostile bidders, whose lawyers carefully comb through a potential target's charter and bylaws? A more plausible explanation is that most IPO companies and their advisors assume that they can protect their staggered board with provisions in the bylaws. In fact, these protections are not foolproof unless they are placed in the certificate of incorporation.

### **Right to act by written consent or call a special meeting**

While IPO companies probably do not intentionally offer a loophole to get around the staggered board, it appears that many of these companies try to balance their staggered board with shareholder-friendly corporate governance provisions. These include the right of holders of a majority of the shares to act by written consent, call a special meeting or amend the bylaws.

Fifty-eight percent of the IPO companies gave shareholders the right to act between annual meetings (either by written consent or by calling a special meeting) and 43 percent allowed them to amend the bylaws. Even among companies with staggered boards, almost 50 percent (11 out of 23) allowed a majority of the shareholders to act between annual meetings.

For a company with a properly protected staggered board, the likely thinking behind these measures is simple. They satisfy the investors' desire for a responsive corporate governance structure without opening the door to a sudden change of control. As long as the company has a staggered board protected by the certificate of incorporation, shareholder rights to act by written consent, call a special meeting or amend the bylaws will not enable dissident shareholders or takeover bidders from gaining control of the board. An exception would be when there already are dissidents on the board, so that only one election is needed to create a new board majority.

The right to act between annual meetings is much more than a fig leaf, however, if the company lacks a staggered board and shareholders can remove directors at any time. Under those conditions, a shareholder right to act may make the company a more attractive takeover target. For example, a prospective bidder who wants to elect a new board majority through a proxy or consent solicitation may find waiting until an annual meeting too restrictive.

If the meeting is less than three months after the bidder decides to make a run at the company, the deadline for making board nominations will probably have passed by the time the bidder is ready to announce an offer. If the meeting is more than six months away, it may not be 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 every year. 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 can be eliminated if shareholders have a mechanism for acting between annual meetings. Assuming that the company does not have a staggered board, the bidder can move immediately to get the shareholders to remove the existing directors and replace them with a board that supports its offer.

Since the right to act between annual meetings is far more meaningful in companies whose directors have one-year terms than in companies with staggered boards, you would expect that the former companies would be less likely to give their shareholders the right to act between annual meetings.

However, the percentage of IPO companies that allow shareholders to act between annual meetings is much higher among those whose directors have one-year terms (80 percent) than among companies with staggered boards (48 percent).

It seems that the IPO companies that did not adopt a staggered board are more willing to allow shareholder participation in corporate governance. Companies with staggered boards opted for more restrictive corporate governance structure in all respects. This, even though shareholder action between annual meetings is much less of a threat to their managers than to those of companies that elect their entire board annually.

There are two ways shareholders can act between annual meetings: by written consent or at a special meeting. Action by written consent is by far the faster of the two. It consumes only as much time as it takes to clear soliciting materials with the SEC and obtain the needed number of consents from shareholders.

Action through a special meeting, however, is a lengthy two-stage process. First the proponent has to get the shareholders to call the special meeting through a solicitation which by itself takes about as long as a consent solicitation. Then there is an additional delay of several months for the meeting to be called and held.

Because action by written consent is so much faster, managers usually fear the right of shareholders to act by written consent more than their right to call a special meeting. This attitude is reflected in the charters and bylaws of the sample IPO companies. Fifty-two percent granted the right to call a special meeting, but only 36 percent granted the right to act by written consent. However, a large majority (70 percent) of the IPO companies without a staggered board

gave their shareholders the right to act by written consent. A company that elects the entire board annually and lets its shareholders act by written consent is the classic example of a company with weak takeover defenses. This shows suggests that companies that elect their entire board annually have a different attitude toward shareholder participation in corporate governance from those with staggered boards.

### **Amendment of bylaws**

The potential importance of shareholder power to amend the bylaws has already been seen in the discussion of “board packing.” However, shareholders cannot accomplish this feat unless they can amend the bylaws. Shareholders may also need to amend the bylaws to effectively exercise their power to remove directors, since some bylaws give the board exclusive authority to fill board vacancies.

Delaware and most other states grant shareholders the power to amend the bylaws. However, these statutes also allow the corporation to require a vote greater than a majority of the outstanding shares (a “super-majority”) for shareholders to exercise this power. Thus, the vote required for shareholders to amend the bylaws is the key to whether shareholders have an effective power of amendment. If a super-majority vote is needed to amend the bylaws, the stockholders’ power of amendment may not be meaningful.

The breakdown between companies that allow shareholders to amend the bylaws by a simple majority and those that require a super-majority follows the same pattern seen in the handling of shareholder rights to act between. No doubt, the power to amend the bylaws can be more significant in a company that elects all directors annually than in a company with a staggered board. Yet the IPO companies that elect all directors annually are much more likely to give their shareholders the power to amend the bylaws by a simple majority vote. Over 88 percent of these companies gave shareholders power to amend the bylaws by a simple majority vote, compared to 33 percent of the staggered board companies (some companies did not provide sufficient information to determine shareholder bylaw amendment rights).

A company’s general approach to shareholder participation in corporate governance appears to be the most important determinant of whether it imposes a super-majority vote requirement for shareholders to amend the bylaws. This despite the fact that shareholder bylaw amendments have less potential for facilitating a change in control of companies with properly protected staggered boards than for companies that elect their entire board annually.

### **Overview**

The most common corporate governance arrangement for IPO companies in the sample is a staggered board, protected by the certificate of incorporation, with strong restrictions on the rights of shareholders to act between annual meetings or amend the bylaws. While investors may prefer a more open governance structure, they seem willing to accept charters and bylaws tailored to the interests of management and the board of directors.

The most important exceptions arise from factors unrelated to the wishes of IPO investors. The companies sometimes inadvertently fail to plug a loophole through which shareholders can override a staggered board. Or, the company's principal shareholders, who do not need a staggered board to maintain control, sometimes do not choose to have one. If these circumstances are missing, IPO companies that allow shareholders to change a majority of the board in less than a year are definitely in the minority.