The tension between boards and investors

Boards would benefit from a clearer understanding of the role they expect the company's shareholders to play.

BY DOUG RAYMOND

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An interesting dynamic has been playing out in recent years as boards and shareholders have struggled to find the proper roles for each in corporate governance, particularly of public companies. This tension has been evident on many fronts, from the adoption of SEC regulations that mandate shareholder voting on executive compensation to the SEC's attempts to expand proxy access for shareholder-nominated directors, the growing acceptance of a majority voting standard in director elections and the decline in the number of companies with standing poison pills. Most of these changes have been championed by institutional investor groups and their advisors, and not infrequently corporate boards have resisted these and similar changes as too much of an intrusion into their oversight of the corporation.

Recently there has been something of a backlash to this trend, a reaction to the significant increase over the last several years in shareholder and derivative litigation that challenges board action. Particularly in the context of a sale of control of a public company, the directors' decision to sell is today uniformly challenged, among other claims, as a breach of the directors' fiduciary duties. Similarly, legal challenges to executive compensation and other decisions by boards have become increasingly common. While the right of shareholders to bring legal actions to hold boards accountable for their actions is a bulwark of good governance, many consider that much of this litigation is brought more for the benefit of the lawyers than to protect the interests of shareholders. Clearly, it cannot be that the directors have breached fiduciary duties in every merger transaction.

As the increase in shareholder litigation shows no signs of abating, some boards have taken steps to discourage litigation against them. One method is to adopt a bylaw that mandates a single exclusive forum for lawsuits that assert a derivative claim against the corporation's directors and officers or any claim for breach of fiduciary duty. These provisions have been used to prevent cases from being filed in jurisdictions that are seen as overly plaintiff-friendly.

More recently, some boards have adopted bylaws that would obligate the losing plaintiff in a lawsuit involving the governance of the corporation to pay the corporation's legal fees. This is a departure from the usual rule in U.S. lawsuits, where parties generally pay their own bills. Last spring the Delaware Supreme Court upheld a "loser-pays" bylaw provision involving a non-stock corporation and attention immediately focused on the possibility that a stock corporation could implement a similar bylaw. The Delaware Bar Association moved quickly to propose legislation that would invalidate that type of bylaw. At the moment, it is unclear whether the Delaware legislature will step in and override or limit the court's decision, but in the meantime many corporations, both in and outside of Delaware, have adopted versions of a loser-pays bylaw.

The shift toward more active engagement by shareholders, and the more recent examples of resistance to this, should cause thoughtful boards to consider more broadly the proper role that their shareholders should play in decisions affecting the company. This necessarily implicates not only the trends mentioned above, but also whether the corporation should view its long-term investors differently than day-traders and other short-term holders.

For example, the board might consider adopting an exclusive forum or "loser-pays" restriction, but apply it only to shareholders who have owned their stock for less than a year. Alternatively, the board could consider imposing these restrictions only on very small shareholders, who do not have a meaningful stake in the company's performance. This echoes some SEC regulations (including its proxy access regulations that were never made effective) that distinguish between larger and smaller shareholders. And in the tension between director and shareholders, it makes sense to be more accommodating to longer-term investors who have a significant stake in the corporation.

It seems likely that many institutional shareholders and proxy advisory firms will oppose these trends as unnecessary restrictions on shareholder rights. In fact, the adoption of such provisions could itself trigger unwanted attention by these groups, and inject the board into a controversy it might prefer to avoid. Although no director enjoys the prospect of being sued, procedural barriers to shareholder litigation should be approached with caution. More broadly, boards would benefit from a clearer understanding of the role they expect the company's shareholders, particularly activist shareholders, to play. As the institutional investors continue to become more vocal, there is ample opportunity for constructive dialogue around these issues. ■

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