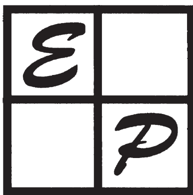

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Destaggering with Class: A Plan for Potential Targets in Troubled Times

By John Mark Zeberkiewicz and Blake Rohrbacher of Richards, Layton & Finger, P.A[1]

Back before the economy changed, we wrote an article discussing strategies by which acquirers could overcome the fact that potential targets' boards of directors had "staggered" terms.[2] Now that stock prices are down, target companies may need help defending themselves against the threat of a hostile takeover. Even as the advantage in the M&A market has tilted away from sellers,[3] boards remain subject to pressure from activist stockholders and other investors to eliminate structural anti-takeover protections.[4] Stockholders continue to press boards to terminate or redeem poison pills[5] (and, in any event, the protection granted by poison pills is diminished by the staggering drops in stock prices experienced by many companies[6]) and to enact other governance reforms that limit the board's ability to resist takeovers, such as granting stockholders the right to call special meetings.[7] And those corporations that maintain staggered boards continue to face pressure to eliminate them[8]—either through stockholder proposals requesting that they do so or through the not-so-subtle hint of a dismal corporate governance quotient.[9]

Whether they are seeking to improve their governance score, or are responding to specific calls from significant or activist stockholders, many boards have considered eliminating their staggered boards.[10] While we make no recommendation whether a board should take this step, we propose in this article a method for doing so that seeks to preserve, for the maximum period possible, the incremental anti-takeover protection offered by a staggered board.

The "destaggering" process is not without risk. As discussed below, the defensive benefits offered by a staggered board may evaporate once the destaggering amendment becomes effective, leaving the subject company more vulnerable to takeover attempts The traditional model for destaggering a board therefore

[1] The opinions expressed in this article are those of the authors and not necessarily those of Richards, Layton & Finger or its clients.

[2] John Mark Zeberkiewicz & Blake Rohrbacher, *Winning the Class Struggle: Acquirer Strategies for Declassifying Classified Boards*, Corp. Governance Advisor, Jan./Feb. 2008, at 21. Briefly, "staggered" (or "classified") boards are those divided into multiple classes with multiple-year terms expiring on a rotating basis. Directors of Delaware corporations are typically elected for one-year terms at each annual meeting. *See* 8 *Del. C.* § 211(b). But a board of directors may be divided into a maximum of three classes with staggered terms of up to three years. *Id.* § 141(d). In a typical staggered board, approximately one-third of the board is elected for a three-year term at each annual meeting.

One of the functions of a classified board is to provide institutional consistency, but it also has the potential to discourage takeovers. Since directors on a classified board may be removed only for cause, *id.* § 141(k)(1), a classified board poses a hurdle for potential acquirers who therefore cannot easily remove directors from a target's board.

[3] *See, e.g.*, Gregory V. Varallo & Blake Rohrbacher, *Lessons from the Meltdown: Reverse Termination Fees*, Deal Law., Nov.-Dec. 2008, at 10, 11.

[4] *See* Joann S. Lublin, *Directors Lose Elections, but Not Seats*, Wall St. J., Sept. 28, 2009, at B4 (noting that stockholders opposed the directors of a certain company partly because it "elects one-third of its board annually," and stating that "[a]ctivists dislike such arrangements because they make it harder for dissidents to gain control").

[5] RiskMetrics, for example, has announced its general policy to recommend in favor of stockholder proposals calling for the redemption of poison pills (or submitting pills to a stockholder vote) and to recommend that stockholders vote "against" or "withhold" votes from directors who adopt poison pills without expressly subjecting them to a stockholder vote. *See* RiskMetrics Group, U.S. Corporate Governance Policy: 2009 Updates 14-15 (Nov. 25, 2008).

[6] *See, e.g.*, William Lawlor et al., *Time to Install a Pill? Dealing with Rights Plans in a Down Market*, Deal. Law., Jan.-Feb. 2009, at 1.

[7] *See* RiskMetrics Group, *supra* note 4, at 6–7 (stating that it will recommend a "withhold" vote on director nominees if a board performs poorly vis-à-vis its peers and lacks accountability and oversight, taking into account, among other things, certain "[p]roblematic provisions," including stockholders' inability to call special meetings).

[8] *See, e.g.*, *id.* at 7 (listing a "classified board structure" as a "[p]roblematic provision"); Lublin, *supra* note 3; *City of Westland Police & Fire Ret. Sys. v. Axcelis Techs., Inc.*, 2009 WL 3086537, at *2 n.10 (Del. Ch. Sept. 28, 2009) ("The Company attributed the [failure of the Company's directors to receive a majority of the votes cast in their unopposed reelection bids] to a recommendation by Institutional Shareholder Services that stockholders withhold their votes for the reelection of the Three Directors due to the failure of the Board to support a proposed change to the Axcelis Certificate of Incorporation eliminating the classified board structure.").

[9] *See, e.g.*, http://www.isscgq.com/CGQratings.htm (listing "Board Structure" as one factor driving the "Corporate Governance Quotient" published by ISS).

[10] *See* Gregory T. Carrott, *The Case For and Against Staggered Boards*, Directorship, Sept. 22, 2009 ("So, perhaps not surprisingly, under pressure from institutional investors, there has been a tremendous decrease in the percentage of companies with staggered boards. Among the Standard & Poor's 500, for example, only 34 percent have a classified board. According to RiskMetrics, 79 publicly traded companies themselves placed declassification resolutions on their ballots in 2008. There were 54 company-sponsored proposals in 2007 and 72 in 2006.").

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poses a potential problem for boards desiring to retain the protection of a classified board. Recent events have actualized the risk of the traditional model. We set forth in this article a solution designed to avoid destaggering risk as long as possible under current law.

The Risks of Destaggering

One of the primary benefits of a properly staggered board as an anti-takeover device is the accompanying prohibition on removing directors without cause. Under Section 141(k) of the General Corporation Law of the State of Delaware (DGCL), directors generally may be removed with or without cause.[11] But if the board of a corporation is "classified as provided in [Section 141(d)]," unless the certificate of incorporation otherwise provides, stockholders may remove directors only "for cause."[12] The Delaware courts have set a high threshold for stockholders seeking to demonstrate cause for removal, making it an unrealistic option for a would-be acquirer to achieve majority control of the board.[13]

To avoid losing the "for cause" removal protection (at least in the short term), many companies choose to destagger over time, allowing each class of directors to serve until the end of their natural terms and destaggering the board completely only when all those terms have expired. In other words, boards typically end their three-class classified structure at the annual meeting of Year 0 and provide that the directors formerly in Class A are up for election to a one-year term in Year 1, the directors formerly in Class B are up for election to a one-year term in Year 2 (along with the directors formerly in Class A, who will have reached the end of their previous one-year term), and all the directors are up for election to one-year terms in Year 3.

Under Delaware law, however, this traditional model is subject to an argument that a "phased" destagger subjected directors to removal without cause immediately. For example, the Court of Chancery, addressing a proposed amendment to declassify a board of directors, held that directors subject to removal without cause are not entitled to serve out their full terms and that the "shareholders may amend the certificate of incorporation to eliminate the classified board, and thereafter remove any director without cause."[14] Similarly, the Court has stated that, as soon as a classified board structure is validly eliminated, the "directors will no longer serve as directors of a 'corporation whose board is classified' [and] will at that time be removable without cause."[15] "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, that corporation's directors can be removed without cause."[16]

This legal argument had only been applied to boards of directors whose classified structures had been dismantled in one fell swoop, and therefore, the risk to a board in the process of destaggering had heretofore been only theoretical. In 2008, however, this risk became real.

At its 2006 annual meeting, Anheuser-Busch approved an amendment to its charter to eliminate its staggered board. In its proxy statement for that meeting, Anheuser-Busch disclosed that the amendment would enable stockholders "to evaluate directors annually" and would assist the company in maintaining "best practices in corporate governance."[17] The text of the amendment stated: "Commencing with the 2007 annual meeting of the stockholders, directors shall be elected annually for terms of one year and shall hold office until the next succeeding annual meeting and until his or her successor shall be elected and shall qualify . . . ."[18] The amendment followed the traditional "phased" model.[19] Interestingly,

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[11] 8 *Del. C.* § 141(k).

[12] *Id.* § 141(k)(1).

[13] Zeberkiewicz & Rohrbacher, *supra* note 1, at 21 & n.6.

[14] *Roven v. Cotter*, 547 A.2d 603, 609 (Del. Ch. 1988); *see also* Zeberkiewicz & Rohrbacher, *supra* note 1, at 21–22.

[15] *Chesapeake Corp. v. Shore*, 771 A.2d 293, 346 (Del. Ch. 2000) (footnote omitted).

[16] Zeberkiewicz & Rohrbacher, *supra* note 1, at 22 (footnote omitted).

[17] Anheuser-Busch Companies, Inc., Proxy Statement (Schedule 14A), at 14 (Mar. 9, 2006).

[18] *Id.*

[19] *See id.* (providing that "[d]irectors elected at the 2004 annual meeting of stockholders shall hold office until the 2007 annual meeting of stockholders; directors elected at the 2005 annual meeting of stockholders shall hold office until the 2008 annual meeting of stockholders and directors elected at the 2006 annual meeting of stockholders shall hold office until the 2009 annual meeting of stockholders.")

the amendment, like the staggered board provision it replaced, was silent on the removal of directors, presumably reflecting the assumption that the protection from removal without cause by statutory default would continue to apply until the board was fully destaggered.

In June 2008, InBev announced its proposal to acquire all of Anheuser-Busch's outstanding shares for $65 per share; Anheuser-Busch announced that the offer was inadequate and not in the best interests of its stockholders.[20] Anheuser-Busch's board sought the freedom to independently pursue its long-term plans for the company,[21] but InBev filed a consent solicitation statement seeking to remove each member of Anheuser-Busch's current board "except to the extent that a court in Delaware finally determines as a matter of law that directors cannot be so removed."[22]

InBev concurrently commenced litigation in Delaware for a declaration that Anheuser-Busch's board was not "classified" as provided in Section 141(d) and, accordingly, that Anheuser-Busch's directors were subject to removal with or without cause. InBev's arguments hewed closely to the Chancery cases discussed above.[23] But the InBev/Anheuser-Busch transaction turned friendly, and the litigation was voluntarily dismissed before the Court had a chance to rule on the issue—much to the chagrin of corporate practitioners not directly involved in the transaction. But the gauntlet had been thrown; the traditional "phased" model had been exposed as subject to attack.

Defining the "Classified" Board

Before exploring how boards may avoid the risk raised in the InBev/Anheuser-Busch litigation, it may be instructive to discuss the basic mechanisms underlying a classified-board structure. Section 141(d) of the DGCL provides that the directors of any Delaware corporation may

> be divided into 1, 2 or 3 classes; the term of office of those of the first class to expire at the first annual meeting held after such classification becomes effective; of the second class 1 year thereafter; of the third class 2 years thereafter; and at each annual election held after such classification becomes effective, directors shall be chosen for a full term, as the case may be, to succeed those whose terms expire.[24]

Section 141(k), which provides as a general rule that stockholders may remove directors with or without cause, works with Section 141(d) to grant directors protection from removal: "in the case of a corporation whose board is classified as provided in subsection (d) of this section, shareholders may effect such removal only for cause."[25]

The crucial language in Section 141(k)(1) is the phrase that defines the directors with protection against removal without cause. In other words, directors are only protected if they serve on a board that "is classified as provided in [Section 141(d)]." Section 141(d) provides the mechanism for classifying a board, and Section 141(k)(1) provides that any directors serving a corporation in compliance with Section 141(d) will be protected from removal without cause.

Building a Better Mousetrap: A Provision for Protected Destaggering

To ensure that directors are protected from removal without cause, therefore, it is important to ensure that the board is "classified as provided in [Section 141(d)]." The typical way of accomplishing this goal is, of course, to divide the board into three classes with rotating terms of three years each. Not as typical, but still in compliance with Section 141(d), is to divide the board into two classes with alternating terms

[20] Anheuser-Busch Companies, Inc., Press Release (Form 8-K), Ex. 99.1, at 1 (June 26, 2008).

[21] *See id.* at 4.

[22] *See* Anheuser-Busch Companies, Inc., Consent Statement of Inbev S.A. (Schedule 14A), at 1 (July 7, 2008). We presume that this "to the extent" language was a hedge as to whether the traditional "phased" model might be bullet-proof, and we surmise that InBev anticipated that only the class of directors already put on the one-year track might be removable without cause.

[23] *See* Plaintiff's Opening Brief in Support of Its Motion for Summary Judgment, *InBev NV/SA v. Anheuser-Busch Cos.*, C.A. No. 3857-VCP (Del. Ch. July 8, 2008).

[24] 8 *Del. C.* § 141(d).

[25] *Id.* § 141(k)(1). Section 141(k)(1) does, however, provide that a corporation may provide otherwise in its certificate of incorporation.

of two years each.[26] Regardless of whether the directors are divided into two or three classes,[27] they will be protected from removal without cause.

With the traditional process of "phased" destaggering, on the other hand, the directors arguably become declassified immediately, leading to the litigation risk posed by the InBev lawsuit. That is, a board following the traditional process will not be divided into "1, 2 or 3 classes," as provided in Section 141(d). Take, for example, Anheuser-Busch. As mentioned above,[28] upon the effectiveness of the charter amendment, it had directors merely serving out their three-year terms and coming up for annual elections. But unless the board is "classified as provided in subsection (d)," the directors are not entitled the "for cause" removal protection under Section 141(k)(1). InBev sought to take advantage of that lack of protection.

In summary terms, the proposal we advance—the "protected" destaggering approach—works by maintaining the classified structure of the board until the destaggering process is complete. That is, the board's structure changes each year: from a three-class board to a two-class board to a one-class board. Each year, as the term of one class of directors expires, those directors are placed in the class of the directors that will be up for election at the next annual meeting. To contrast with the traditional model described above, in the protected destaggering approach, the board is divided into three classes (Classes A, B, and C) at the annual meeting in Year 0. At the annual meeting in Year 1, the board is reclassified into a board with two classes, and the directors from Class A (whose terms expire) upon reelection are placed with the directors in Class B. That is, at the annual meeting in Year 1, the board has two classes (Class A+B and Class C). At the annual meeting in Year 2, the board is reclassified into a single class, and the directors from Class A+B upon reelection are placed with the directors in Class C to form a single class (Class A+B+C). The form text of our proposed provision may be found in the Appendix to this article.

The theory behind the protected destaggering approach is that, unlike in the traditional model, the board remains "classified as provided in [Section 141(d)]" for each of the three years that it takes to destagger fully. That is, the board complies with Section 141(d) in the first year because it is classified into three classes (with each class being elected on staggered one-, two-, and three-year terms), in the second year because it is classified into two classes (with each class being elected on staggered one- and two-year terms), and in the third year because it is classified into one class (with the directors being elected to one-year terms).

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[26] A hyper-technical argument exists under the DGCL that a board can be classified into a single class that merits protection under Section 141(k). That is, Section 141(d) provides that directors of a Delaware corporation may "be divided into 1, 2 or 3 classes." It is unsurprising, therefore, to see directors divided into three or even two classes. But, since the statute explicitly provides that it may be so, the question may be asked regarding the effect of having a board with directors "divided into 1" class. Arguably, Section 141(k)(1) should still apply to a board with directors divided into a single class, since it applies to any board that is "classified as provided in [Section 141(d)]," and Section 141(d) contemplates a board with directors divided into one class.

While this may seem frivolous at first blush, it is important to note that Section 141(k)(1) does *not* refer to a board that is "classified into 2 or 3 classes as provided in Section 141(d)." It instead applies to any board "classified as provided" in Section 141(d), which itself states that directors may be "divided into 1" class.

If this argument were to succeed, it arguably would provide protection from removal without cause for directors of a corporation with a charter or bylaws stating that the directors of the corporation "are divided into a single class." Some charters containing such language do in fact exist. *See*, *e.g.,* Vacation Properties International, Inc., Registration Statement (Form S-1), Ex. 3.1 (Mar. 12, 1998) (providing, in the certificate of incorporation, that "[t]here shall be one class of directors of the Corporation," that "directors shall be elected to hold office until the next annual meeting of the stockholders and until their successors have been duly elected and qualified," and that "[n]o director may be removed from office by a vote of the stockholders at any time except for cause"); Samsonite Corporation, Current Report (Form S-1A), Ex. 3.2 (June 20, 2007) (providing, in the certificate of incorporation, that "[a]ll directors shall be of one class and each director shall serve for a term ending at (i) the annual meeting following the annual meeting at which the director was elected or (ii) the first annual meeting after the director was appointed" but specifying that "any Director or the entire Board of Directors may be removed, with or without cause, by the holders of a majority of the shares of capital stock of the Corporation then entitled to vote at an election of directors").

Despite the statutory language, a Delaware court could nevertheless find that interpreting subsections (d) and (k) of Section 141 to protect directors serving on a board "divided" into one class from removal without cause would lead to an "absurd" result. *See Spielberg v. State*, 558 A.2d 291, 293 (Del. 1989) ("[T]he statute must be viewed as a whole, and literal or perceived interpretations which yield mischievous or absurd results are to be avoided."). The court could, for example, point to the comment to the 1974 legislation creating the new Section 141(k), in which the drafters stated, "In the case of directors *elected for a term of years* to a classified board under § 141(d), removal may be only with cause." 2 R. Franklin Balotti & Jesse A. Finkelstein, *The Delaware Law of Corporations and Business Organizations* § 141, at IV-14 (3d ed. 2009) (emphasis added); *see also* S. Samuel Arsht & Lewis S. Black, *The Delaware General Corporation Law: Recent Amendments*, 30 Bus. Law. 1021, 1023–24 (1975) (noting that one exception to the general rule that stockholders may remove directors with or without cause occurs where "a corporation has a classified board (staggered terms) and the certificate of incorporation does not otherwise provide").

[27] Or possibly one. *See supra* note 26.

[28] *See supra* note 19.

To be clear, the "for cause" removal protection provided in the third year may not survive an eventual judicial challenge,[29] but the protected destaggering approach provides *at least* two more years of protection from removal without cause than the traditional model, if not three more. While the traditional model is subject to challenge (as in the InBev litigation) immediately upon the charter amendment's effectiveness, the protected destaggering approach provides more certain protection against removal in the first and second years since the board remains "classified as provided in [Section 141(d)]." The third year, while not as certain, is no less protected than the third year of the traditional model and may even provide full protection.[30]

In following the protected destaggering approach, boards and their counsel should keep a few things in mind. First, if the existing staggered board provision contains a customary requirement that the number of directors in each class be "as nearly as equal as possible," that clause may need to be eliminated or changed so that directors can be assigned into the new classes (while preserving their otherwise natural terms). Second, the destaggering provision should specify the time at which the board is no longer classified and should expressly provide that, from and after such time, directors may be removed with or without cause. Third, because this destaggering approach will put more directors up for election in every year, it will not prevent an acquirer from winning control at the ballot box. The protected destaggering approach will only prevent an acquirer from removing directors without cause for at least two (and possibly three) of the three years that it takes to destagger completely.

Conclusion

Even though many companies in the current economic environment may be attractive targets for unwanted takeovers, they continue to receive pressure from institutional stockholders and stockholder activists to eliminate structural anti-takeover devices, such as staggered board provisions. If a board determines that eliminating the classified structure is advisable, it should consider whether it is nonetheless appropriate to preserve the protection against removal of directors without cause for the maximum period permitted under the statute.

In years past, boards have attempted to accomplish this goal through a "phased" destaggering method. No Delaware court has yet ruled on whether directors in the midst of a phased destaggering are subject to removal without cause. The protected destaggering approach described in this article, while untested by the courts, should offer additional protection from removal without cause for at least two (and possibly three) years. This additional time may be valuable to a board seeking to implement a long-term strategy in a challenging environment, ensuring that its stockholders (and not a hostile acquirer) reap the benefits of the company's long-term plans.

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[29] *See supra* note 26.

[30] The benefits of the approach that we advance in this article may be seen in a real-world example. In 2008, Fortune Brands, Inc. received a stockholder proposal from a notorious proponent requesting that its board take steps necessary to destagger. *See* Fortune Brands, Inc., Proxy Statement (Schedule 14A), at 45–46 (Mar. 6, 2008). The board recommended that stockholders vote against this proposal, stating its belief that the staggered board "plays an important role in ensuring that the interests of all stockholders are protected and maximized in connection with an unsolicited takeover proposal" and that the structure would "prevent[] a potential acquirer from replacing a majority of the Board with its own nominees at a single meeting" and "gain[ing] control of the Company without paying a fair value to the Company's stockholders" by, among other things, "eliminat[ing] the threat of imminent removal of a majority of Board members." *Id.* at 46-47.

Despite the board's recommendation, the precatory proposal to eliminate Fortune's staggered board was approved. *See* Fortune Brands, Inc., Quarterly Report (Form 10-Q), at 55 (Aug. 8, 2008). At its next annual meeting, Fortune proposed an amendment to its charter to eliminate the staggered board, but, consistent with its belief that preserving the "for cause" removal was important to the company, it adopted a protective approach along the lines we advocate. *See* Fortune Brands, Inc., Proxy Statement (Schedule 14A), at 1 (Mar. 9, 2009). "If this item is approved by stockholders, Article VIII, Section 4 of the Certificate of Incorporation would be amended to provide that, once the Board has become declassified in 2012, directors may be removed with or without cause." *Id.* at 48.

Appendix: Text of Proposed Destaggering Proposal

The text of our proposed destaggering proposal, applicable to a proposal presented at a company's 2010 annual meeting of stockholders, is set forth in full below:

1. The number of the directors of the Company shall be determined solely by resolution of the Board of Directors. Subject to the special right of the holders of any class or series of stock to elect directors:

   a. From the effective date of this Certificate of Amendment until the election of directors at the 2011 Annual Meeting of stockholders, pursuant to Section 141(d) of the General Corporation Law of the State of Delaware, the Board shall be divided into three classes of directors, Class I, Class II and Class III (each class as nearly equal in number as possible), with the directors in Class I having a term expiring at the 2011 Annual Meeting, the directors in Class II having a term expiring at the 2012 Annual Meeting and the directors in Class III having a term expiring at the 2013 Annual Meeting.

   b. Commencing with the election of directors at the 2011 Annual Meeting of stockholders, pursuant to Section 141(d) of the General Corporation Law of the State of Delaware, the Board shall be divided into two classes of directors, Class I and Class II, with the directors in Class I having a term that expires at the 2012 Annual Meeting and the directors in Class II having a term that expires at the 2013 Annual Meeting. The successors of the directors who, immediately prior to the 2011 Annual Meeting, were members of Class I (and whose terms expire at the 2011 Annual Meeting) shall be elected to Class I; the directors who, immediately prior to the 2011 Annual Meeting, were members of Class II and whose terms were scheduled to expire at the 2012 Annual Meeting shall become members of Class I; and the directors who, immediately prior to the 2011 Annual Meeting, were members of Class III and whose terms were scheduled to expire at the 2013 Annual Meeting shall become members of Class II with a term expiring at the 2013 Annual Meeting.

   c. Commencing with the election of directors at the 2012 Annual Meeting of stockholders, pursuant to Section 141(d) of the General Corporation Law of the State of Delaware, there shall be a single class of directors, Class I, with all directors of such class having a term that expires at the 2013 Annual Meeting. The successors of the directors who, immediately prior to the 2012 Annual Meeting of stockholders, were members of Class I (and whose terms expire at the 2012 Annual Meeting) shall be elected to Class I for a term that expires at the 2013 Annual Meeting, and the directors who, immediately prior to the 2012 Annual Meeting, were members of Class II and whose terms were scheduled to expire at the 2013 Annual Meeting shall become members of Class I with a term expiring at the 2013 Annual Meeting.

   d. From and after the election of directors at the 2013 Annual Meeting of stockholders, the Board shall cease to be classified as provided in Section 141(d) of the General Corporation Law of the State of Delaware, and the directors elected at the 2013 Annual Meeting (and each Annual Meeting thereafter) shall be elected for a term expiring at the next Annual Meeting and may be removed with or without cause.

Each director elected at any Annual Meeting shall hold office until such director's successor shall have been duly elected and qualified.

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