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Winning the Class Struggle: Acquirer Strategies for Declassifying Classified Boards

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Directors of a Delaware corporation are generally elected at each annual meeting for one-year terms.[1] Under the General Corporation Law of the State of Delaware, however, a board of directors may be divided into classes with staggered terms of up to three years.[2] Where a corporation's board is classified, the directors are usually divided into three classes, with approximately one-third of the board being elected at each annual meeting.

Classified boards serve several functions, including providing institutional consistency,[3] but it is their potential to discourage takeovers that typically attracts most attention.[4] Directors on a classified board may be removed only for cause,[5] so potential acquirers cannot simply come in and remove hostile directors on a target's board. Removal for cause is generally no easy task, and no potential acquirer seeking to act quickly would risk the costs and delays of the litigation that would assuredly follow any purported removal for cause.[6] The classified-board structure is, along with cumulative voting, essentially the only statutorily certain way to protect against removal without cause.[7] Therefore, classified boards are considered standard, and potent, takeover defenses. For example, in early October 2007, Oracle Corporation made an unsolicited offer (which later expired) to buy BEA Systems Inc.[8] Commentators had cited BEA's classified board as a takeover defense that would have posed a hurdle to Oracle's desired acquisition.[9]

But classified boards are not perfect fortresses, they may be defeated in some circumstances. The first question when facing a classified board is which governing document contains the classification provision. A corporation may classify its board either its certificate of incorporation or its bylaws (either an initial bylaw or in a bylaw adopted by a stockholder vote).[10] Though the method of declassification varies depending on which document contains the relevant provision, each depends on the same principle—once a classified board is declassified, the directors may be removed without cause.

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Post-Declassification Removal of Directors

The issue of post-declassification removal was first raised and decided in *Roven v. Cotter*, by the Delaware Court of Chancery in 1988.[11] The bylaws of Citadel Holding Corporation had provided for a classified board of directors, but the Citadel board adopted a resolution recommending that, at the company's upcoming annual meeting, the stockholders amend the company's certificate of incorporation to declassify the board.[12] The Citadel board further resolved that, when the certificate amendment became effective, the bylaws would also be amended to declassify the board.[13] Moreover, Citadel's stockholders were going to be "asked to vote to remove without cause the current directors of the corporation, if and when the charter amendment becomes effective."[14]

Alfred Roven, a Citadel director who would have been removed, sued to enjoin Citadel's actions. The Court held first that directors subject to removal without cause, even those who serve on a classified board, are not "entitle[d]" to serve out their full terms.[15] It then held that "[t]he Citadel shareholders may amend the certificate of incorporation to eliminate the classified board, and thereafter remove any director without cause."[16]

This reasoning was reaffirmed in *Chesapeake Corp. v. Shore*, a 2000 case from the Court of Chancery.[17] Defendant Shorewood Packaging Corporation had "adopted a host of defensive bylaws" to avoid a takeover attempt by Chesapeake Corporation by "mak[ing] it more difficult for Chesapeake to amend the Shorewood bylaws to eliminate its classified board structure, unseat the director-defendants, and install a new board amenable to its offer."[18] Chesapeake sued to challenge those bylaws, but Shorewood argued that "the

Shorewood stockholders [we]re prohibited from voting to eliminate the company's classified board structure and subsequently seating a new board."[19] The Court rejected Shorewood's claim for several reasons, including that

> [section 141(k)] provides protection to the directors of a "corporation whose board is classified." By the clear authority of 8 *Del. C.* § 109, the Shorewood stockholders have the power to amend the company's bylaws to eliminate a classified board structure. As soon as that validly happens, the Shorewood directors will no longer serve as directors of a "corporation whose board is classified." They will at that time be removable without cause.[20]

The Court noted also that stockholders could not be forced to wait until the directors' terms expire to declassify a board, stating that it found "no language in § 141 that would support the proposition that the General Assembly wished to limit the ability of stockholders to determine and immediately implement such a fundamental governance change pursuant to § 109."[21]

Therefore, once a corporation's classified-board provision—whether in the certificate of incorporation or the bylaws—has been repealed, assuming no contrary provisions in the corporation's certificate,[22] that corporation's directors can be removed without cause.[23]

Declassification When Board is Classified in Certificate of Incorporation

If a corporation's certificate of incorporation contains a provision classifying the board of directors, declassification cannot be done by stockholder fiat. Amendments to a certificate of incorporation require action by both the board of directors and the stockholders.[24] Special tactics are therefore necessary to declassify a board against its will when it is classified in the certificate of incorporation.

The surest way to declassify a board of directors in this circumstance—assuming, *inter alia*, that the certificate of incorporation does not place a cap on the total number of directors[25] or require that the number of directors in each class be as nearly equal as possible[26]—is to expand the size of the board. A potential acquirer may be able to expand the board and then "pack" the board with sufficient new directors such that it can exercise control over the corporation. For example, a board divided into three classes of three directors each will have three directors up for each annual election. If a potential acquirer were to elect those three directors, its directors would be on the losing end of a 6-3 board split. If, on the other hand, the potential acquirer were to expand the class up for election from three to seven, and then elect seven new directors, the acquirer's directors would immediately gain control of the board in a 7-6 majority. Once the acquirer's directors have control of the board, they can adopt a resolution amending the certificate of incorporation to declassify the board and put the amendment to a stockholder vote. If the stockholders approve the amendment, the acquirer can then seek to remove the remaining six directors without cause.

This method of declassification is more difficult than declassifying a board classified in a corporation's bylaws since several types of provisions in a target corporation's governing documents could block or hinder such a strategy. First, if the number of directors is fixed in the corporation's certificate of incorporation, an acquirer could not expand and pack the board. Second, if the certificate provides that the classified board be divided into classes "as nearly as equal as possible," an acquirer could not pack a single class. It would have to instead pack each class of the board equally, and it is possible that the incumbent directors would have the power to appoint new directors to the expanded classes not up for election—thereby defeating the purpose of packing the board altogether. Third, if the corporation's governing documents grant the board of directors the exclusive authority to appoint new directors, an acquirer may not be able to pack the board at all.[27] Fourth, if the bylaws or certificate contains a supermajority stockholder vote provision,[28] the steps in the declassification process outlined above could be more difficult to accomplish. Fifth, the certificate of incorporation may prevent an acquirer from acting on its own schedule by prohibiting action by written consent[29] and/or by prohibiting or restricting stockholders from calling special meetings.[30] Though such provisions may not prevent declassification, they would serve to limit any declassification attempt to the board-called annual stockholder meeting.

In summary, though it may be difficult, a board may be declassified even if the classification provision is in the corporation's certificate of incorporation.

Declassification When Board is Classified in Bylaws

Declassifying a board when the classification provision is in the bylaws is generally much easier for a potential acquirer because bylaws may be amended by the stockholders.[31] In such a context, a potential acquirer may generally declassify the board by amending the corporation's bylaws. The moment that the board is declassified, the corporation's directors may be removed without cause.[32] Where the declassification amendment does not provide that the directors' terms automatically expire upon declassification,[33] it is recommended that the acquirer remove all the directors or all the directors not elected by the acquirer.[34] Once the directors are removed, the acquirer and its elected directors can either appoint new directors to fill the vacancies or (if possible) adjust the size of the board to the acquirer's preference.

Declassification through a corporation's bylaws is not always possible, however. If the bylaws contain a supermajority stockholder vote provision limiting amendments, for example, the acquirer's attempt to declassify the board could be made far more difficult. As noted above, limitations on action by written consent also may prevent a potential acquirer from amending the bylaws at its chosen time. Another issue raised by declassification in general—but most relevant when the classified-board provisions are in the bylaws (because declassification is more possible)—is the existence of "poison debt." These debt instruments can cause large balloon payments to come due upon the change of control in a board of directors.[35] Therefore, declassifying the board may, if an acquirer is not careful, lead to a painful outcome.

Conclusion

The struggle against a classified board can be daunting. As we hoped to demonstrate in this article, however, a determined acquirer has at its disposal several ways to overcome the protections inherent in the classified-board structure. On the other hand, target boards also have ways to bolster the defenses provided by the classified-board structure. No short article could do justice to the intricacies and myriad counter-maneuvers possible in a battle over a classified board, but it is our hope that this article provides a general introduction to the most important tricks and traps involved with classified boards.

Notes

1. *See* 8 *Del. C.* § 211(b).

2. *Id.* § 141(d).

3. The staggering of directors' terms "has an obviously legitimate and important purpose, namely, to preserve in the corporation stability and continuity of experienced management,—a purpose which is not confined to corporate organization but has long been pursued even in governmental bodies, notably in the Senate of the United States." *Janney v. Phila. Transp. Co.*, 128 A.2d 76, 80 (Pa. 1956). Classified-board provisions find counterparts in the US Constitution. The terms of US Senators, like the terms of directors on a classified board, are staggered, with each US Senator serving a six-year term and one third of the membership in the Senate up for election every two years. *See* US Const. art. I, § 3, cl. 2.

4. 1 Robert H. Winter et al., *Shark Repellents and Golden Parachutes: A Handbook for the Practitioner* § 4.1.1, at 115 (1992 Supp.) ("The implementation of the staggered board is generally regarded as the most important provision limiting an Offeror's ability to effect a rapid change of management.").

5. 8 *Del. C.* § 141(k)(1). The certificate of incorporation may provide that directors serving on a classified board may be removed by stockholders with or without cause. *Id.* Maintaining the limitation on removal without cause, however, is necessary to preserve the anti-takeover benefit that board classification provides—namely, that the structural delay in a change in control will operate to discourage hostile offers.

6. *Cf. Rohe v. Reliance Training Network, Inc.*, 2000 WL 1038190, at *3 n.6 (Del. Ch. July 21, 2000) (listing several charges "held to constitute cause for removal: malfeasance in office, gross misconduct or neglect, false or fraudulent misrepresentation inducing the director's appointment, willful conversion of corporate funds, a breach of the obligation to make full disclosure, incompetency, gross inefficiency, and moral turpitude" (internal quotation marks omitted)). Moreover, if the stockholders seek to remove a director for cause, they must allow the director to present, at the corporation's expense, a prepared defense statement along with the proxy materials submitted for the stockholders' consideration. *Campbell v. Loew's, Inc.*, 134 A.2d 852, 861–62 (Del. Ch. 1957).

7. *See* 8 *Del. C.* § 141(k); *see also Rohe*, 2000 WL 1038190, at *11 (noting that a corporation's bylaws could not prevent stockholders from exercising their removal authority); *id.* ("Section 141(k) provides no limitation on the right of stockholders to remove a member of a non-classified board. Like the right to elect directors, Delaware law considers the right to

remove directors to be a fundamental element of stockholder authority." (footnote omitted)).

8. Vauhini Vara, *Oracle Discloses Pitch for BEA*, Wall St. J., Oct. 13, 2007, at A3; Vauhini Vara & Denise Jia, *Oracle Lets BEA Bid Die; Icahn Pushes for Auction*, Wall St. J., Oct. 29, 2007, at A3.

9. Posting of Dana Cimilluca to Deal Blog, *http://blogs.wsj.com/deals/2007/10/12/can-ellison-penetrate-beas-shark-cage/* (Oct. 12, 2007, 1:00 PM) ("Can Ellison Penetrate BEA's Shark Cage?".)

10. 8 *Del. C.* § 141(d).

11. 547 A.2d 603 (Del. Ch. 1988).

12. *Id.* at 603–04. This proposed amendment would also provide that Citadel's directors could be removed with or without cause, regardless of whether the board was classified. *Id.* at 604.

13. *Id*.

14. *Id.* ("Thus, if the foregoing proposals are properly adopted, their total effect will be: (1) to permit either a classified or unclassified board, although for present purposes the board will be declassified, (2) to allow the removal of directors by the stockholders with or without cause, regardless of any such classification and (3) to remove all incumbent directors without cause.").

15. *Id.* at 608.

16. *Id.* at 609.

17. 771 A.2d 293 (Del. Ch. 2000).

18. *Id.* at 296.

19. *Id.* at 297.

20. *Id.* at 346 (footnote omitted).

21. *Id*.

22. Cumulative voting provisions may limit the stockholders' ability to remove directors without cause. 8 *Del. C.* § 141(k)(2). In addition, where the holders of any class or series of stock are entitled under the certificate of incorporation to elect one or more directors, the holders of that class or series of stock may remove any director so elected without cause, but the holders of the outstanding shares of stock as a whole may not remove any such director without cause. *Id.* § 141(k).

23. *Cf. Roven*, 547 A.2d at 607 ("[T]o the extent that *Essential Enterprises*, is codified in § 141(k), it simply represents the proposition that when a board is classified in the certificate of incorporation, and there is no provision for removal without cause [in the certificate], a director is entitled to serve out his 'full term' unless removed by the stockholders for cause.") [referring to *Essential Enterprises Corp. v. Automatic Steel Products, Inc.*, 159 A.2d 288 (Del. Ch. 1960)].

24. 8 *Del. C.* § 242(b)(1).

25. The number of directors may be fixed in the corporation's bylaws or in the corporation's certificate of incorporation. *Id.* § 141(b). As mentioned above, where the number is fixed in the certificate of incorporation, it may not be amended by stockholder action alone.

26. "There is no statutory requirement that the classes of directors be equal in number . . . ." 1 Edward P. Welch et al., *Folk on the Delaware General Corporation Law* § 141.10, at GCL-IV-211 (5th ed. 2006). But the Delaware courts require that corporations adhere to their certificates of incorporation. *Cf., e.g.*, *Prickett v. Am. Steel & Pump Corp.*, 253 A.2d 86, 88–89 (Del. Ch. 1969) ["The election of Muscat and Keating for one-year terms, pursuant to the 1965 by-law, was in irreconcilable conflict with the corporation's charter provision establishing staggered terms of three years each. Neither the by-law nor the election under it effectively changed the charter requirement. In short, since the corporate charter provides for three-year terms, the election of Muscat and Keating as directors for terms of one year each was 'irregular,' and each achieved only 'de facto' status. And that status will end with the election of directors under the order of this Court." (citation omitted)].

27. *See* 8 *Del. C.* § 223(a)(1) (providing that, unless the certificate or bylaws provide otherwise, "newly created directorships resulting from any increase in the authorized number of directors elected by all of the stockholders having the right to vote as a single class may be filled by a majority of the directors then in office"). Where the certificate of incorporation provides the board with the sole power to fill vacancies resulting from any removal or resignation of a director or from expansion of the board, a potential acquirer's initial effort to create new directorships to pack the board would likely be defeated.

28. *See id.* § 102(b)(4) (providing that a certificate may contain supermajority vote provisions); *id.* § 216 (suggesting that bylaws may change the default majority rule for quorums and voting).

29. *See id.* § 228(a).

30. *See id.* § 211(d).

31. *See id.* § 109(a) providing that directorial power to amend the bylaws ("shall not divest the stockholders or members of the power, nor limit their power to adopt, amend or repeal bylaws").

32. Unlike an amendment to a certificate of incorporation, which must be filed with the Delaware Secretary of State to be effective, *id.* §§ 103(d), 242(b)(1), a bylaw amendment may generally be effective immediately.

33. The declassification amendment may explicitly phase out the classified-board structure over time. *Cf., e.g.*, *Harrah's Entm't, Inc. v. JCC Holding Co.*, 802 A.2d 294, 306–07 (Del. Ch. 2002).

34. *Roven*, 547 A.2d at 604 ("Moreover, to avoid any question of when the current directors' terms expire, the shareholders will be asked to vote to remove without cause the current directors of the corporation, if and when the charter amendment becomes effective.").

35. *See generally Law Debenture Trust Co. of NY v. Petrohawk Energy Corp.*, 2007 WL 2248150, at *11 (Del. Ch. Aug. 1, 2007) ("That is, the Continuing Director Provision turned the Notes into a form of 'poison debt,' which made a hostile acquisition more difficult by requiring the Notes to be paid in full with a one percent premium if the incumbent board did not sign off on the transition. The import of the Provision was to give the incumbent board the power to determine whether a transaction would trigger a Change of Control or not.").