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The attached article, Institutional Investors Should Not Facilitate Corporate "Ambushes", was published in Columbia Law School's Blog on Corporations and the Capital Markets on March 15, 2013

March 15, 2013

Institutional Investors Should Not Facilitate Corporate "Ambushes"

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In the upcoming proxy season, shareholders at several major corporations will be asked to vote on proposals submitted by shareholder activists requesting that the board of directors facilitate the ability of shareholders to act by written consent. This means that, rather than the most important decisions being made at an annual or specially called shareholders meeting, such fundamental changes as replacing the board or even selling the company could be made, in many cases, with the pen stroke of a bare majority of shareholders, often without notice or information to other shareholders, and without time for thoughtful consideration. Companies can be caught completely by surprise – "ambushed" – when fundamental changes are presented to them as a *fait accompli*.

Because unexpected upheavals are so disruptive, and the threat of them so distracting to boards and management, most state corporation laws only permit action by written consent if it is unanimous, unless a company's charter provides otherwise. The charters of most widely held public companies (even in Delaware where the statutory presumption is reversed) do not permit action by written consent but require that shareholders act at meetings, so that all shareholders will receive proper notice and information about the issues to be considered, hear both sides of any contested matter, and have adequate time for reflection.

Reasonable minds can and do differ as to whether some subset of the shareholders should be able to convene special shareholder meetings in between annual meetings. American corporate law – like our political system – has generally embraced a "republican" form of democracy, in which shareholders elect a board of directors whom they entrust to oversee management and, if they are dissatisfied, can replace at the next election. In recent years, however, trade unions and shareholder activists, supported by powerful proxy advisory firm ISS, have had considerable success making California-style recall elections the norm. This is part of a sea-change that is shifting corporate America from its traditional board-centric approach to a European-style model in which major decisions about corporate direction and policy are made by shareholders (or really by unelected shareholder intermediaries), rather than by boards of directors, who are elected and subject to strict fiduciary duties. A variety of developments has brought this about, most significantly the widespread adoption of majority voting in director elections, coupled with the ever-tightening ISS policy of recommending that shareholders reject directors who do not accede to their demands. Having virtually eliminated takeover defenses like standing "poison pills" and staggered boards, the activists are now seeking to ensure that shareholders can take action (most importantly, to remove the board and sell the company) at any moment. This shift towards shareholder intermediary-centric governance has led to an over-emphasis on short term results, to the significant detriment of the economy and the employees of companies forced to reduce investment and employment to avoid short term declines in performance.

While reasonable investors might favor having the right to ask for recall elections, it is difficult to formulate a reasonable basis for allowing shareholders in widely-held public companies to act by written consent rather than by meeting. Action by consent is essentially a convenience mechanism that dispenses with the requirement for a meeting because the outcome is a foregone conclusion. This makes sense for companies with controlling shareholders. But for almost all public companies, the difference between having to act at a meeting and being able to act without one is effectively the ability of a handful of large shareholders to sell the company without having to take into account the views or votes of, or even to inform, the rest of the shareholders. It is an *in terrorem* pressure tactic to be exploited by hostile bidders, and an Achilles heel which can deny directors a reasonable ability to maximize shareholder value.

Most shareholder activists and many institutional investors today want America's corporations to be vulnerable to hostile takeovers. Whether they are right that this will lead to a more efficient allocation of capital, or whether this is an imprudent and short-termist position, is debatable. But in any case, hostile takeovers do not depend on shareholders being able to act by written consent. The right to remove directors at the next annual meeting should arguably be sufficient, but certainly a raider needs no more than to be able to act at a special meeting. All the written consent adds is an element of uncertainty and coercion – the risk that a raider can knock on the door waving a few pieces of paper and say: "Hand over the keys, this is my company now!" – that can deny the board the opportunity to make a value-maximizing decision.

Prudent and responsible institutional shareholders should not support the activists and ISS in their efforts to mandate shareholder action by written consent, which will be distracting and destabilizing for America's public corporations.