DECLASSIFYING THE CLASSIFIED

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ABSTRACT

Despite the prevalence of staggered boards, only lately have they become the focus of corporate debate, and the literature on them is still limited. Scholars assume that staggered boards by definition mean a guaranteed term of office, unless cause for removal is present. They further believe that staggered boards contribute to corporate stability, long-term planning, and the board's independence from management. They primarily debate the desirability of staggered boards in takeovers, some suggesting that staggered boards coupled with poison pills have become the most effective way to prevent hostile takeovers. Scholars also note that overwhelmingly shareholders are powerless to undo staggered boards without the board's consent and that state legislatures are unlikely to amend the statutes in favor of shareholders.

This article argues that we can safely sever the link between staggered boards and entrenchment in office. It suggests that the traditional rationales supporting entrenched staggered boards are no longer valid. In fact, a Delaware statute, protecting staggered boards against removal without cause, was based on a misreading of a judicial opinion, which was not even good law at the time it was enacted. The article draws an analogy from agency law to contend that the law should not tolerate the irrevocability of staggered terms in quasi-agency relationships of the kind that exist between shareholders and directors, notwithstanding contractual provisions to the contrary. Indeed, other countries with similar statutory protections require only monetary damages for unjustified removals. They treat shareholders' removal power as mandatory and unwaivable. A look at independent agencies, the closest constitutional analogy, shows that there, too, staggered terms and removal protection warrant only compensatory damages, not reinstatement. This

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article thus argues for similar treatment of staggered boards and removal-for-cause protections, which would resolve one of the most difficult problems in corporate governance today. By permitting only monetary damages, not entrenchment, to directors removed without cause, their entitlement to office is transformed from a property rule to a liability rule, which is fully justified under the contractual theory of efficient breach and restores shareholder power to its intended potency.

TABLE OF CONTENTS

I. INTRODUCTION

> *"The Courts of this State will not allow the wrongful subversion of corporate democracy by manipulation of the corporate machinery or by machinations under the cloak of Delaware law."*[1]

We have finally come to recognize that corporate elections must be reinvigorated. The SEC has proposed new rules granting shareholders greater access to ballots, which in turn allows them to better influence who will run the corporation for them.[2] But even that will not solve the problem posed by staggered boards—the predominant board structure in publicly-held corporations—where typically only a minority of the board stands for election each year and removal is possible only for cause.[3]

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[1]MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1127 (Del. 2003) (quoting Giuricich v. Emtrol Corp., 449 A.2d 232, 239 (Del. 1982)).

[2]For the SEC's proposed rule, see Security Holder Director Nominations, 68 Fed. Reg. 60,784, 60,785 (proposed Oct. 14, 2003) (to be codified at 17 C.F.R. ptrs. 240, 249, 274). The comments on this proposed rule are available at http://www.sec.gov/rules/proposed/s71903.shtml. Under existing law, while shareholders may be eligible to include some proposals in the proxy materials sent by the corporation to all shareholders, Rule 14a-8 explicitly excludes proposals relating to the election of the board (17 C.F.R. § 240.14a-8(i)(8) (2005)). Thus, if shareholders wish to contest the board's (and indirectly the management's) proposed candidates to the board, they have to incur the expenses of conducting a "proxy contest," including the expenses of printing and distributing the materials themselves. *Id.* The SEC's proposed new Rule 14a-11 would somewhat improve this situation by requiring, under certain conditions, the board to include shareholder proposed nominations in the corporation's proxy materials that are distributed before the shareholders' meeting. Security Holder Director Nominations, 68 Fed. Reg. at 60,784-60,785. Business' interests emphatically oppose the proposed rule. *See* John C. Coffee, Jr., *The SEC Under Attack*, NAT'L L. J. , Dec. 6, 2004, at 17. Vice Chancellor Leo Strine of the Delaware Court of Chancery has even suggested that it is "moribund." Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1776 (2006).

[3]Staggered boards are boards that are subject to staggered terms under which only a part of the board stands for election each time. BLACK'S LAW DICTIONARY 184 (8th ed. 2004). Though the full term of all directors is usually the same, it expires at different intervals thus guaranteeing continuity with change on the board. *See* DEL. CODE ANN. tit. 8, § 141(d) (2005). The overwhelming majority of publicly-held corporations have staggered boards, sometimes known as classified boards. Robin Sidel, *Staggered Terms for Board Members Are Said to Erode Shareholder Value, Not Enhance It*, WALL ST. J., Apr. 1, 2002, at C2 (reporting that between sixty to seventy percent of U.S. public corporations have staggered boards). *See also* Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J.L. ECON. & ORG. 83, 95-96 (2001) (reporting that between 1994 and 1997, about forty percent of companies that underwent an initial public offering had staggered boards).

Despite their prevalence, the literature on staggered boards is still sparse.[4] Only lately have scholars refocused their attention on staggered boards, primarily debating their desirability in takeovers as well as considering their economic ramifications more broadly.[5] Some have claimed that staggered boards pose the most formidable obstacle to hostile takeovers when combined with a poison pill. Others defend them for that very reason. Many applaud staggered boards as a governance devise for promoting stability, independence, and long-term planning in corporations. All agree that they are here to stay: shareholders typically cannot undo them without board consent. In fact, boards routinely ignore precatory resolutions to repeal staggered terms, even though such proposals have enjoyed the highest level of shareholder support in recent years. Nor are state legislatures expected to amend legislation in favor of shareholders.

This article argues that those opposing theories on staggered boards may find common ground in recognizing a heretofore unrealized shareholder power to remove even staggered members. It asserts that the problem with staggered boards is primarily that of governance, not economic or antitakeover, in nature. In fact, none of the traditional rationales made in favor of staggered boards are valid in modern times. Further, the Delaware statute, protecting staggered boards against removal without cause, was based on a misreading of a judicial opinion that was no longer good law at the time the statute was enacted. Above all, contrary to conventional understanding, staggered terms and removal-for-cause provisions are the starting, rather than ending, point of statutory construction. This article contends that, because the law does not tolerate the irrevocability of agency relationships, the quasi-agency relationship that exists between shareholders and directors should be revocable. Shareholders should be able to remove directors, notwithstanding contrary contractual provisions. In the absence of cause, under this agency theory, the company should compensate staggered board members for their removal from office.[6] In fact, this is exactly how similar statutory

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[4]Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 STAN. L. REV. 791, 793 n.7 (2002) (commenting that while scholarship on poison pills is "voluminous," it is "considerably smaller" with regard to classified boards). Over the years, authors have dealt with staggered boards only in passing, typically commenting that staggered boards are used as a defensive technique against hostile takeovers.

[5]*See infra* Part II.

[6]Under current law, "for cause" requires misfeasance or nonfeasance in office. 2 WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 356 (rev. vol. 2006). If there were no legal grounds for removal, then the attempted removal is void. *Id.* § 362. A director may challenge such removal in court and be reinstated in office. *Id.* §§ 362-363.

provisions have been interpreted in other countries as well as in independent agencies, the closest constitutional analogy.[7] This approach transforms the protection on a director's entitlement to office from a property to a liability rule,[8] which further aligns with law's and economics' support of efficient breach of contracts.[9] Such statutory interpretation, if accepted, would solve one of the most difficult problems facing corporate governance today.

All states allow for staggered boards if a corporation has a certain minimum number of directors.[10] In fact, staggered boards have become the predominant board structure of publicly-held corporations.[11] The typical structure of staggered boards is to divide directors into three classes, with directors in each class being elected for three-year terms, only a third of whom stands for election each year.[12] Thus, shareholders annually elect a minority of the board, which undermines corporate law's allocation of power between shareholders and directors—the board sets the policy and monitors the management of the corporation, but shareholders annually elect their board.[13] Moreover, while the default rule is that shareholders always have the power to remove directors, in Delaware—the preeminent state jurisdiction in U.S. corporate law[14]—shareholders may remove

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[7]*See infra* Part III.F.1.

[8]*See infra* Part IV.

[9]*See infra* Parts III.D & IV.

[10]Even California, the last state to join this trend, succumbed to the competitive pressure to attract incorporations. CAL. CORP. CODE §§ 301-301.5 (2006). *See also* Susan A. Rose, *Optional Cumulative Voting & Staggered Terms of Directors: Is the California Climate Warming to Corporations?*, 27 SAN DIEGO L. REV. 467 (1990) (providing that California's recent legislation suggests that it has made a concerted effort to provide a hospitable environment for corporations).

[11]*See* Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 889 (2002) (finding that staggered boards in publicly-traded companies increased from thirty-four percent in 1990 to over seventy percent in 2001).

[12]The New York Stock Exchange refuses to list the common stock of corporations whose boards are "classified into more than three classes of approximately equal size and tenure." 1 ARTHUR FLEISCHER, JR. & ALEXANDER R. SUSSMAN, TAKEOVER DEFENSES ch. 6, § 6.05, at 27 n.92 (6th ed. Supp. 2004). The Delaware statute, too, limits the number of classes to three. DEL. CODE ANN. tit. 8, § 141(d) (2005).

[13]The corporation's "business and affairs . . . shall be managed by or under the direction of the board of directors." DEL. CODE ANN. tit. 8, § 141(a) (2005). Generally, shareholders annually elect their board. *Id.* § 211.

[14]Statistics confirm Delaware's position as the leader in corporate dealings:

> As is well known, Delaware has by far the largest stake of incorporations: [Among publicly traded non-financial firms, Delaware is the domicile of] 58 percent of all firms, 59 percent of the Fortune 500 firms, and even a higher percentage—68 percent—of firms that went public in the period 1996-2000.

Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON.

staggered board members only for cause unless the certificate provides otherwise.[15] By restricting shareholders' appointment and removal powers, staggered boards thus diminish shareholders' supervisory power over directors and the accountability of corporate boards.

Staggered board provisions may be set forth in either the bylaws or the corporation's charter, though the charter provides better protection for staggered boards because shareholders may not repeal them without the board's consent.[16] Massachusetts even treats staggered boards as the default arrangement in corporations that have voting stock registered under the Securities Exchange Act of 1934, so that corporations must opt out in their charter if they do not desire staggered boards.[17]

Corporations may further protect staggered boards by requiring a supermajority of shareholders to undo staggered boards. Moreover, corporations have also complemented staggered board provisions with provisions protecting against a change in the board's size without its consent to prevent packing the board with new members, thus diluting existing members' power. Boards also have been authorized to fill

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383, 389 (2003). Delaware law is considered the de facto national corporate code. *See, e.g.*, Bayless Manning, *State Competition: Panel Response*, 8 CARDOZO L. REV. 779, 783-84 (1987).

[15]*Id.* § 141(k)(1). *Cf.* MODEL BUS. CORP. ACT §§ 8.06, 8.08(a) (2005) (setting the opposite default rule with regard to staggered boards). The Act does not distinguish between the removal of staggered and non-staggered boards. Under the Act, shareholders may remove directors with or without cause unless the articles of incorporation restrict the removal "for cause." *See id.* § 8.08(a).

[16]Under section 141(d) of the Delaware General Corporation Law, a staggered board provision may be included in the certificate of incorporation, or an initial bylaw or a bylaw adopted by a shareholder vote. DEL. CODE ANN. tit. 8, § 141(d) (2005). Once the corporation provides for a staggered board, the procedure for its repeal depends on the instrument in which it is provided. While the board has sole authority to initiate the procedure for amending the charter, see DEL. CODE ANN. tit. 8, § 242(b)(1) (2005), "the power to adopt, amend or repeal bylaws shall be in the stockholders entitled to vote." *See id.* § 109(a). The charter may authorize the board to amend the bylaws, but even then the ultimate power over the bylaws is in the hands of the shareholders. *Id.* Bebchuk has recently suggested that the law be amended to grant shareholders the power to initiate and adopt changes in the charter without board approval. *See* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 836 (2005). The U.K. grants such powers to the general meeting of shareholders. *Id.* at 847-49.

[17]MASS. GEN. LAWS ch. 156B, § 50A (2004). This was adopted as an antitakeover statute in response to the attempted hostile takeover of Norton in 1990. Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1859 (2002). Daines found that the stock prices of corporations affected by this legislation declined. Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559, 1579 n.70 (2002) (citing Robert M. Daines, Do Classified Boards Affect Firm Value? Takeover Defenses after the Poison Pill 16-20 (NYU, Ctr. for Law & Bus. Research Paper No. 02-05, Dec. 2001), *abstract available at* http://papers.ssrn.com/sol3/ papers.cfm?abstract_id=317700).

vacancies created on the board.[18] It is only when shareholders must depend on directors to undo staggered boards or when they can repeal them by supermajority vote alone that these arrangements truly undermine shareholder supervisory power. Only then are staggered boards effectively entrenched.

It should come as no surprise, then, that in recent years, staggered boards have become the center of debate, with shareholders repeatedly adopting precatory resolutions in favor of their abolition.[19] Christopher Shier, writing for the Institutional Shareholder Services, reports: "In 2002, shareholder proposals requesting the repeal of classified boards ranked among the highest in terms of the number of shareholder proposals relating to any single corporate governance issue, and received the highest average level of voting support."[20] Yet, boards have routinely ignored such proposals from shareholders.[21] In other words, despite shareholders' decisions to undo staggered boards, they have been unsuccessful in enforcing their will, due in part to the very entrenchment at issue.

Legal academia has refocused its attention on staggered boards as well. In 2002, the *Stanford Law Review* held an influential symposium on their article, *The Powerful Antitakeover Force of Staggered Boards:*

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[18]FLEISCHER & SUSSMAN, *supra* note 12, at 6-29.

[19]Patrick S. McGurn, a special counsel to the Institutional Shareholder Services (ISS), writes, "Over the past decade, resolutions to repeal classified boards have appeared on ballots at hundreds of companies.... Since the 2000 proxy season, repeal proposals have averaged support in excess of fifty percent of the votes cast." Patrick S. McGurn, *Classification Cancels Corporate Accountability,* 55 STAN. L. REV. 839, 840 (2002) (quoting Inst. S'holder Servs., Voting Results Database, 2000-2002 (on file with author)).

[20]CHRISTOPHER SHIER, CLASSIFIED BOARDS 1 (IRRC Governance Research Service, Background Report C, Mar. 2003). The average support level was sixty-two percent of the votes cast. *Id.* at 2. According to the Investor Responsibility Research Center (IRRC), in the forty-eight companies facing resolutions to repeal classified boards during 2003, the average support level for such resolutions was sixty-three percent. As of July 29, 2004, 56 such resolutions had been proposed in 2004 and their average level of support was 66.2%. *See* http://www.irrc.org/company/classified_bd.html.

[21]"[I]t is rare for a company to take action following a shareholder proposal, regardless of the support generated by the proposal." SHIER, *supra* note 20, at 8. This was true even when shareholders repeatedly passed resolutions to de-stagger the board. *Id.* Lately, however, some boards have voluntarily repealed staggered terms in response to precatory resolutions. *See* Strine, *supra* note 2, at 1772 n.35. For a study that suggests a correlation between firms with better governance structures and boards' decisions to de-stagger, see Timothy A. Kruse et al., *Undoing the Powerful Anti-Takeover Force of Staggered Boards* (May 24, 2006), *available at* http://ssrn.com/abstract=891534. *Cf.* Mira Ganor, *Why do Managers Dismantle Staggered Boards?* (June 12, 2006), *available at* http://ssrn.com/abstract=908668 (suggesting that boards' de-staggering is positively correlated with two factors: (1) shareholder pressure in the form of precatory resolutions and (2) the amount of CEOs' unvested restricted options). A board's decision to de-stagger voluntarily is still a minority phenomenon. *Id.*

Theory, Evidence, and Policy,[22] by Lucian Bebchuk, John Coates, and Guhan Subramanian, which harshly criticized the effects of staggered boards in the takeover scenario. The article's authors argued that staggered terms combined with a poison pill provide the most formidable obstacle to hostile takeovers.[23] While shareholders' decisions regarding their corporate governance should generally be respected, Bebchuk, Coates, and Subramanian claimed that shareholders adopted staggered board provisions at a time when these provisions lacked the antitakeover effects they hold today, particularly in conjunction with shareholder-rights plans or so-called "poison pills." Shareholders, therefore, never consented to the antitakeover effects of staggered boards. It follows, the authors say, that the consensual basis for staggered boards in the takeover context is flawed.

Surprisingly, all the academic participants in the symposium supported staggered boards as a governance mechanism.[24] They all accepted staggered boards' contributions to corporate stability and long-term planning. Rather, the debate centered on the desirability of staggered boards in a takeover context, where the boards may prevent the consummation of hostile tender offers. Only now does Bebchuk argue that, even outside the takeover context, staggered boards are faulted for their association with negative economic results.[25]

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[22]Bebchuk et al., *supra* note 11.

[23]*See id.* at 904. A poison pill is one of the most common defensive techniques against a hostile takeover devised for the first time by the law firm of Wachtell, Lipton, Rosen & Katz. RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 740-47 (2d ed. 1995). A typical pill is a share purchase rights plan that is triggered when a potentially hostile raider reaches a certain percentage of holdings of the corporation's stock (usually between ten and twenty percent). Bebchuk et al., *supra* note 11, at 904-05. Once the plan is triggered, it allows existing shareholders to purchase corporate stock at a nominal price, thus diluting the hostile acquirer's holdings and making it prohibitively expensive for it to pursue a hostile takeover. *Id.* There are several variations of the poison pill, including "'flip-in" and "flip-over" features, all intended to dilute the raider's holdings thus deterring it from proceeding with a hostile as opposed to a friendly deal, i.e., one negotiated with the board. *See* GILSON & BLACK, *supra*, at 740-42.

[24]The symposium respondents included: Bainbridge, *supra* note 4; Mark Gordon, *Takeover Defenses Work. Is That Such a Bad Thing?*, 55 STAN. L. REV. 819 (2002); Lynn A. Stout, *Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex ante Valuation Problem*, 55 STAN. L. REV. 845 (2002); Leo E. Strine, Jr., *The Professorial Bear Hug: The ESB Proposal as a Conscious Effort to Make the Delaware Courts Confront the Basic "Just Say No" Question*, 55 STAN. L. REV. 863 (2002). The only response to the authors' article, questioning laconically the validity of staggered boards in general, was by a special counsel of the ISS. *See* McGurn, *supra* note 19.

[25]*See* Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409, 410 (2005). Recent studies support these findings. *See, e.g.*, Olubunmi Faleye, *Classified Boards, Firm Value, and Managerial Entrenchment*, J. FIN. ECON. (forthcoming), *available at* http://ssrn.com/abstract=877216; Kruse et al., *supra* note 21.

Specifically, this article argues that the main difficulty with staggered boards is their restriction on shareholder removal power, a corporate governance matter, rather than their antitakeover or economic effects. The solution to staggered boards, in turn, should focus on reasserting shareholder removal power. This can be done under existing law, through statutory reinterpretation, without necessitating boards' or legislatures' cooperation.

Part II presents the existing debate on the desirability of staggered boards in the takeover context, portraying that debate as a dispute over the allocation of decision-making power between shareholders and directors in which those supporting shareholder decision-making power oppose staggered boards and vice versa. This article argues that, despite the above authors' contention, staggered boards were already recognized for their antitakeover consequences in the nineteenth century and justified on that basis. The specific workings of staggered boards, allegedly revealed for the first time by the authors, have long been known as well. In other words, we cannot undermine the consensual basis for staggered boards in the way the authors suggested. Though the debate on staggered boards has focused primarily on takeovers, this article argues that the antitakeover effect is just one by-product of the problem with staggered boards. In fact, common ground may be found between the otherwise opposing views on staggered boards through recognition of shareholder removal power.

Part III seeks to redefine the debate about staggered boards by undermining their theoretical foundations even apart from the takeover context, but rather as applied in the regular course of business. It argues against entrenched staggered boards, based on an interdisciplinary approach, taking into account historical, comparative, contractual, and constitutional perspectives, as well as the imperatives of law and economics.

Part III further suggests that none of the traditional rationales offered in support of entrenched staggered boards—e.g., that they promote corporate stability, long-term planning and even directors' independence from management—are true in modern corporate America. Moreover, though the Delaware statute that restricts shareholder removal power with respect to staggered boards was intended to codify the rationale of a judicial opinion, its drafters both misinterpreted and applied an invalid judicial decision on the subject. Consequently, the governance and statutory bases for entrenched staggered boards are, at best, shaky.

This article will draw an analogy from agency law to examine the relationship between shareholders and directors. Entrenched staggered boards are found to serve neither minority shareholders nor other constituencies. This article thus contends that entrenched staggered boards

should be treated as illusory because the law usually does not tolerate the irrevocability of quasi-agency relationship of the type existing between shareholders and directors—any other agreement to the contrary notwithstanding.

Moreover, even when a statute protects an appointee against removal without cause, as is the case in Delaware with respect to staggered boards, it is the nature of the relationship that defines how we should construe this removal protection. For example, courts would sometimes allow even those appointed under a for-cause removal provision to be removed. In fact, this is exactly how other countries, as well as courts dealing with removal in independent agencies, have treated similar provisions.

Based on the above analysis, this article concludes by offering a straightforward solution to staggered boards: recognize shareholder power to remove directors of staggered boards. Delaware and other state statutes may be construed to comport with this policy by distinguishing the power to remove directors from office from the monetary damages that may be due to them as a contractual remedy in case of unjustified removals. This reinterpretation of the Delaware statute will transform the protection accorded to staggered board members' entitlement to office from a property to a liability rule.

The impact of this article may be far-reaching. Because the overwhelming majority of publicly-held corporations in the United States have staggered boards, the proposed solution would allow a new approach to corporate boards: maintaining staggered terms (for those corporations that prefer them), on the one hand, and shareholder removal powers, on the other. As a result, shareholders' supervisory powers would increase, as would their ability to determine, albeit indirectly, the fate of tender offers.

II. STAGGERED BOARDS IN TAKEOVERS: THE DEBATE

Staggered boards have recently become a subject of fierce academic debate because of their use in takeovers. In fact, staggered boards may have proliferated because of their antitakeover consequences. The debate is conducted along legal, as well as empirical, lines. As this article will show, the empirical data is controversial and inconclusive. This leaves the legal front, where scholars are divided. Those who support "director primacy" defend the power of directors to reject a hostile takeover, including by the use of staggered boards. Those who support "shareholder primacy," however, argue for the right of shareholders to decide the fate of a hostile takeover, notwithstanding staggered boards. The first group supports the legal status quo, while the other seeks to change current Delaware law by granting decision-making power in hostile offers to

shareholders. This Part will suggest that, contrary to the contentions made by staggered board opponents, the antitakeover effects of staggered boards are not new or unknown and may not serve as a basis to undermine shareholder consent to them. Nonetheless, a common ground between the opposing schools on staggered boards may be found by recognizing shareholder removal power even with respect to staggered boards.

A. *The Underlying Legal Debate: Decision-Making Power*

1. Supporters of Shareholder Primacy

In the most recent, influential article on staggered boards, Bebchuk, Coates, and Subramanian condemn the use of staggered boards as a takeover defensive tactic.[26] In particular, they suggest that the combination of a staggered board and a poison pill presents an almost insurmountable obstacle to hostile takeovers, whereas either one by itself does not have this effect.

A poison pill alone requires a potential bidder to win a proxy contest to replace the board before it can proceed with a hostile bid.[27] Once a new board is elected, however, it can redeem the pill, allowing the bid to take place. Conversely, a staggered board by itself seems to require a potential bidder to win two annual board elections to control a majority of the board. The bidder, though, may proceed with the hostile bid and purchase the majority of shares, even if it cannot immediately translate that power into control of the board. In fact, it has long been argued in the literature that, even in a staggered board, directors would resign in the face of a new controlling shareholder in order to avoid possible damage to their reputation.[28] Thus, either defensive technique by itself does not substantially restrict a hostile takeover.

When the two defenses are combined, however, even after winning a proxy contest, the potential bidder would control only a minority of the board. Therefore, it would be unable to redeem the poison pill and go ahead with the bid. Instead, it would have to wait an additional year and

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[26]Bebchuk et al., *supra* note 11.

[27]Otherwise, if the bidder reaches a certain percentage of ownership, the poison pill is triggered and the bidder's holdings in the corporation are diluted. *Id.* at 904-05. No bidder has ever risked triggering a poison pill. *Id.*, GILSON & BLACK, *supra* note 23, at 781.

[28]This is so in light of the "inevitability" of the hostile bidder gaining control of the corporation. Bebchuk et al., *supra* note 11, at 903-04, 940 (citing ROBERT CHARLES CLARK, CORPORATE LAW 576 (1986)); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981)).

win a second proxy contest before gaining control of the board, redeeming the pill and completing the hostile bid.

Bebchuk, Coates, and Subramanian argue that the costs to potential bidders of this combined defensive tactic are substantial. They are forced to wait a minimum of a year, and an average of one-and-a-half years, to gain control of the board. This is a substantial waiting period that may be too costly for bidders to bear and which may frustrate potential bids altogether.[29] In addition, potential bidders have to win two elections a year apart (rather than one) to gain control of the board and redeem the pill. Thus, it makes no sense for a hostile bidder to make a firm offer for the shareholders to consider in the first round of elections when the target's value may drastically change over the course of the year-long wait for the second round of elections. This, in turn, makes it harder to win the first round of elections.[30] The above authors go so far as to say that triennial elections of the entire board may impose the same average delay period of one-and-a-half years without imposing the minimum waiting period of a year nor the necessity of winning two separate elections.[31] Consequently, it may be a less formidable obstacle to takeovers.[32]

To supplement their argument, Bebchuk, Coates, and Subramanian suggest that shareholders did not foresee these harsh consequences of staggered boards when they adopted staggered board provisions and that shareholders, practitioners, and academics are unaware of these consequences even today.[33] They contend that most instances of staggered board provisions were adopted before the 1990s, when Delaware courts did not yet allow directors, as a practical matter, to "just say no" to a tender offer. Thus, although shareholders did not give their informed consent to staggered boards, they no longer can undo them.[34]

Bebchuk, Coates, and Subramanian recommend that if a potential bidder wins one proxy contest, Delaware courts should treat the proxy contest as a referendum on the offer and require the board to redeem the pill and allow the bid to take place. This approach aligns with Delaware case law by relying on voting to trump an undesirable poison pill.[35] The authors assumed at the time without much discussion that, in the regular

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[29]Bebchuk et al., *supra* note 11, at 914-19.

[30]*Id.* at 919-24.

[31]*Id.* at 918. If a bidder appears just before the scheduled election, it does not have to wait the minimum one-year imposed under the staggered regime. *Id.*

[32]*Id.*

[33]*See* Bebchuk et al., *supra* note 11, at 901-02.

[34]*Id.* at 939-44.

[35]*Id.* at 944-50.

course of business, staggered boards were desirable because they allow for board stability and independence.[36] In other words, as Vice Chancellor Leo E. Strine of the Delaware Court of Chancery eloquently writes: "Although staggered boards are critical to [Bebchuk's, Coates', and Subramanian's] proposal, the authors prescribe a judicial cure for a quite different toxin: the poison pill."[37]

It is crucial for the authors' argument that shareholders have never consented to the antitakeover consequences of staggered boards. Otherwise, we should respect their choice. Contrary to their contention, however, staggered boards have always been recognized for their antitakeover effect and justified in part on that basis.[38] We find in a comment from the 1950s, for example:

> Sometimes all shareholders are better served by a classified board than if there were a right to an annual election of all directors: for example, in situations where a new group

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[36]*Id.* at 892, 947, 950-51. Since then, Bebchuk has broadened his attack on staggered boards due to their negative economic ramifications even outside the takeover context. *See* Bebchuk & Cohen, *supra* note 25, at 430.

[37]Strine, *supra* note 24, at 863. Under *Unocal*, a board may use defensive tactics only if two conditions are met: first, the target board must have a basis for concluding that the hostile bid poses a threat to the company; second, the defensive measure must be reasonable in relation to the threat posed. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985).

In reality, Strine explains, these conditions are easily met under Delaware law. The courts have avoided the need to determine whether a board may "just say no" to a hostile bid by the use of two doctrines: "substantive coercion" and "proxy out." Strine, *supra* note 24, at 863-65. Under the substantive coercion doctrine, proposed by Ronald Gilson and Reiner Kraakman in *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247 (1989), and adopted in part by the Delaware Supreme Court in Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1154 (Del. 1989) and Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1367 (Del. 1995), the board may identify a "threat" in a bid that the stockholders may mistakenly over value. Under the proxy out doctrine, poison pills are reasonable and not preclusive, since the shareholders may elect different directors to office who may redeem the pill. *See* Moran v. Household Int'l, Inc., 490 A.2d 1059, 1080 (Del. Ch. 1984), *aff'd*, 500 A.2d 1346 (Del. 1985); Strine, *supra* note 24, at 875-77.

Strine suggests that Bebchuk, Coates, and Subramanian force the Delaware courts to confront the "just say no" question by undermining the validity of both "substantive coercion" and "proxy out" doctrines if a staggered board loses one election contest over a hostile bid. *Id.* at 988-80. They claim that there is no substantive coercion in that case since the board had enough time to present its case to the stockholders in an election setting. *Id.* They further claim that the proxy out option is unavailable to shareholders in that case. *Id.* Shareholders need to win two election cycles, a year apart, to gain a majority of a staggered board, but no bidder can wait that long to know the results of its bid for the corporation. *Id.*

[38]Bainbridge criticizes Bebchuk, Coates, and Subramanian for this proposition as well, pointing to literature dating from 1998 that observed the antitakeover effects of staggered boards. Bainbridge, *supra* note 4, at 793 n.8. Bebchuk, Coates, and Subramanian, however, argue that staggered boards overwhelmingly predated the 1990s. Bebchuk et al., *supra* note 11, at 895.

> attempts to capture control of the corporation with a windfall gain as the objective, or a group intends to gain control of the corporation for a captive source of supply or market.[39]

And even if we go further back to the nineteenth century, we find that legislatures specifically adopted staggered boards as an antitakeover measure. The Missouri legislature in a statute from 1872, for example, allowed railroad companies to adopt staggered board provisions for that very purpose:

> The probable object of this particular statute was to prevent "rings" of speculators, such as the infamous "Erie Railroad ring," from purchasing a bare voting majority of stock in small railroad companies, electing only their own agents to the board, and quickly selling the companies from under the minority stockholders. Although classification postponed the capture of the board by such "rings," some more permanent protection for minority shareholders was written into the 1875 constitution.[40]

Moreover, the specific workings of this defense, alleged to have been revealed for the first time by Bebchuk, Coates, and Subramanian—that it requires insurgents to win two election cycles rather than one and imposes a delay period of at least a year before they can gain control of the board—were specifically addressed in the literature from the 1950s. As one author wrote: "Classification . . . makes it prohibitively expensive for almost any dissatisfied group of shareholders ever to challenge the management since at least two annual proxy contests are required for a majority to gain control."[41]

Thus, from a consensual perspective, the only new development, if any, is the extent of the antitakeover consequences, not their existence. This can hardly be a justification for undermining shareholders' consent and releasing shareholders from their obligations. Moreover, the extent of the

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[39]Comment, *Cumulative Voting—Removal, Reduction and Classification of Corporate Boards,* 22 U. CHI. L. REV. 751, 758 (1955). *See also* Leonard D. Adkins, *Corporate Democracy and Classified Directors,* 11 BUS. LAW. 31, 32 (1955) (stating that staggered boards discourage takeover attempts by increasing proxy costs through the requirements of having to win the majority of votes for two years).

[40]David E. Rosenbaum, *Classified Boards in Missouri,* 32 MO. L. REV. 251, 258 (1967). Obviously, the modern takeover activity differs from the rings that looted corporations.

[41]Edmund A. Stephan, *Cumulative Voting and Classified Boards: Some Reflections on* Wolfson v. Avery, 31 NOTRE DAME L. REV. 351, 376 (1956).

consequences is the result of Delaware jurisprudence, and generally a change of law is not legally recognized as grounds for releasing parties from their commitments.[42]

But has the extent of the antitakeover consequences truly changed? To make this claim Bebchuk, Coates, and Subramanian rely on the assumption that members of staggered boards who do not enjoy the protection of a poison pill would resign before the expiration of their term if a new controlling shareholder appeared.[43] But nowhere do they, or the authors upon whom they rely, provide empirical evidence for this claim, however plausible it may be.[44] In fact, the difficulty is all that much the greater, given that Bebchuk, Coates, and Subramanian hold the opposing belief—that is, when a majority of the shareholders (this time dispersed shareholders) desire members of the staggered board to resign to allow a bid to go forward, the directors will not do so because of the protection of the poison pill.[45] No explanation is offered as to why the reputation incentive should be enough in the former, but not the latter, case. In both cases, aside from resignation, the directors continue in office against the will of the majority shareholders, whether their ownership is concentrated or disbursed and despite any damage to reputation.[46] Thus, nothing in the authors' article supports undermining the consensual basis of entrenched staggered boards.

In addition, the authors treat corporate election as a referendum on the bid, even though in an election, as opposed to a referendum, there are typically several "bundled" issues. Shareholders' opinions regarding members of the board may be unrelated to the prospective bid, especially in light of the fact that the board may block the offer anyway. Bebchuk, Coates, and Subramanian would nonetheless consider the vote a decision on the merits of the prospective bid. Their opinion is all the more

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[42]John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1689 (1989) (noting that shareholders are on notice that the law may change).

[43]Bebchuk et al., *supra* note 11, at 899, 903-04.

[44]*See, e.g.*, Ronald J. Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, 34 STAN. L. REV. 775, 793-96 (1981-1982).

[45]Bebchuk et al., *supra* note 11, at 916.

[46]In this regard, it would be interesting to examine whether directors who resist bids favorable to shareholders are replaced when their staggered term is due to expire. If not, it may suggest some explanation for the difference between the two scenarios noted in the text. Bebchuk, Coates, and Subramanian did not examine this question.

perplexing when in other works they oppose viewing an election as a referendum on a specific issue.[47]

Moreover, even if we accept the contention that the election turns on the hostile bid and should be viewed as a referendum on it, according to Delaware law, directors do not have to follow shareholders' opinions in the matter even when these opinions are known. Instead, directors are protected under the business judgment rule, notwithstanding the election. In Strine's words:

> Under traditional fiduciary duty principles, the decision of an informed, disinterested board to pursue a business strategy authorized by the corporation's charter and not involving any matter requiring a stockholder vote is protected by the business judgment rule. The mere fact that the stockholders had elected a dissenting minority to the corporation's ESB [Effective Staggered Board, i.e., staggered boards that are effectively entrenched] in one election would not require the incumbent majority to give way on matters of policy.[48]

As will be established in the next Part, this suggests that Bebchuk, Coates, and Subramanian attack a mere side effect of staggered boards, i.e., their antitakeover consequences, when the real problem of staggered boards is more general, i.e., the limitation on shareholders' ability to replace the board. In fact, takeovers are highly encouraged in the literature as a way to monitor management and replace it when it underperforms,[49] but this can sometimes be achieved more directly by allowing shareholders to replace the board. Thus, the solution to staggered boards should directly address their entrenchment consequences, which would, at the same time, indirectly treat their negative ramifications for takeovers.

Stated differently, this part of the article has demonstrated that the authors' attempts to define the difficulty with staggered boards as one of lack of shareholder consent is unconvincing. The next Part will show that a solution can be found only when staggered boards are found problematic because of their irrevocable nature.

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[47]Ironically, Bebchuk is familiar with this bundling problem, suggesting in another place that elections may not replace the need to allow shareholders to practically manage the firm. Bebchuk, *supra* note 16, at 857.

[48]Strine, *supra* note 24, at 868.

[49]*See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 715-16 (1982).

2. Supporters of Director Primacy

Surprisingly, in the symposium held on the article by Bebchuk, Coates, and Subramanian, the academic participants unanimously questioned the validity of the critique on staggered boards, even in takeovers.[50] All shared the assumption that "director primacy" best serves the interests of the corporation, including its shareholders, though each offered a different rationale for this approach.

Stephen Bainbridge, for example, explains that the authors' proposal would place the decision on tender offers in the hands of the shareholders instead of the board and, as such, runs afoul of basic corporate governance principles.[51] "Director primacy," he claims, not only describes current corporate doctrine, but also should continue to be the leading principle of corporate governance. In other words, it is both a positive, as well as normative, model.[52] Under the director primacy model, directors have the authority to decide both day-to-day and long-term policies of the corporation.[53] Directors have to maximize shareholders' wealth but otherwise enjoy almost dictatorial powers, which Bainbridge openly characterizes as "Platonic."[54] This is a desirable model, he contends, because it promotes efficiency. Bainbridge therefore advocates leaving directors' discretion unfettered and subject only to the *Unocal* standard of reasonableness.[55] In other words, Bainbridge rejects the authors' attack on staggered boards because he believes directors—rather than shareholders—are best suited to run and make decisions for the corporation, including hostile takeover considerations.

Based on her work with Margaret Blair, Lynn Stout would also leave it to directors to decide the fate of tender offers.[56] Stout and Blair analyze how to create incentives for public firm participants—including shareholders, employees, and creditors—to contribute to the enterprise

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[50]*See* sources cited *supra* note 24.

[51]Bainbridge, *supra* note 4, at 794-95. This is in line with his other work, including Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2002); Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006).

[52]Bainbridge, *supra* note 4, at 795.

[53]*Id.* at 800-01.

[54]*Id.* at 802.

[55]*Id.* at 817. For an explanation of the *Unocal* standard, see *supra* note 37.

[56]*See, e.g.*, Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 250-51 (1999).

beyond their contractual obligations.[57] They claim that to overcome team production problems, firm participants give control of the corporation to the board, which acts as a "mediating hierarch."[58] As a result, the board must act in the interests of the different constituencies of the corporation, not just the shareholders.[59] This is beneficial to the shareholders from an *ex ante* perspective because it encourages the different constituencies to contribute to the success of the corporation.[60] Stout's approach therefore is that staggered boards enable directors to serve the interests of the different constituencies of the corporation, and thus do not pose a difficulty in takeovers, even if they seem to frustrate shareholder will.

Bringing the practitioner point of view to bear, Mark Gordon also supports granting the board the ultimate authority to decide a takeover. In particular, he defends staggered boards as a takeover defense.[61] Thus he finds existing law on staggered boards satisfactory:

> [I]n the "real world," the legal, practical and economic considerations tend to even out in a rough justice sort of way: that is, when a public company receives a hostile takeover offer at a price that is attractive to a majority of its stockholders, it may leverage its takeover defenses to get a better deal or find a better offer, but its days of independence are probably numbered.[62]

Gordon suggests that the general fiduciary duties of directors to act in the best interests of the shareholders are sufficient in the takeover context as well.[63] He trusts the board to make the right choice, even if it has the freedom not to do so. He also suggests, however, that the focus in law reform should be on encouraging companies to include in their boards independent directors to further protect against abuse of directorial power.[64]

All of these authors thus criticize Bebchuk, Coates, and Subramanian's article for its attempt to replace board discretion with

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[57]Thus, for example, an implicit incentive exists when employees expect to be compensated for their extra work if the firm succeeds. *See id.*

[58]Stout, *supra* note 24, at 848-49. *See also* Blair & Stout, *supra* note 56, at 250 (stating that the mediating hierarchy solution requires that team members give up some rights in order to profit from team production).

[59]Stout, *supra* note 24, at 849.

[60]*Id.* at 849-50.

[61]Gordon, *supra* note 24, at 837.

[62]*Id.* at 820.

[63]*Id.* at 820-21.

[64]*Id.* at 821, 831-34.

shareholder discretion on takeovers. Instead, they assume that corporate governance should be based on director primacy and should rely on directors' general duties of care and loyalty to provide the necessary protection for the interests of shareholders. The authors' approach, however, is relevant only so long as directors continue in office.

While Bainbridge, Stout, Blair, and Gordon reject granting shareholders the ability to replace a board's judgment with their judgment, none rejects the ultimate right of shareholders to replace the directors altogether. As Bainbridge explains the directors' actions in the face of a proxy contest: "the incumbent board members remain in office, and therefore remain legally obligated to conduct the business, unless and until replaced."[65] Even under Stout's model of team production, shareholders both possess and should retain the power to elect and remove directors.[66] In particular, this should be the case in light of the fact that requiring directors to serve the interests of different constituencies may release them from their obligations altogether. "[A] manager told to serve two masters (a little for the equity holders, a little for the community) has been freed of both and is answerable to neither."[67]

Moreover, the more power directors have, the more shareholders are silenced, and the more important it is to guard shareholders' power to remove directors.[68] This should be true regardless of whether the directors are independent or not, whether in the takeover context or outside it.[69] The analysis in favor of recognizing shareholder removal power, set forth in Part III, may thus be compatible even with the arguments made by the supporters of director primacy.

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[65]Bainbridge, *supra* note 4, at 808.

[66]Stout, *supra* note 24, at 849 n.12. *See also* Blair & Stout, *supra* note 56, at 309-15 (noting that shareholders' power to elect directors and to vote on certain basic corporate changes are in reality "virtually meaningless").

[67]FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 38 (1991).

[68]For a discussion of the reverse relationship between the right to voice opinions and the right to exit the relationship, see ALBERT O. HIRSCHMAN, EXIT, VOICE AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES 44-54 (1970).

[69]In fact, the performance and utility of independent directors are much contested. *See, e.g.*, Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 922 (1999) ("[S]tudies of overall firm performance have found no convincing evidence that firms with majority independent boards perform better than firms without such boards.").

B. *The Empirical Debate*

The debate on staggered boards is conducted along empirical lines as well. Bebchuk, Coates, and Subramanian support their theoretical critique of staggered boards with empirical findings: "[N]o bidder has successfully fought through two proxy contests to win control of an ESB [Effective Staggered Board] target."[70] Further, "ESBs nearly *double* the average target's odds of remaining independent."[71] This in turn "reduces target shareholder returns on the order of 8-10% in the nine months after a hostile bid is launched."[72]

Their empirical findings, however, have also been debated. Stout suggests that their study is too narrow in two respects. First, they focus on an *ex post* analysis of the effects of antitakeover measures while ignoring the *ex ante* benefits derived from the adoption of such measures, which may encourage employees to make firm-specific investments.[73] It is not at all clear, Stout argues, whether the antitakeover devices' net effect (taking into account both their *ex ante*-positive and *ex post*-negative effects) on shareholders' wealth is negative.[74] Second, Bebchuk, Coates, and Subramanian focus on the antitakeover measures' effect on shareholders' wealth alone, but do not discuss whether their net effect on society as a whole is negative[75] Gordon has further questioned the factual bases for

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[70]Bebchuk et al., *supra* note 11, at 914. By effective staggered boards, Bebchuk, Coates, and Subramanian mean staggered boards that are provided for in the certificate and cannot be circumvented by "packing the board"; in other words, staggered terms that can only be undone with the board's consent. *Id.* at 912-13.

[71]*Id.* at 931. In the short run, measured nine months after the initial bid, ESBs increase the target's odds of remaining independent from thirty-four percent to sixty-one percent, and in the long run, measured thirty months after the bid's announcement, they increase them from twenty-three percent to forty-seven percent. *Id.* at 931, 933.

[72]*Id.* at 939. The likelihood of a hostile takeover diminishes under an ESB scenario without a compensating benefit in the form of higher premiums if a takeover does take place despite of the ESB. *Id.* at 936.

[73]Stout, *supra* note 24, at 847-48.

[74]*Id.*

[75]*Id.* at 857. In support of her claims, Stout asserts *inter alia* the fact that firms overwhelmingly adopt antitakeover devices before going public. *Id.* at 853. Stout relies on John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers,* 89 CAL. L. REV. 1301, 1376 (2001), in writing that the "percentage of IPO firms with staggered boards rose from 34% in [sic] early 1990s to 82% in 1999." Stout, *supra* note 24, at 853 n.23.

She finds additional support in the fact that states with strong antitakeover statutes did better at attracting corporations than states that provided lesser protection to the board. *Id.* at 854. Further, studies seem to suggest that corporations that underwent dual class recapitalization, thus increasing the likelihood of board entrenchment, "enjoyed abnormally positive stock market and operating returns in the four years following the announcement." *Id.* at 855. She does agree, however, that the adoption of antitakeover devices "midstream," i.e., after firms went public and

their assertions.[76]

It should thus be obvious that this debate on staggered boards cannot be decided on the basis of empirical findings. In fact, even Bebchuk, Coates, and Subramanian seem to concede as much.[77] Rather, we are left with the two schools in corporate law. One school, which Bainbridge and others represent, supports the expansion of director power. The other, represented by Bebchuk, supports the broadening of shareholder power.

This article may provide common ground for the two approaches. It neither advocates the replacement of managerial power, currently entrusted by law to the board, with shareholder power, as Bebchuk suggests, nor does it almost blindly trust the board, as in Bainbridge's approach. Rather, it suggests that while directors and not shareholders should decide corporate affairs in line with the director-primacy model, shareholders should have the power to replace directors altogether. Put differently, this article argues that staggered boards should be condemned regardless of their use in the takeover context because shareholders should retain the power to determine the composition of the board. This forces shareholders to decide whether a particular corporate issue is important enough for them to force the replacement of directors who are otherwise satisfactory. Generally, if shareholders are satisfied with the board, they will not replace it, even if their will regarding certain issues is frustrated. Thus, it would leave managerial power by and large with the board as

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had matured, and without shareholders' consent, adversely affects shareholders and is unjustified. *Id.* at 858.

[76]Gordon attacks Bebchuk's, Coates', and Subramanian's findings on six grounds: (1) They examine only hostile, not friendly, transactions; (2) the bid itself has crippling effects on the target corporation; (3) half of the hostile bids in their study are "bear hug bids," i.e., offers without an accompanying proxy fight or tender offer; regardless of whether or not the board is staggered, corporations faced with such bids tend to remain independent due to the lack of commitment on the part of the prospective bidder; (4) the authors recommend that firms enjoy only the weaker defense of effective annual elections to the board but fail to prove that staggered boards have a stronger antitakeover effect when compared to annual boards; (5) they do not distinguish between corporations based on their state of incorporation; moreover, they make particular policy recommendations with regard to Delaware law, though only half of the corporations they study are Delaware corporations; and (6) the authors assume, without examination, that shareholders rejected boards' decisions to stay independent, but this may not have been the case. Gordon, *supra* note 24, at 823-29.

[77]In their reply to the symposium participants, Bebchuk, Coates, and Subramanian note:

> What should be clear is that the takeover policy choices that have been debated for over half a century are ones that neither deductive theory nor plausibly testable evidence can be expected to resolve in a way that is compelling and demonstrably indisputable to those who are inclined to disagree, at least any time in the near future.

Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants*, 55 STAN. L. REV. 885, 915 (2002).

existing law determines, while giving shareholders ultimate veto power.[78]

III. THE LEGAL CASE AGAINST STAGGERED BOARDS

Part III now moves from the takeover context, which has been the focus of academic debate on staggered boards, to examine the validity of staggered boards as a governing device in the regular course of business. The article will first challenge the traditional rationales offered in support of staggered terms. Then it will show, in turn, how Delaware's statutory history, principles of agency law, as well as law and economics, comparative corporate law, and even constitutional law all undermine entrenched staggered boards. All these different perspectives suggest that shareholders should enjoy an unwaivable power to remove directors even of staggered boards. In light of this analysis, this article offers a solution to staggered boards that both aligns with current statutory law and these disciplines. By solving the problem of staggered boards as a governance device, it will also offer a remedy to the harsh consequences of staggered boards in takeovers.

A. *Reexamining the Rationales for Staggered Boards*

Proponents of staggered boards usually argue that they promote stability and long-term planning in corporations. They further assert that staggered boards ensure independence from management. This article will examine the traditional rationales in support of staggered boards outside the takeover context and show why they do not survive scrutiny.

1. Stability

Advocates argue that staggering the board provides continuity in the oversight over the management of the corporation. Since only a part of the board is replaced at each annual election, staggering the board guarantees

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[78]Thus, accountability will not destroy authority. *See* KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 77-78 (1974). Bebchuk advocates a different approach in his recent article, *The Case for Increasing Shareholder Power*, *supra* note 16, at 857-62. He asserts that shareholders should be able to retain their directors on the one hand, yet compel the directors to abide by their will on the other hand. In other words, he believes shareholders should be able to replace directors' discretion with their own without necessitating a change of director personnel. He believes that the shareholders' removal power cannot replace the shareholders ability to make decisions instead of the board because shareholders may at times wish to effect their will without removing existing directors. But the very problem with the removal power that Bebchuk decries, that it requires shareholders to remove even otherwise satisfactory directors to enforce their will on corporate issues, is the advantage this author sees in it as described in the text.

that at any time at least some of the board members will be experienced directors familiar with the corporation. Thus, it also ensures continuity in the pursuit of corporate plans.[79]

But, should stability be the goal of corporate law? In the modern corporate environment, "the only constant feature of corporate organization is change."[80] Corporate performance, rather than directorial stability, should be the measure of success. Obviously, corporate performance sometimes requires board continuity and stability, but at other times, it does not. Furthermore, in the typical widely-dispersed ownership structure of U.S. public corporations, shareholders normally reelect incumbent directors thus preserving continuity whether or not the board is staggered.[81] The reality many times is that "boards elect themselves."[82] Thus, what staggered terms truly achieve is continuity, even on those otherwise rare occasions when shareholders desire to turn over the board.

Moreover, staggered terms provide a unilateral commitment from the company to the directors for their full term in office. Staggered terms do not bind directors to serve their full term, as they may resign whenever they choose to do so.[83] Thus, they tie shareholders'—but not directors'—hands, and achieve stability only in the very limited one-sided sense that shareholders commit to a specific composition of the board.

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[79]Comment, *supra* note 39, at 758. *See also* Richard H. Koppes et al., *Corporate Governance Out of Focus: The Debate Over Classified Boards*, 54 BUS. LAW. 1023, 1025 (1999) ("[C]lassified boards can be valuable for corporations . . . [by] promoting the continuity, stability, and independence of the corporation's leadership and allowing the board to focus on long-term strategies to improve shareholder value.").

[80]EASTERBROOK & FISCHEL, *supra* note 67, at 109.

[81]For elaboration, see *infra* text accompanying notes 93-96. Professor A.A. Berle, for example, described shareholders' meetings as a "kind of ancient, meaningless ritual like some of the ceremonies that go with the mace in the House of Lords." A.A. BERLE, JR., ECONOMIC POWER AND THE FREE SOCIETY 2, 6 (1967), *in* BUSINESS AND GOVERNMENT: THE PROBLEM OF POWER (Howard D. Marshall ed., 1970). Edward Jay Epstein, similarly, suggested that corporate elections are "procedurally much more akin to the elections held by the Communist party of North Korea" than real democratic elections because "they normally provide only one slate of candidates." EDWARD J. EPSTEIN, WHO OWNS THE CORPORATION? MANAGEMENT VS. SHAREHOLDERS 13 (Priority Press, N.Y., 1986). *See also* Rose, *supra* note 10, at 483 n.133 (noting that boards usually remain constant, even with annual terms, because incumbent directors are "virtually assured of reelection").

[82]Blair & Stout, *supra* note 56, at 311 (emphasis omitted). *See also* Bainbridge, *supra* note 4, at 801 n.60 (stating that absent a proxy contest, the current directors nominate the next board of directors).

[83]DEL. CODE ANN. tit. 8, § 141(b) (2005).

2. Long-Term Planning

Another argument in favor of staggered boards is that when directors are judged every few years, rather than annually, it allows them to plan and implement corporate programs with long-term benefits to the corporation. Rather than focusing on short-term results, directors know that they will be judged on results generated over time.

In fact, following the economic literature, Martin Lipton and Steven Rosenblum, leading M&A practitioners, argue that the most serious problem in corporate governance today is shareholder focus on short-term results.[84] They claim that since shareholders hold a diversified portfolio, they have an interest in maximizing short-term profits and take little interest in the corporation's long-term success.[85] To enable directors to focus on long-term planning, crucial for the corporation's survival and success, Lipton and Rosenblum even suggest changing corporate elections from an annual to a quinquennial (occurring every five years) system.[86] Staggered terms achieve this goal without reforming corporate elections.

What the long-term planning rationale assumes is that board elections turn on director performance. Thus, if we want directors to concentrate on long-term planning, we should lengthen their terms. In practice, however, director elections rarely focus on director performance. In fact, as already suggested, directors are rarely removed even when elections are held annually.[87] Furthermore, though shareholders have the right to elect directors in publicly-held firms with dispersed shareholders, it is the senior management that usually determines de facto the identity of those sitting on the board.[88] Managers are also the ones more directly in charge of corporate performance. A board's failure to perform reflects

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[84]Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 189 (1991). *See also* Jeremy C. Stein, *Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior*, 104 Q. J. ECON. 655, 655-56 (1989) (arguing that directors' desire to achieve high stock prices may lead them to behave "myopically"—inflating current earnings at the expense of longer term benefits).

[85]Lipton & Rosenblum, *supra* note 84, at 206.

[86]*Id.* at 229. Lipton and Rosenblum compare their quinquennial system to the terms of American presidents and senators: "Like the four-year terms of American presidents and the six-year terms of senators . . . it encourages a focus on long-term policy decisions." *Id.*

[87]*See supra* note 81.

[88]CLARK, *supra* note 28, at 94 ("In most matters, small individual shareholders in public corporations simply vote for whomever and whatever management recommends."). *See also* Bayless Manning, Book Review, 67 YALE L. J. 1477, 1485-89 (1958) (reviewing J.A. LIVINGSTON, THE AMERICAN STOCKHOLDER (1958)) (discussing management's default power due to lack of shareholder action).

management's own failure to achieve. Thus, managers would not undoubtedly support replacing the managerial team—including themselves—for failure to perform. Staggered terms therefore are not necessitated by the need to redirect corporate attention from short-term to long-term performance. Put differently, though many may wish to see corporate elections turn on director performance, they typically do not. Rather, stability and even managerial entrenchment dominates performance in director elections.

3. Independence from Management

In more recent writings, authors have suggested that staggered terms protect the independence of the board from management control. They argue that, if directors are guaranteed prolonged periods in office, they are better isolated from management's control and may even display independent judgment.[89] In this respect, staggered terms fit with the law's preference for independent directors on the board.[90]

Though the claim is that staggered boards are better insulated from management interference, in fact, directors are still very much dependent on management for reelection as well as for providing them with the information necessary to perform their jobs.[91] Moreover, the independence of a director overwhelmingly depends on whether he or she has business and family ties with senior management.[92] The term of office would not significantly alter the performance of a director who is otherwise biased towards management. Staggering directors' terms thus does not substantially increase their independence. Staggering terms, however, does make the board, if anything, even more removed from shareholder control.

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[89] *See, e.g.*, Koppes et al., *supra* note 79, at 1051.

[90] An otherwise self-interested transaction may be valid under the business judgment rule if approved by independent directors. The Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, 775-77, requires an entirely independent audit committee for every company listed on a national securities exchange. The revisions of New York Stock Exchange listing standards require a majority of independent directors overall and entirely independent compensation and nominating committees. *See* Section 303A of the Corporate Governance Rule Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee As Approved by the NYSE Board of Directors August 1, 2002 (No. SR-NYSE-2002-33 filed Aug. 16, 2002), *available at* http://www.nyse.com/pdfs/corp_gov_pro_b.pdf.

[91] *See supra* note 88.

[92] *See, e.g.*, Gordon, *supra* note 24, at 833 (presenting seven factors to use to determine whether a board is independent); Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1497 (1989) ("[A] majority of board members are often either subordinates of the chief executive or persons who have economic affiliations with the corporation that are under the chief executive's control.").

In reality, all three rationales for staggered boards—the need to achieve stability, long-term planning, and independence from management—fail because staggered terms lessen rather than enhance director dependence on shareholders. Regardless of staggered boards, there is too much stability in corporate boards, director elections do not focus on performance (whether short-term or long-term) and directors depend on senior management.

Additionally, staggered boards can address none of these difficulties because they derive from the fact that in the regular course of business, shareholders do not take an active interest in the corporation, including director election. This is the well-known "rational apathy" problem.[93] Each shareholder holds only a small stake in the corporation, and it may not be rational for him or her to be involved in corporate affairs.[94] Even if this problem were overcome, shareholders would face difficult problems of coordination and "free-riding," where many enjoy the efforts of a few without sharing the costs.[95] Under current proxy rules, the costs of initiating a proxy contest against incumbent directors are especially heavy. While the board may propose new members and distribute material at corporate expense, the insurgents must bear the costs themselves.[96] In fact, this is what enables management to determine de facto board composition, though, de jure, this right belongs to the shareholders.

Thus, when shareholders desire to change the board despite these formidable obstacles, they should be allowed to do so. Staggered terms prevent just this by restricting the exercise of shareholder removal power to a limited period when issues that could have been pressing enough to overcome "rational apathy," "collective action," and "free riding" problems may have been forgotten or lost their importance.[97] This leads one to the conclusion that, while the rationales offered in support of staggered boards may have been relevant in the nineteenth century, they fail to deal with the reality of modern corporate America.

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[93]*See, e.g.*, CLARK, *supra* note 28, at 389-94.

[94]*Id.*

[95]*Id.*

[96]*See, e.g.*, Security Holder Director Nominations, 68 Fed. Reg. at 60,786; *see also* Strine, *supra* note 24, at 865 n.6 (providing that in addition to spending the company's money, the incumbent directors retain almost unlimited discretion regarding timing).

[97]Shareholders' voting power serves as a "safety net to protect against extreme misconduct." Blair & Stout, *supra* note 56, at 312.

B. *Delaware Law*

The competition between states to attract incorporation has led to the great debate on whether there is a "race for the bottom," with states seeking favor from managers by adopting antitakeover statutes.[98] Statutory staggered board provisions, however, date back at least to the nineteenth century, if not earlier, and thus predate the recent trend of antitakeover statutes.[99] Though staggered boards are "old news," the provision dealing with their removal in Delaware is modern. Since Delaware is the most prominent jurisdiction on corporate law in the United States, this article will next examine the history of the adoption of the provision, demonstrating the shakiness of the statutory basis for entrenched staggered boards.

1. Delaware Statutory History

Under Delaware law, directors manage or supervise the management of the corporation.[100] Shareholders have the right to elect the directors annually unless the certificate or the bylaws provides for a staggered board.[101] Section 141(k), which deals with the removal power of the shareholders, provides in relevant part:

> (k) Any director or the entire board of directors may be removed, with or without cause, by the holders of a majority of the shares then entitled to vote at an election of directors, except as follows:
>
> (1) Unless the certificate of incorporation otherwise provides, in the case of a corporation whose board is

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[98] *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 67, at 212 (providing both sides of the debate); Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437, 1437 (1992) (advocating "a substantial expansion of the role of federal law in shaping corporate law rules"). *But see* Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559, 1563 (2002) (suggesting that the question of whether states are "racing to the top or bottom" may not be the right question to ask).

[99] W. Edward Sell & Lloyd H. Fuge, *Impact of Classified Corporate Directorates on the Constitutional Right of Cumulative Voting*, 17 U. PITT. L. REV. 151, 160 (1956) (writing that staggered boards may even be traced back to the seventeenth century).

[100] The corporation's "business and affairs . . . shall be managed by or under the direction of the board of directors." DEL. CODE ANN. tit. 8, § 141(a) (2005).

[101] *Id.* §§ 211(b), 141(a)-(b), (d), & (k).

> classified as provided in subsection (d) of this section, shareholders may effect such removal only for cause . . . .[102]

This section was enacted in 1974. The commentary to the section reveals that the restriction on removal of staggered boards was intended to codify the rationale of the court opinion in *Essential Enterprises Corp. v. Automatic Steel Products, Inc.*[103]

In *Essential Enterprises Corp.*, decided in 1960, the chancery court ruled that a bylaw provision that allowed for the removal of a director without cause was inconsistent with a certificate of incorporation provision providing for a staggered board.[104] Because corporate law holds the certificate superior to bylaws, the court found the bylaw provision invalid.[105] In other words, the court's opinion seems to imply that classified boards inherently protect directors against removal without cause. The court further suggested that "reasonable predictability in our business society"[106] supersedes shareholder interests in controlling a company.

At the time *Essential Enterprises Corp.* was decided, however, it was unclear whether shareholders could remove directors without cause, even if the board was not staggered.[107] There was no statutory provision dealing with shareholder removal power at all and in common law directors had a vested right (an "entitlement") to serve out a full term unless there was cause for their removal.[108]

In fact, this is exactly how the same Delaware court understood its own decision in *Essential Enterprises Corp.* in 1970. In *Everett v.*

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[102]*Id.* § 141(k).

[103]159 A.2d 288 (Del. Ch. 1960). The General Corporation Law Committee of the Delaware State Bar Association suggested: "This amendment is patterned, in large part, on Section 39 of the Model Business Corporation Act. In the case of directors elected for a term of years to a classified board under section141(d), removal may only be with cause. This codifies the rationale of *Essential Enterprises Corp.*" Official Comment to 1974 amendment to § 141, *reprinted in* 2 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS § 141 (3d ed. 1998) (citation omitted). While the section was patterned after the MBCA, it deviates from it in an important respect: under the MBCA, the default rule is that even staggered board members may be removed without cause. *See* MODEL BUS. CORP. ACT § 8.08(a).

[104]*Essential Enters. Corp.*, 159 A.2d at 291.

[105]*Id. See also* DEL. CODE ANN. tit. 8, § 109(b) (2005) ("The bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation . . . .").

[106]*Essential Enters. Corp.*, 159 A.2d at 291.

[107]Roven v. Cotter, 547 A.2d 603, 605 (Del. Ch. 1988).

[108]*See* Official Comment to MODEL BUS. CORP. ACT § 8.08, at 8-66 (explaining that the common law position was that directors had "a statutory entitlement to their office and can be removed only for cause . . . .").

Transnation Development Corp.,[109] a case that did not involve a staggered board, the court found *Essential Enterprises Corp.* inapplicable, not because it dealt with staggered boards, but because the statute was amended in 1967 to recognize the possibility of removal, a possibility that was not recognized when *Essential Enterprises Corp.* was decided.[110] In other words, the court interpreted *Essential Enterprises Corp.* to mean that shareholders had no removal power except for cause, independent of the type of board the corporation had, and that this reasoning was no longer applicable after the 1967 statutory amendment. Thus, section 141(k) restricted the power to remove a staggered board based on a judicial opinion that was no longer good law. [111]

2. Severing the Link Between Staggered Terms and Removal for Cause

Even if we interpret *Essential Enterprises Corp.* to mean that staggered boards imply restriction on the power of shareholders to remove directors, and that this is an inherent part of staggered terms, such a holding would not have been correct even when the case was decided. Already in 1938, the Delaware Supreme Court considered whether staggered terms imply restrictions on the removal of directors.[112] The court treated this question as a matter of statutory construction. After examining different statutes that provide simultaneously for staggered terms and removal without cause, the court concluded:

> The foregoing citations of authority show that where the question has arisen in a direct way courts of ultimate authority in their states have decided that where the term of a statutory office has been defined as for a definite term of years with a provision, however, for removal by the appointing power before the expiration of the named period, the two provisions,

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[109]267 A.2d 627 (Del. Ch. 1970).

[110]All that the 1967 statutory amendment did (§ 141(b)) was to acknowledge the possibility that a director's term may end with removal. DEL. CODE ANN. tit. 8, § 141(b) (2005). It did not even discuss whether the shareholders might remove a director without cause. *Id.* The court decided that shareholders may remove a director without cause pursuant to a bylaw that was adopted after the director was elected. *Everett*, 267 A.2d at 629.

[111]*See also Roven*, 547 A.2d at 608 (holding that since the 1974 addition of § 141(k), the director's entitlement of serving a full term on a classified board has been restricted); S. Samuel Arsht & Lewis S. Black, *The Delaware General Corporation Law: Recent Amendments*, 30 BUS. LAW. 1021, 1025 (1975) (stating that "the prohibition found in the 1974 amendment [of § 141(k)] results from a misreading of [*Essential Enters. Corp.*]").

[112]Collison v. State *ex rel.* Green, 2 A.2d 97 (Del. 1938).

> when read and construed together, as they must be according to the well known canon of construction governing the subject, result in the view that the term is an indefinite one, to be held during the pleasure of the appointing power, but ending in any event not later than the specified number of years.[113]

Though the statute in question, the Delaware Workmen's Compensation Law of 1917, provided for staggered terms for members of the Industrial Accident Board, the court found that this could be consistent with removal without cause.[114] Members of the board could serve their maximum term in office unless removed earlier by the appointing power.[115] In other words, this, too, lends support to an interpretation that *Essential Enterprises Corp.* applied only to the statute as it existed prior to 1967, i.e., a statute silent on the question of removal of directors.

That the Delaware legislature also understood that staggered terms and removal without cause may be compatible is reflected in section 141(k) of the Delaware General Corporations Act.[116] Despite codifying *Essential Enterprises Corp.*, the statute allows for removal without cause even in the case of staggered terms as long as the removal power was explicitly provided for in the certificate of incorporation.[117] In other words, the Delaware legislature recognized that there is no inherent conflict between staggered terms and removal without cause. Members of the board may still serve staggered terms unless the shareholders decide to remove them before the end of their terms.

This is also how the Delaware Court of Chancery understood the relationship between staggered terms and removal authority. In *Roven v. Cotter*,[118] the court decided that, despite a staggered board provision, shareholders were entitled to amend the certificate and provide for removal without cause and apply this amendment to sitting directors. In the court's words:

> The General Corporation Law now clearly and unambiguously contemplates removal in sections 141(b) and

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[113] *Id.* at 106.

[114] *Id.* at 99.

[115] *Id.*

[116] DEL. CODE ANN. tit. 8, § 141(k) (2005).

[117] *Id.* The default rule is against removal without cause, but shareholders may "opt out" of this arrangement in the certificate of incorporation. *Id.*

[118] 547 A.2d 603 (Del. Ch. 1988).

> 141(k). . . . The former section recognizes that a director's term may be extinguished by removal. The latter specifically empowers shareholders to remove directors with or without cause, including a classified board if the certificate of incorporation so provides. . . . If a director is potentially subject to removal without cause, even on a classified board, then § 141(d) could not possibly entitle a director to serve a "full term" contrary to basic principles of corporate democracy, and the expressed will of the majority. That is of particular significance here, since it is the shareholders who will make the final decisions respecting . . . [the] corporate structure. Their resolve should not be thwarted under the present circumstances even by a determined minority.[119]

This supports the conclusion that, although the prevailing understanding is that staggered terms require by definition protection against removal without cause, this understanding is flawed. Staggered terms and protection against removal without cause are two separate issues. Adopting one mechanism does not necessarily mean embracing the other.

3. The Takeover Context

Though no court has found fault with the practice of staggered boards, in January 2003, the Delaware Supreme Court decided to invalidate a staggered board's decision to expand its size from five to seven members and to fill the vacancies created with two new members.[120] Because the board acted to diminish the effect of shareholders' choice at an impending contested election of the board, the court required the board to show "compelling justification" for its action, which it failed to do.[121]

The court found that even if the expected contest would not have changed control of the board, it was enough that the board's action would dilute the power of new minority representatives on the board for the decision to be invalid.[122] The court further stated that, when such board action is taken as part of a defensive tactic against a hostile takeover, the board must first satisfy the "compelling justification" standard for intervening in corporate elections, and only then may it proceed to show

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[119] *Id.* at 607-08 (citation omitted).

[120] MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1132 (Del. 2003).

[121] *Id.* at 1129-32.

[122] *Id.* at 1132.

that it has fulfilled the *Unocal* requirements of reasonableness and proportionality.[123]

The rationale underlying the court's decision was the protection of the shareholders' franchise. Thus the court held:

> Maintaining a proper balance in the allocation of power between the stockholders' right to elect directors and the board of directors' right to manage the corporation is dependent upon the stockholders' unimpeded right to vote effectively in an election of directors. . . . Accordingly, careful judicial scrutiny will be given a situation in which the right to vote for the election of successor directors has been *effectively frustrated* and denied.[124]

The court's decision follows Delaware's judicial policy by allowing defensive techniques, including poison pills, on the assumption that if shareholders are dissatisfied with such measures they can simply replace the board.[125] In fact, while scholars may honestly dispute whether directors use defensive tactics to benefit themselves or the shareholders, and whether an intermediate standard of review (such as *Unocal*) may be appropriate, corporate elections should serve as the archetype of a conflict of interest situation where directors' entitlement to office is at issue. In the election context, a more exacting scrutiny standard—the "compelling justification" standard—is indeed warranted.[126]

Though the leading commentators, Bainbridge, Stout, and others discussed above, have suggested that the difficulty with staggered boards may be dealt with under the general duties of directors to act with due care and loyalty, the *MM Cos.* Court found that the context of corporate democracy differs sharply from that of the general management of the

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[123]*Id.* at 1131.

[124]*M&M Cos.*, 813 A.2d at 1127. Similarly, in *Blasius*, the court of chancery found that by expanding the board's size from seven to nine and appointing two new members to prevent a dissident from taking control, the board breached its duty of loyalty to the shareholders. The court held:

> The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests. . . . [W]hether the vote is seen functionally as an unimportant formalism, or as an important tool of discipline, it is clear that it is critical to the theory that legitimates the exercise of power by some (directors and officers) over vast aggregations of property that they do not own.

Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988).

[125]*See* Strine, *supra* note 24.

[126]For regular conduct of corporate business, the business judgment rule provides a relaxed standard of review of directorial discretion. *MM Cos.*, 813 A.2d at 1130.

corporation. This, too, supports this article's proposition that once it is recognized that staggered boards pose a problem in terms of corporate democracy and not because of their defensive nature, a new set of mechanisms to deal with them may then be available, as shall be explained below.

C. *Directors as Quasi-Agents*

The general principles of agency law, which underlie corporate law, also require removal power for shareholders notwithstanding staggered terms.[127] Under agency law, a principal may terminate the relationship with his or her agent, though he or she may be liable for damages for breach of contract.[128] "The authority of the agent may be revoked at any time by the principal even though the original authorization was characterized as 'irrevocable.' This results inevitably from the fact that agency is a consensual relationship and a principal, therefore, cannot be compelled to retain another as his agent."[129] There is a clear distinction between the power to terminate the agency relationship and the remedies available as a result of unjustified terminations. A principal, however, may not unilaterally terminate the agency relationship when it was granted to protect the interests of third parties or of the agent. In those cases, however, it is not a "true agency."[130] Though directors are not agents per se and do not take orders from shareholders,[131] directors, like agents and other fiduciaries, must act for the benefit of the corporation and not themselves.[132]

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[127]*See, e.g.*, Jennifer Hill, *Visions and Revisions of the Shareholder*, 48 AM. J. COMP. L. 39, 42-44 (2000) (describing changing visions of the shareholder-board relationship, including that based on agency principles).

[128]WILLIAM A. GREGORY, THE LAW OF AGENCY AND PARTNERSHIP 97 (3d ed. 2001).

[129]*Id.*

[130]This is the situation of "powers coupled with an interest" or "powers coupled with security." *Id.* at 111-12.

[131]In the past, directors were treated as shareholders' agents. Hill, *supra* note 127, at 42-43. Directors had to follow shareholders' instructions. *Id.* But this approach called for accountability without authority. Today, directors are selected to exercise their best independent business judgment and are treated as a corporate organ. Only when dealing with fundamental corporate decisions are the decisions entrusted to the shareholder meetings. Thus, shareholders cannot usually override board decisions. *Id.* at 48. *Cf.* GREGORY, *supra* note 128, at 110 ("It is believed that it should always be within the power of the principal to manage his own business and that includes the power of the principal to reassume the control over his own business which he has but delegated to his agent.").

[132]*See* CLARK, *supra* note 28, at 141-57.

When identifying the corporation as the beneficiary of directors' duties, we speak of an amorphous body. It remains crucial to identify specifically whose interests directors should serve. The answer should affect how we interpret the removal power of shareholders and whether agency law may serve as analogy. With this in mind, I will first examine whether, despite granting shareholders the appointment power, directors on staggered boards should be isolated from removal to protect the interests of other constituencies, such as employees or creditors. This article will then examine whether they should be isolated from removal to protect the interests of minority shareholders.

1. Shareholders and Other Constituencies

When suggesting that shareholders should have the right to remove directors at will, one should not ignore the likely effects of such a rule upon the interests of other corporate constituencies. Making directors removable at the shareholders' will would necessarily make them more responsive to shareholders' interests. This, however, might be to the detriment of other corporate constituencies. Are they the beneficiaries of directors' fiduciary duties as well?

Undoubtedly, directors owe fiduciary duties to the corporation.[133] The question arises, however: is there a correlated duty to maximize the welfare of a particular group of beneficiaries? Though this old question may be traced back to the famous Dodd-Berle debate of the 1930s in the pages of the *Harvard Law Review*, it is subject to renewed debate.[134] The two main camps are divided between those who support shareholder primacy and those who advocate corporate social responsibility. The former argue in favor of maximizing shareholders' wealth.[135] The latter

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[133] *Id.* at 141.

[134] *See* Adolf A. Berle, Jr. *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049, 1049 (1931) (writing in support of the shareholder primacy norm); E. Merrick Dodd, Jr., *For Whom are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1160 (1932) (arguing in support of corporate social responsibility). As Licht recently explained, however, both agreed that in practice the shareholder primacy norm prevails. Amir N. Licht, *The Maximands of Corporate Governance: A Theory of Values and Cognitive Style*, 29 DEL. J. CORP. L. 649, 690-98 (2004). But while Dodd believed that the desirable norm should be that of corporate social responsibility, Berle believed it is unfeasible and non-enforceable.

[135] In the famous *Dodge v. Ford Motor Co.* case, the Supreme Court of Michigan decided that

> [a] business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end
>
> . . . .
>
> [I]t is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and

require directors to take into account the interests of other corporate constituencies (sometimes referred to as stakeholders), such as employees and creditors, and may even expand the list to include the community.[136]

Those favoring the shareholder wealth maximization norm raise a few arguments in support of it as the desirable model. They first argue that shareholders are the residual claimants of the corporation.[137] Shareholders are not entitled to a fixed sum of money from the corporation in the form of salary or interest as employees or creditors do. Rather they are entitled to the indefinite remainder after all other claims against the corporation are satisfied.[138] They thus have the best incentive to monitor the directors (and indirectly the managers). Blair and Stout even suggested that shareholders' voting rights are "partial compensation for shareholders' unique vulnerabilities."[139]

Supporters of the shareholder wealth maximization norm further add that by requiring directors to maximize shareholder wealth, other constituencies' interests are served as well. As the residual claimants, by definition shareholders are not paid until all other claims are settled first. Thus, by maximizing shareholders' wealth, the corporation acts in the interests of employees as well as creditors. It increases the likelihood that the latter's claims will be satisfied.[140] It enlarges the pie to everyone's

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for the primary purpose of benefiting others . . . .

Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919). Berle similarly wrote: "[A]ll powers granted to a corporation or to the management of a corporation . . . whether derived from statute or charter or both, are necessarily and at all times exercisable only for the ratable benefit of all the shareholders as their interest appears." Berle, *supra* note 134, at 1049. *See also* CLARK, *supra* note 28, at 17-19 (arguing that the ultimate purpose of a corporation is to earn profits for shareholders).

[136]*See* William T. Allen et al., *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U. CHI. L. REV. 1067 (2002) (describing the debate between supporters of the property vs. entity model). Under the property model, directors should maximize shareholders' financial returns. *Id.* at 1071-72. In contrast, under the entity model, directors should manage the corporation to maximize the value that the entity generates for society in the long term. *Id.* at 1083-90.

[137]EASTERBROOK & FISCHEL, *supra* note 67, at 35-39.

[138]Similarly, in cases of dissolution, shareholders receive the left-overs (if any) only after all other claims against the corporation have been satisfied. *See* MODEL. BUS. CORP. ACT § 6.40 (2005).

[139]Blair & Stout, *supra* note 56, at 314. "Unlike . . . other stakeholders who enter express contracts with the firm or at least interact regularly with its representatives, and who hence have other opportunities to influence the distribution of firm rents, shareholders rarely have the opportunity to negotiate directly with the firm for advantages." *Id.*

[140]Even Blair and Stout, who do not characterize shareholders as the only residual claimants of the corporation, agree that "[m]aximizing the value of a firm's stock can benefit not just shareholders but other stakeholders in the firm as well . . . . Thus, share value can sometimes be a proxy for, or an indicator of, the total value of rents being generated by the corporation." *Id.*

satisfaction. In contrast, those with definite claims do not have an interest in maximizing corporate profits since they will not enjoy from the additional success of the corporation nor suffer from its failure as long as the corporation fares well enough to cover their claims. In sum, identifying directors' duties with maximization of shareholder wealth is efficient.[141]

Moreover, supporters argue that shareholders' interests are relatively homogenous when compared to other constituency groups. Creditors' interests, for example, vary with the availability as well as kind of security they enjoy on their loan. Employees' interests vary with their rank as well as the type of job they perform. Shareholders, in contrast, share a common interest in maximizing corporate value and, more directly, their shares' value. Because their interests are more aligned, shareholders can thus best and most efficiently monitor directors' (and indirectly management's) performance.[142]

If the above stated arguments are not sufficiently convincing, an additional argument is advanced: any other rule that would require directors to maximize other constituencies' wealth would leave directors practically with no supervision. A servant told to serve multiple masters is a servant free of supervision, since he or she may always invoke the conflicting interests against each other.[143] In other words, any rule other than one requiring directors to maximize shareholders' wealth is infeasible.

Those supporting the maximization of stakeholders' wealth advance ethical as well as economic considerations in its favor. They argue that shareholders are not the only residual claimants of the corporation.[144] Some

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at 313-14.

[141]EASTERBROOK & FISCHEL, *supra* note 67, at 36.

[142]Again, even Blair and Stout, who otherwise advocate for a team production analysis of the firm, agree that only shareholders should have voting rights based on their relatively homogenous interests. Blair & Stout, *supra* note 56, at 313. *Cf.* Iman Anabtawi, *Some Skepticism about Increasing Shareholder Power*, 53 UCLA L. REV. 561 (2006) (asserting that shareholders have divergent interests depending on short-term versus long-term investment, diversified versus non-diversified holdings, characterization as insiders versus outsiders, hedged versus unhedged holdings, etc.).

[143]*See* EASTERBROOK & FISCHEL, *supra* note 67, at 38. *See also* Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U.PA. L. REV. 2063, 2065 (2001) (arguing shareholder wealth maximization as a "utilitarian greatest-good-for-the-greatest-number philosophy). *But see* Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189 (2002) (arguing that empirically the business world shows preference for governance structures that grant directors discretion to serve other constituencies' interests).

[144]MARGARET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 237-40 (1995) (stating that all of a company's stakeholders share inevitably in the residual risk of the firm); Stout, *supra* note 143 ("[S]hareholders are only one of several groups that can be described as 'residual claimants' or

further claim that the stakeholder maximization norm enhances shareholders' wealth *ex ante* since other constituencies would more willingly agree to contribute to the corporate entity when they are treated as beneficiaries.[145] Scholars even characterize the debate as really being one about how to maximize the general societal welfare, explaining that even those adhering to the shareholder wealth maximization norm believe that, by focusing on shareholders' interests, directors maximize returns for society as a whole.[146]

The statutory support in favor of the stakeholder maximization norm is evident by the fact that most states have adopted corporate constituency statutes, which allow directors to consider other constituencies' interests in making corporate decisions.[147] These statutes, however, were adopted to curtail hostile takeovers and have been largely interpreted as allowing consideration of other constituencies' interests to the extent that it is in the best interests of the shareholders as well. In other words, constituency statutes were enacted to assist corporations in fending off hostile bids and they should not be interpreted as intending to redefine the corporate objective.[148]

'residual risk bearers,' in the sense that they expect to enjoy benefits (and sometimes to endure burdens) beyond those provided in their explicit contracts."). This is most obvious when the corporation is at the vicinity of bankruptcy. *See also* Credit Lyonnais Bank Nederland N.V. v. Pathe Commc'ns, No. 12,150, 1991 Del. Ch. LEXIS 215, at *108 (Del. Ch. Dec. 30, 1991) ("[O]perating in the vicinity of insolvency, a board of directors is not merely the agent of the residual risk bearers, but owes its duty to the corporate enterprise."). "The vicinity of bankruptcy," however, is a vague concept and it may be difficult to draw the line as to when corporate actions fall within this vicinity. Moreover, it may be debatable as to when the corporation leverages its business de facto at the risk of creditors, rather than shareholders, such that creditors should be treated as materially residual claimants. In fact, that at times creditors' claims resemble residual interests is reflected in contractual terms. Creditors sometimes provide in their contract with the corporation that during the period of default they are entitled to participate in selecting directors. In cases of insolvency, effectively the creditors take over the management of the corporation through the actions of the receiver. *See also* Uriel Procaccia, *The New Israeli Companies Law: Some Theoretical Highlights*, 1 EUROPEAN CO. & FIN. L. REV. 206 (2004) (suggesting to abandon the claim-residuality argument and envision all corporate claimants as embodied in one person, the corporation).

[145]Stout, *supra* note 24, at 849-50.

[146]REINIER R. KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 18 (2004); *see also* EASTERBROOK & FISCHEL, *supra* note 67, at 38 (explaining that maximizing profits for shareholders assists the other constituencies automatically).

[147]As of 1999, forty-one states had adopted constituency statutes. Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2526 (2005).

[148]Lynda J. Oswald, *Shareholders v. Stakeholders: Evaluating Corporate Constituency Statutes Under the Takings Clause*, 24 J. CORP. L. 1, 3-4 (1998). According to the American Law Institute (ALI), though the corporation may take into account other constituencies' interests, especially when dealing with hostile takeovers, this can be done as long as they are in line with

How does this debate pertain to shareholder removal power? For one thing, although this debate is as current and vibrant as ever, the shareholder maximization norm has prevailed and enjoys overwhelming support among academics, practitioners and courts alike.[149] Even strong supporters of the director primacy model tend to agree that directors should maximize shareholders' wealth.[150] If this is the prevailing model, then shareholders should be treated materially as the principals of the directors for removal purposes. It is not enough to grant shareholders appointment. To align directors' interests with that of shareholders, we should also make shareholders' removal power potent.

Moreover, it should be emphasized that even those supporting the stakeholder maximization norm include the shareholders among the beneficiaries of that norm. The reverse is not true. As aforementioned, requiring directors (as well as managers) to serve the interests of all groups leaves them free to follow their own will. In other words, even if theoretically one is persuaded that the stakeholder maximization norm is better justified, practically it is the more difficult, if not impossible, to enforce.[151] It is better to make directors answerable to the shareholders through a potent removal power than to leave directors unaccountable to all.

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the long-term interests of shareholders. Committee on Corporate Law, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253, 2268-69 (1990) (citing ALI, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS DISC. DRAFT NO. 2A, § 602 (1989)).

[149]The court in *Dodge v. Ford Motor Co.* stated: "A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end and does not extend to a change in the end itself." Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919). Under the ALI's *Principles of Corporate Governance*, "a corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain." ALI, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 2.01(a) (1994). "Shareholder wealth maximization is usually accepted as the appropriate goal in American business circles." Roe, *supra* note 143, at 2065. Hansmann and Kraakman even state: "There is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value." Henry Hansmann & Reiner H. Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439 (2001). *See also* Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 466 (1992) (arguing that decisions should be made for shareholders because "maximizing their wealth necessarily maximizes the wealth of the [corporation]"); D. Gordon Smith, *The Shareholder Primacy Norm*, 32 J. CORP. L. 277, 278 (1998) (noting that all directors have a fiduciary duty to the shareholders to make decisions in their best interest).

[150]*See, e.g.*, Bainbridge, *supra* note 51.

[151]Licht has suggested that this debate is unsolvable since its solution depends on psychological traits of corporate managers. Licht, *supra* note 134, at 745. Some are able to cope with diverse and conflicted beneficiary groups and others need cognitive closure and thus a defined narrow group of beneficiaries. *Id.*

Stated differently, as long as a legal system does not commit to the stakeholder maximization norm to the point of granting other constituencies rights to appoint members to the board, this system should further entitle the shareholders to remove directors they appoint at will. Having it otherwise compromises boards' responsiveness, even to the one group that appoints them and potentially can monitor them and sanction them with removal.

Under Delaware's law more specifically, directors owe their fiduciary duties to the corporation as well as its shareholders.[152] "The theory of our corporation law confers power upon directors as the agents of the shareholders . . . ."[153] Delaware also never adopted a constituency statute, though in *Unocal Corp.* the court allowed the board, when deciding the fate of a hostile takeover, to take into account the "impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally) . . . ."[154] *Revlon Inc.* later, however, limited the scope of this ruling by deciding that "[a] board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders."[155] Thus, our generalized discussion regarding the quasi-agency relationship existing between shareholders and directors is very much applicable in the Delaware's context as well.

2. Minority Shareholders

We still need to ask, though, whether we should isolate directors from shareholders' control by means of staggered boards in order to protect the interests of minority shareholders. According to this proposition, although the majority of shareholders appoints directors, directors should

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[152]Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983); Unocal Corp. v. Mesa Petroleum Co., 493 A. 2d 946, 955 (Del. 1985). *See also* Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595, 611-12 (1997) (noting that directors owe duties to both the shareholders and the corporation at various times).

[153]Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 663 (Del. Ch. 1988).

[154]Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985). For a suggestion to impose the *Unocal* standard on non-shareholder constituency statutes, see STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 741-47 (2002).

[155]Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) (citing *Unocal Corp.*, 493 A.2d at 955). *See also* Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1286-87 (Del. 1989) (holding that directors may treat various bidders during a hostile takeover in any manner as long as they act in fairness with respect to shareholder interests). *Cf.* Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140, 1150 (Del. 1989) (deciding that absent the *Revlon* circumstances, directors are not obliged to maximize short-term interests of shareholders, but may instead pursue a longer investment horizon).

serve the interests of all shareholders, and this can be done only if they are protected from removal by the majority until the end of their term.

To begin, this article's analysis concentrates on the typical U.S. public corporation characterized by dispersed ownership. In this scenario, the acute agency problem is along the axis of directors and shareholders, rather than the axis of majority and minority shareholders. Even acknowledging that shareholders are not a monolithic group, the difficulty with the stated proposition is that staggered boards in general sacrifice, rather than promote, minority interests. This becomes most obvious when the corporation has an otherwise cumulative voting mechanism in place.[156]

> By classifying a board of directors[sic] the number of directors to be elected at each election is reduced. By reducing the number of directors to be elected the significance of cumulative voting is reduced. That is, if a board of nine directors is elected completely each year, it only takes one tenth plus one of the shares being voted in order to elect a director to the board. If a board of nine directors is classified into three classes of three directors each, then one fourth plus one of the shares being voted is needed to elect one director to the board.[157]

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[156]"Under cumulative voting, each shareholder has a number of votes equal to the number of shares he owns times the number of directorships to be filled . . . but the shareholder can distribute them among candidates as he wishes." CLARK, *supra* note 28, at 362. A minority shareholder may thus cast all his or her votes for a single candidate and have a better chance of electing that candidate to the board. In contrast, under the common system of straight voting, a majority shareholder may elect all the directors since at each vote for director he or she has a majority. *See id.*

[157]Sell & Fuge, *supra* note 99, at 162. *See also* Comment, *supra* note 39, at 754 (stating that "majority groups have . . . used board classification to forestall minority representation"). The mathematics, however, may be more complicated. Thus, for example, if three members are elected annually, a minority of twenty-five percent plus one may elect one director each year and may reach a total of three members on the nine-member board. If all nine directors were elected simultaneously then the same minority would be able to elect only two members to the board. *Id.* On the other hand, a minority of twenty-three percent will be able to elect no members on such classified board, while it would have been able to elect two if the board was unclassified. *See* William R. Leckemby, Jr., Note, *Classification of Directors and its Effect upon Cumulative Voting in Corporate Elections*, 56 DICK. L. REV. 330, 333-35 (1952).

In other words, staggering the board dilutes, and might even prevent, minority representation. In practice, staggered boards have often been used in the past to undermine cumulative voting.[158]

Though cumulative voting is no longer common, the same rationale applies even outside the cumulative voting context.[159] Minority shareholder representation is diluted under staggered board provisions. Thus, for example, if the minority is able to obtain some representatives through bargaining with other shareholders, it will be less able to do so if fewer directors are elected at one time.

The only exception occurs when staggered terms are connected to classes of shares. Under this scenario, staggered terms may serve the minority as a class. Empirically, however, in the overwhelming majority of cases, this is not how staggered boards are structured.[160] If staggered terms are tied to the protection of directors as a class, they should be treated as an entrenchment device as discussed in this article. On the other hand, if they are truly installed to protect minority shareholders, we should respect this governance mechanism. This is not likely to become common practice in public corporations, however, since it would differentiate the prices of the shares of the corporation and have the potential to create deadlock and dissension on the board.

Of course, one must not confuse minority interest with their power to elect directors to the board. Even if the minority lacks the power to elect directors, they may have a legitimate interest that directors be less accountable to the majority so that directors may protect minority interests as well. In this context, however, we may borrow arguments from the

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[158]In fact, in 1955 the Illinois Supreme Court found staggered boards unconstitutional in light of the state's constitutional provision for cumulative voting. Wolfson v. Avery, 126 N.E.2d 701, 710-12 (Ill. 1955). The court interpreted cumulative voting to mean proportional representation. A different reading, more common with other state courts, could have saved the staggered board statute. Under this reading, cumulative voting is seen as intending to grant the minority some, though not proportional, representation on the board. *See* Coffee, *supra* note 42, at 1646-47.

[159]*See* Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124 (1994) (discussing the demise of cumulative voting and arguing for its revival as a tool in the hands of institutional investors to affect the composition of the board). Interestingly, while by 1945 cumulative voting provisions were mandatory in twenty-two states and permissive in fifteen, by 1992 only six states maintained mandatory provisions and an additional forty-four chose the permissive mode. *Id.* at 145-46. Already in the 1990s, only a small percentage of public corporations had cumulative voting arrangements. *Id.* at 160.

[160]*See, e.g.*, Surjit Tinaikar, *The Disclosure Effects of Dual Class Ownership Structures* (Jan. 2006) (unpublished thesis, University of Toronto), *available at* http://accounting.eller.arizona.edu/docs/Workshop_papers/Tinaikar_2-05.pdf (explaining that U.S. dual class firms have fewer staggered boards than single class firms because their capital structure affords them protection against hostile takeovers).

shareholders-stakeholders debate and conclude that here, too, it is preferable that directors be held accountable to the majority rather than to none at all. Other remedies, including minority oppression law and appraisal rights, may be more tailored to protect minority rights.

In sum, in accordance with general principles of agency law, we should respect the shareholders' choice to dismiss their directors notwithstanding the existence of staggered terms, while allowing directors to sue for damages. Any other interpretation of the Delaware statute would run against the policy underlying agency law that does not tolerate the irrevocability of quasi-agency relationships of the type existing between shareholders and directors. In the last Part, this article examines whether such an interpretation of the Delaware statute is indeed possible.

D. *Basic Principles of Law and Economics*

From a law and economics perspective, it does not matter whether the relationship between shareholders and directors falls legally under agency. It is sufficient that directors control shareholders' assets and that the shareholders' welfare depends on the actions of the directors to recognize the relationship as one of agency.[161]

The challenge is to enable directors to monitor the management of the corporation while ensuring that they do not abuse their power to promote their interests at shareholders' expense. This is the famous problem of the modern publicly-held corporation where ownership and control of the corporation are separated.[162] Corporate law and economics literature focus on the difficulty of how to minimize the agency costs created by this separation of interests.[163]

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[161]KRAAKMAN ET AL., *supra* note 146, at 21.

[162]As Berle and Means observed in the 1930s, though in the past shareholders held both ownership and control of corporations, with the dispersion of ownership, it became increasingly difficult for shareholders to coordinate and exercise control over the corporation. *See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION & PRIVATE PROPERTY 66-116 (1968). Many hold too few shares and are rationally ignorant regarding corporate affairs. But this development, rather than being idealized, was a by-product of modern industry—corporations needed to raise large sums of money, investors needed to diversify their risks, and the management needed to become professional. *Id.* Later scholars, adhering to director primacy, have almost idealized this concentration of power in the hands of directors as discussed *supra* Part II.A.2.

[163]These "agency costs" are composed of the costs that shareholders bear to monitor directors (and indirectly the managers), that directors (and managers) bear to signal their loyalty (bonding costs), and that shareholders bear due to the divergence of management's decisions from those which would maximize shareholders' welfare (residual loss). *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976); *see also* Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980) (explaining how the separation of security