Corporate Board Elections and Internal Controls

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Panel remarks by B. Espen Eckbo, Tuck Centennial Professor of Finance and Founding Director, Center for Corporate Governance, Dartmouth College; ECGI Research Associate

Moderator: Roberta C. Ramo, Shareholder, Modrall, Sperling, Roehl, Harris & Sisk P.A and 1st Vice President, The American Law Institute

Next, we will hear from Professor Espen Eckbo, of the Tuck School, and also a Founding Director of the Centre for Corporate Governance, at Dartmouth College.

Espen Eckbo: Thank you very much. I'm the odd man out here since I'm a financial economist and not a legal scholar like the rest of my panel. I'd like to talk about how Corporate Governance is a multi-front push. It has come up in the panel discussion as well that it is difficult to talk about voting reform unless you also talk about defensive tactics and the kinds of resistance firms can make to hostile takeovers.

Perhaps the most important voting right I, as a shareholder, have is to sell my shares to the highest bidder. If I'm not allowed to do that, then my voting rights are being cut quite considerably. I'm talking about the poison pill, so lets go back a little bit in history.

In the 1970' and early 1980's, excess capacity developed in much of corporate America primarily due to technological innovations. Also, as the oil price went up in the mid 1970s, oil companies experienced an enormous increase in free cash flow—with no commensurate increase in valuable investment projects. The result was value-destroying overinvestment on a massive scale. That started a wave of hostile takeovers because managers and boards resisted paying out dividends and down-sizing their firms. The hostile takeovers generated resistance activity, and one of the big inventions of course, was the poison pill. A pill effectively forces a potential buyer to negotiate with the board or management before a takeover can go through. Negotiations are required even if a majority of shareholders want to sell. So, the pill undermines shareholder voting rights. If the purpose of the takeover is to get rid of the board, then it is, of course, very hard to get an agreement. The poison pill has proven to be a every effective takeover deterrent.

During the 1980's, more and more firms adopted the pill. The courts basically confirmed that the pill was consistent with good business judgement and the degree of hostile takeovers dwindled to almost zero. In the 1990's, institutional shareholders, who had lost the ability to sell their shares to a hostile bidder, gradually became too big to sell their shares in the market without creating serious price pressure. Because of this, they started saying "let's go into the annual meetings and change the board that way". That's when they discovered that the system for electing directors is flawed.

That's why we're talking today about the board election system. I applaud efforts to make the system more efficient. But, if we don't get a culture for taking these pills out of the equation, I don't think we're going to get very far. Now I'm very glad to see that someone like Marty Lipton is predicting that this will happen at an increasing rate. Annual general meetings where institutional owners are having enough clout to embarrass boards are starting to question poison pills and classified boards. The goal is to elect independent boards that think like shareholders.

Creating boards that in a real sense represent shareholders requires a rapid-fire way to change the board. This requires election reform. We had a debate on this two years ago with the SEC which led us nowhere. Defenders of status quo argued that is was somehow "dangerous" to allow shareholders to have a say in the operations of the firm through the board. The issue of allowing shareholders to get closer to the firm is a very sensitive one with a lot of key people.

In Europe by the way, this issue is even more sensitive than in the United States. Europe has a hard-wired conflict of interest problem in their boards. In Germany, 50% of the supervisory board seats must be allocated to employees. In Scandinavia, I'm from Norway myself, where we also have a two-tiered board system, one third of the supervisory board seats are allocated by law to employees. And when you have that structure, it's very hard to close plants in response to excess capacity. So there are built in conflicts of interest. You don't really want directors that sit with these conflicts of interest to be responsible for downsizing or hiring and firing managers.

So, let's do the voting reform, but also, let's not forget that maybe the biggest issue is the ability of boards to resist takeovers in their own self interest. How can we tell that resistance is driven by self-interest? When the court gets a case of hostile takeover, how does it determine that the target board is not acting in shareholder interest? It's nearly impossible. It's like trying to catch somebody speeding without knowing how fast they were going. The courts have an enormous problem distinguishing 'good' from 'bad' management in hostile takeover cases.

To avoid the courts having the last word, in a sense, let's tear down structural defences such as pills and staggered boards. Only then may shareholders exercise their presumptive right to sell the shares to the highest bidder.