

April 9, 2014

Board Classification in Maryland: Evaluating Section 3-803 of the MGCL

Since 1999, Section 3-803 of the Maryland General Corporation Law (the “MGCL”) has permitted the board of directors of a Maryland corporation or the board of trustees of a Maryland real estate investment trust with a class of equity securities registered under the Securities Exchange Act of 1934 and at least three independent directors or trustees to elect to classify itself notwithstanding any contrary provision in the charter, declaration of trust or bylaws and without a stockholder vote. This statute, adopted by the Maryland legislature specifically to address the abuses of hostile takeovers, has recently received negative commentary from governance scorekeepers and activists. Green Street Advisors has urged boards to opt out of Section 3-803, REIT Zone Publications has issued several missives similarly attacking Section 3-803 and a union group, focused on the hotel industry, has sent stockholder proposals seeking an opt-out from this provision of Maryland law.

As is regrettably common with corporate governance scorekeepers and activists, they take an unbending one-size-fits-all position. On this issue, they declare with utter certainty that it is never appropriate for the board of any Maryland corporation or REIT to classify itself without stockholder approval under any circumstance now or in the future. Recently, they have asserted that, as is permitted by the MGCL, the boards of all Maryland companies should opt out of the provisions of Section 3-803 and condition any future opt-in on a stockholder vote. This approach ignores the fact that the directors, who are statutorily required to act in the best interests of the company, have the most information about the company and are, therefore, in the best position to evaluate the governance of the company.

Classified boards have been a common feature of corporate governance for nearly 100 years. At the most, they defer a change of control of the board for a year. We continue to believe that a classified board serves important and legitimate corporate governance objectives, including (a) providing a modest measure of continuity and stability in business strategies, operations and management; (b) enabling the board to focus on long-term value maximization strategies rather than short-term stock price movements; and (c) protecting the company from coercive takeovers by encouraging would-be acquirers to negotiate with the board, as the stockholders’ elected representatives. In addition, a board’s power under Section 3-803 to classify itself provides a valuable tool to promptly and effectively respond to a hostile attack that is not in the best interests of stockholders, which would likely not be possible if it were necessary to obtain stockholder approval in advance. Let’s be clear: A classified board will not stop a fully-financed premium bid for a company, but it will prevent a sudden shift of the board into the hands of people seeking a low-ball sale of the company or other transaction not necessarily in the best interests of the company or all the stockholders.

Unlike the governance scorekeepers and activists, we do not take a hard and fast, arbitrary position with no exceptions or acknowledgement of differing situations. We recognize that a classified board and the board's power to classify itself may not be right for all companies at all times and under all circumstances. We also recognize that there are arguments in favor of a declassified board or opting out of Section 3-803, including that a declassified board enables stockholders to register their views annually on the performance of the entire board and each director and that declassifying or opting out of Section 3-803 would be popular with many institutional investors and corporate governance critics. We think these arguments should be weighed by a board together with the benefits of classification in various circumstances, and we are especially concerned about a board effectively renouncing for all future boards of the company the availability of a protection against hostile takeovers.

We have advised many boards on opting into Section 3-803 and on considering whether to retain the power to classify itself. In addition, we have recently received questions from clients and others on Section 3-803. In general, we recommend that a board:

- Receive legal, financial and other relevant advice (including empirical data) on the advantages and disadvantages, for the company, of a classified board and Section 3-803;
- Analyze the company's existing and desired governance profile, considering its overall takeover risk profile and available defenses;
- Evaluate options in between remaining subject to Section 3-803 and opting out of it entirely (e.g., providing that any opt-in to Section 3-803 be submitted for stockholder approval within twelve months); and
- Discuss the board's position on these issues with and solicit the views of the company's major stockholders.

Electing to opt out of Section 3-803 is a significant and likely permanent loss to a company's defenses against hostile takeovers and we recommend that a board carefully evaluate the facts as they relate to the particular company.

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As always, please do not hesitate to call any of us if you have any questions or comments about any of the foregoing or any other matter of Maryland law.

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