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To Our Clients:

Quinquennial Election of Directors:
A Proposal for Discussion

Corporate governance is the hot topic:

- long-term business planning vs. short-term maximization of stock prices
- the SEC vs. the Pennsylvania statute
- institutional investment policies -- patient capital or hot money
- management entrenchment or shareholder democracy
- Business Roundtable vs. Council of Institutional Investors
- the rediscovery of the proxy fight by corporate raiders
- shareholders vs. stakeholders; which constituents count the most
- should the proxy system be restructured and if so to what end -- more gadfly resolutions or a new approach for the modern era of finance corporatism

We need to strike a balance. A balance that facilitates long-term planning by corporations but does not entrench bad management. A balance that continues the ability of shareholders to police bad management but does not play into the hands of the corporate raiders.

To accomplish these objectives, consideration should be given to changing the corporate governance system so that directors are elected for five-year terms. Under this new quinquennial system directors would run on the corporation's record for the past five years and the corporation's strategic plan for the next five years. Any shareholder or group of shareholders with 5% of the outstanding shares or shares having an aggregate market value of $5,000,000 would have the same access to the corporate proxy machinery as the management.

The present system of corporate governance is an anachronism. It stems from the days when shareholders were real owners, not transitory professional investors; when there were no tender offers, no risk arbitrageurs, no junk bonds and no pressures on both corporate management and institutional investment managers to show ever better quarterly performance. It is not suitable for the modern era. It lends itself to abuse by corporate raiders whose only objective is their own enrichment. It enables corporate raiders to subvert business combination and corporate constituency statutes and shareholder rights plans by combining a tender offer with a proxy fight. It vitiates the just say no defense.

The new system would substitute a quinquennial meeting for the annual meeting. There would no longer be any need for staggered boards; all directors would be elected at the quinquennial meeting. There would no longer be any need for nonvoting or low voting stock; all public corporations would be subject to a one share one vote requirement. If someone wished to combine a hostile tender offer with an attempt to facilitate the tender offer by replacing the board, this could be done only at the quinquennial meeting. The just say no defense to a hostile tender offer would be available at all times other than at the quinquennial meeting when the shareholders might decide to elect directors who would sell the corporation.

The quinquennial system would permit corporations to pursue long-term planning without fear that investment in research and development, plant and equipment, expanding markets and similar short-term depressants on earnings would result in a takeover. It would remove the pressure on boards of directors to maximize share prices in the short run. It would also remove the pressure on institutional investors to sell out good, successful, well-managed companies just because someone is offering a premium to the market price. Institutions would have an opportunity to be the patient, long-term investors they profess to want to be.

The quinquennial system would assure good management and sound business strategies. The requirement that directors run for election on the corporation's five-year record and its strategic plans for the next five years would assure that the directors perform their principal function of choosing competent managers and holding those managers to achieving their business plans. Directors do not want to run the risk of a losing proxy fight. Indeed, they do not want to run the risk of creating a situation that invites a proxy fight. Since any shareholder or group with the requisite ownership could conduct a proxy fight at the corporation's expense, the threat of a proxy fight would serve to police the actions of the directors not just as they approach the five-year intervals, but continuously. Yet, at the same time, directors and managers will have the time to demonstrate that their plans will produce long-term results free of the fear of a takeover if those plans penalize short-term performance, as often they must. Thus, the quinquennial system strikes the needed balance of preserving ultimate shareholder control but not forcing bad business policies and dangerous leverage on corporations seeking to avoid the threat of takeover.

By preventing hostile takeovers between the five-year intervals, the quinquennial system would facilitate negotiated acquisitions; particularly common stock mergers that avoid the undue leverage now plaguing American business. The fear of a raider interfering with a common stock merger forces too many good mergers to either be abandoned altogether or structured in a way that overburdens the combined companies with debt. While hostile takeover interference with mergers would be limited, the quinquennial system would have no effect on the ability of shareholders to vote down any merger they did not approve.

Also the quinquennial system can improve the directors' oversight of a corporation's compliance with laws. Directors would be removable between five-year intervals for personal criminal conduct or willful malfeasance and could also be removable if the corporation were guilty of such conduct.

The quinquennial system would eliminate the need for statutes like that about to be enacted in Pennsylvania. It would not eliminate the need for shareholder rights plans and it would not eliminate the need for business combination and corporate constituency statutes unless as part of the new system the hostile tender offer is also eliminated, as I believe it should be.

The quinquennial system is worthy of consideration and debate. Obviously it would require a number of related changes in the state laws of corporate governance and in the SEC proxy regulations and the rules of the stock exchanges. It would be easiest to implement it through federal action, but hopefully it would be promulgated as a uniform state law and adopted by all states, thus avoiding federal instrusion in corporate governance.

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