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Maryland Law Implications of the SEC's Proxy Access Rules

The proxy access rules recently adopted by the Securities and Exchange Commission have many implications for the nomination, election and service of directors under Maryland law. We have been receiving questions from our clients about the interaction of the new rules with Maryland law and their corporate governance documents.

The New Rules

New Rule 14a-11 under Regulation 14A (the "Proxy Rules") of the SEC will generally require a company reporting under the Securities Exchange Act of 1934 or a registered investment company to include in its proxy materials the nominees (up to the greater of one nominee or 25% of the total number of directors, even if the board is classified) of one or more shareholders who (a) have continuously owned shares with at least three percent of the company's total voting power in the election of directors for the three years before filing the new required notice on Schedule 14N and (b) continue to own the three percent minimum through the date of the shareholders meeting. The new rule will not be available to shareholders holding securities for the purpose of changing control of the company or gaining a number of directorships that exceeds the number of nominees that a company is required to include under the rule. Rule 14a-11 does not apply to foreign private issuers, companies whose only public securities are debt securities and, for at least the next three years, "smaller reporting companies."

Amended Proxy Rule 14a-8(i)(8) will require a company subject to the Proxy Rules to include in its proxy materials, under certain circumstances, shareholder proposals to establish a procedure in the company's governing documents for including shareholder nominees for director in the company's proxy materials.

The new rules will become effective on November 15, 2010, well in time for the 2011 proxy season.

Our Recommendations

It is important to note that new Rule 14a-11 requires inclusion of qualifying shareholder nominations in the company's proxy materials but leaves in place advance notice requirements for director nominations outside of Rule 14a-11, director qualifications and various shareholders meeting provisions governed by state law and typically found in company bylaws.

While recognizing that there are variations in the circumstances and governing documents of each company, we are advising clients to consider the following actions in light of the new rules:

1. *Review Advance Notice Bylaws.*

a. General. Our form of advance notice bylaws will accommodate shareholder nominations made under new Rule 14a-11 and shareholder proposals of nomination procedures under amended Rule 14a-8(i)(8). The procedures and informational requirements of the new rule operate independently of, and not in conflict with, our advance notice provisions. However, for consistency with existing provisions in our form, we are adding a provision disclaiming any effect of the advance notice bylaws on the rights of shareholders under new Rule 14a-11.

b. Advance notice period. For several years, we have been recommending advance notice of 120 to 150 days before the anniversary of mailing of the prior year's proxy statement for shareholder nominations and business proposals, consistent with the existing minimum 120-day requirement in Rule 14a-8. The 120- to 150-day advance notice window has now been adopted in Rule 14a-11.

c. Information and verification requirements. Since 2006, when we introduced the first hedging disclosure provisions in advance notice bylaws, hundreds of public companies have adopted them and their scope has expanded. It has also become mainstream for advance notice bylaws to provide for the company's right to require updating and verification of information by a shareholder proponent. With proxy access, it continues to be important for companies to have robust information and verification requirements for shareholder nominations outside of new Rule 14a-11.

2. *Review "Majority Voting" Provisions.* In recent years, many companies have adopted some type of majority voting in uncontested director elections, *e.g.,* to be elected, each nominee must receive the affirmative vote of a majority of the total number of votes cast or affirmatively withheld as to (or voted against) the nominee. For most of these companies, plurality voting remains the voting requirement when there are more nominees than directors to be elected. Bylaws should be reviewed to ensure that these provisions and any cross-references to advance notice bylaws are expanded to provide for plurality voting in a situation where there are more nominees than directors to be elected due to the presence of a Rule 14a-11 nominee.

3. *Review and Consider Director Qualifications.* New Rule 14a-11(b)(9) requires a nominee for election as a director of a non-investment company to meet any applicable "objective" independence criteria of a national securities exchange or association and a nominee for director of an investment company to not be an "interested person," as defined in

the Investment Company Act of 1940. Under the new rule, a company may not exclude from the proxy materials nominees who fail to meet director qualifications in the company's governing documents, but the SEC recognizes in its adopting release for the new rules that such qualifications might "preclude the company from seating a director who does not meet these qualifications . . . ." Thus, the SEC accepts the anomaly that a company may be required to include in its proxy materials a nominee who will not be able to serve as a director if elected.

The Maryland General Corporation Law ("MGCL") has long provided that: "Each director of a corporation shall have the qualifications required by the charter or bylaws of the corporation." For over ten years, we have suggested director qualifications as a positive way to enhance the value and operation of the board. Many boards have already identified (and some have set forth in corporate governance guidelines) the most desirable backgrounds and experience, both general and company-specific, for board membership. Boards that have not already done so may want to consider incorporating some of these characteristics as director qualifications in the bylaws. Objective criteria may include minimum age, minimum stock ownership in the company, a prohibition on short or hedged positions in company stock, relevant industry or sector experience or prior board, senior executive or financial experience with a public company. While objective criteria are easier to administer, subjective criteria may be considered as well. Boards may also wish to consider what documentation should be required of a nominee as evidence of qualification.

The SEC's position that director qualifications may not be a ground for excluding an individual from proxy access but may still entitle the company not to seat an elected nominee under state law poses the issues of when the determination of non-qualification is made, by whom and how implemented. Under the MGCL, directors serve "until their successors are elected and qualify." In the case of an election, it is usually determined by certification of the voting results by the inspector of election followed by a declaration by the chair of the meeting that the nominees meeting the vote requirement have been elected. (Sometimes the chair makes a declaration based upon the preliminary results, subject to receipt of the inspector's final certificate; sometimes the meeting is adjourned before the inspector's certificate is signed and delivered and then reconvened to receive the certificate, followed by the chair's declaration.) In the case of qualifications, we recommend establishing a procedure for the board or perhaps the nominating committee to determine whether any nominee not previously determined to be qualified is in fact qualified. Once a determination of qualification is made, it may (but is not required to) be announced before the meeting is convened and then should form the basis for a declaration by chair of the meeting, after receipt of the inspector's report, of the nominees who have been, in the words of the MGCL, "elected and qualif[ied]."

4. *Review Provisions for Fixing Number of Directors and Filling Vacancies.* The MGCL permits the board to have the exclusive power to fix the number of directorships (within

any limits in the charter) and to fill vacancies. Many of our clients have opted in to these provisions and proxy access obviously makes them even more important.

5. *Review Other Bylaw Provisions Relating to Shareholders Meetings.* With the greater likelihood of contested meetings of shareholders, it is prudent to have up-to-date provisions giving the chair broad authority to conduct and adjourn the meeting and detailing the duties of the inspectors. Provisions on shareholder-requested special meetings should also be reviewed.

6. *Prepare for Shareholder Proposals to Establish Procedures for Shareholder Nominations.* Under the MGCL, the board may be given exclusive power over amendments to the bylaws and the bylaws of most of our Maryland public company clients so provide. Thus, shareholders of these companies are not able to amend the bylaws to establish a procedure, in addition to Rule 14a-11, for including shareholder nominees in the company's proxy materials. However, a shareholder who meets the existing requirements for proposals under Rule 14a-8 will be able to make a precatory proposal recommending to the board that it amend the bylaws to establish a procedure for including shareholder nominees for election as directors in the company's proxy materials. Boards may want to consider whether to adopt such procedures before shareholders propose them. We reiterate our advice of past years that Maryland law specifically recognizes the right of directors to refuse to take action recommended by the shareholders, even if recommended by a substantial majority.

7. *Review All Corporate Governance Documents for Compliance and Consistency.* Proxy access potentially implicates not only charters and bylaws but also corporate governance guidelines, committee charters (especially the nominating committee's) and various company policies. All should be reviewed for compliance and consistency with the new rules and with each other.

8. *Review the Director Nomination and Board Self-Evaluation Processes.* It has been several years since the SEC adopted rules regarding disclosure of the process for consideration and nomination of candidates for election as directors and the New York Stock Exchange added an annual board self-evaluation to its corporate governance standards. More recently, the SEC required disclosure in the annual meeting proxy statement of the "specific experience, qualifications, attributes or skills that led to the conclusion" that each nominee and incumbent director should serve as a director of the company. An open, neutral and thorough nomination process and a careful, candid and comprehensive board self-evaluation process can yield positive substantive results as well as assuring shareholders that the board seeks to attract and retain highly qualified directors. Companies may want to review and possibly enhance these processes.

It is important to emphasize in this regard that there are now potentially four ways for shareholders to influence director nominations. They can (a) recommend an individual for nomination by the board through the procedures established by the nominating committee, (b) nominate an individual under the advance notice bylaws (which will often be followed by a proxy contest), (c) nominate an individual under Rule 14a-11 to be included in the company's proxy materials or (d) nominate an individual for inclusion in the company's proxy materials pursuant to procedures, if any, established in the company's bylaws or other governing documents.

9. *Review GRIds and Other Corporate Governance Ratings.* With the greater exposure to action by management-unfriendly holders that proxy access will facilitate, now is a good time to review the company's overall corporate governance posture. The support of ISS and the other proxy advisers can often be critical in a proxy contest and having a good corporate governance rating can help. In our experience, there are often points that a company can pick up with little or no impact on its operations and sometimes proxy advisers make mistakes. We continue to emphasize, however, that under the MGCL a director's actions should be guided by what he or she reasonably believes to be in the company's best interests, not by what proxy advisers or others say is good corporate governance.

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We are available to discuss any of the foregoing matters.

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