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GETTING NOTHING FOR SOMETHING

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A lot of controversy has recently been swirling around Subtitle 8 of Title 3 of the Maryland General Corporation Law ("Subtitle 8"), especially its provision that allows a board of directors to classify itself into three classes without a stockholder vote and despite any contrary provision in the charter or bylaws. In fact, Subtitle 8 has been the law in Maryland since 1999, when the Maryland legislature, by overwhelming margins, approved the Unsolicited Takeovers Bill, which was signed by the Governor and became effective on June 1, 1999.

Subtitle 8 (occasionally called the "Maryland Unsolicited Takeovers Act" or "MUTA") permits a Maryland corporation (or a Maryland real estate investment trust formed under Title 8) with a class of equity securities registered under the Securities Exchange Act of 1934 and at least three independent directors to elect, by provision in its charter or bylaws or by resolution of its board of directors and notwithstanding any contrary provision in the charter or bylaws, to be subject to any or all of five provisions, including:

- a classified board;
- a two-thirds vote of outstanding shares to remove a director;
- a requirement that the number of directors be fixed only by vote of the board of directors;
- a requirement that a vacancy on the board of directors be filled only by the affirmative vote of a majority of the remaining directors and for the remainder of the full term of the class of directors in which the vacancy occurred and until a successor is elected and qualifies; and
- a provision that a special meeting of stockholders must be called upon stockholder request only on the written request of stockholders entitled to cast a majority of the votes entitled to be cast at the meeting.

Subtitle 8 also permits the charter or a board resolution to prohibit the corporation or a Title 8 real estate investment trust from electing to be subject to any or all provisions of the Subtitle. (For convenience hereafter, we shall refer just to a REIT, whether formed under the Maryland General Corporation Law as a corporation or under Title 8 as a real estate investment trust.)

For many years, newly formed Maryland REITs have adopted classified boards and the substance of the other Subtitle 8 protections in their original charters or bylaws and have

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thus not needed to opt in to Subtitle 8. Some pre-1999 REITs and some post-1999 REITs without classified boards or other Subtitle 8 provisions have opted in to Subtitle 8 to adopt one or more of its provisions.

For the past several years, classified boards, like shareholder rights plans and plurality voting, have been under attack by proxy advisers, institutional shareholders and academics. These attacks have asserted the need for more "accountability" and a fear of "entrenchment." In more recent years, some of these same activists have gone even further and demanded that boards not only declassify, redeem their rights plans and give up plurality voting but also promise never (at least without a shareholder vote) to reclassify, adopt a new rights plan or revert to plurality voting. In Maryland, as Barry Vinocur has pointed out, at least 13 REIT boards have declassified (or promised to do so in the near future) and adopted a charter provision that the REIT will not reclassify under Subtitle 8 without a shareholder vote. A shareholder vote, of course, requires an annual or special meeting of shareholders, a process likely to take at least several months, typically not soon enough to provide any timely or effective benefit to a company under attack.

Nevertheless, the pressure for REIT boards to give up the right to classify (or reclassify) under Subtitle 8 continues. Boards are wise to resist this pressure for several reasons:

1. *There is no economic benefit to the REIT.* Declassifying (or promising not to classify or reclassify) will not lease more space, increase rents or lower interest rates. It may pick up some points on Green Street's scorecard but plenty of REITs have successfully sold equity with classified boards. Generally speaking, it is better for a company to have more choices than fewer. For example, I do not know of a single REIT charter that caps a board's power to borrow. So, why give up, for no economic benefit to the REIT, an option that may provide some protection against an effort by investors or activists with goals other than those typically held by long-term shareholders to seize control of the company on a short-term basis in what may be temporarily unfavorable market conditions? The decision to opt out of Subtitle 8 is not whether to classify the board, which would at least be discussable in terms of good or bad corporate governance (see next paragraph), but whether to effectively give up *even the choice* of classifying the board at some future time under unknown circumstances, thereby tying the hands of all future boards.

2. *There is no significant reliable data showing a correlation, much less causation, between non-classified boards and economic performance.* Economic performance of REITs is driven by management and assets, not by corporate governance. Just last year, using a comprehensive sample for the period from 1978 through 2011, Martijn Cremers, Lubomir P. Litov and Simone M. Sepe, in *Staggered Boards and Firm Value, Revisited*, showed that firms adopting a classified board increase in firm value and, conversely, that declassifying is associated with a decrease in firm value. Likewise, in 2010, Michael E. Murphy, in *Attacking the Classified Board of Directors: Shaky Foundations for Shareholder Zeal*, concluded that the value of companies with and without classified boards was nearly identical and that the effects on company value were insignificant if the company's shares are widely held, without a ten percent or greater shareholder.

Indeed, Murphy surveyed previous literature (including articles by Harvard Law Professor Lucian Bebchuk, a well-known vocal opponent of classified boards) to conclude that classified boards do not affect operational performance and noted that there is some evidence to support the conclusion that companies with classified boards have improved operational performance. In short, Murphy concluded that classified boards actually have a very wide range of impacts on companies, and thus a "case-by-case" approach is best. There are other studies reaching similar conclusions.

3. *The primary purpose of classified boards is to provide continuity and stability to the company and its management in developing and executing its strategies.* Classified boards have been around for nearly 100 years. They encourage the recruitment and retention of new directors by permitting them a reasonable period of time to become familiar with the company before coming up again for election. Developing, implementing and executing a long-term strategy can generally not be done in only one year. REIT boards and managements found this out during the financial crisis when they were forced to refinance their companies and reposition their assets, often resulting in major strategic changes, the benefits of which may not be realized in only one year. The courts for years have held that the power to set the time horizon over which the company will be operated rests squarely with the board. As a necessary corollary, the board is entitled to protect the company from changes to its strategies and policies. This is especially true where the board makes a choice explicitly conferred on it by the legislature.

4. *The board, as the elected representatives of the shareholders and with more information than any single shareholder, is in the best position to decide on appropriate protections for its strategies.* Not content with electing the board and letting it choose and evaluate the CEO and collaboratively develop the company's strategy, some shareholders and uninvested activists want to tell the board what to do. We see this encroachment especially in the recommendations of Institutional Shareholder Services Inc. ("ISS") to withhold or vote against directors for a single small infraction of ISS's policies, *regardless of the company's economic performance*. ISS also threatens to, and often does, recommend against directors who fail to implement within the following year even just one precatory proposal approved by shareholders, regardless of the company's economic performance – a position diametrically opposite to generations of settled corporate law in Maryland, Delaware and elsewhere. Even more vividly, we see this encroachment in the efforts to restrict the board's exercise of its rights under Subtitle 8 to protect its strategies and policies. These moves are often advanced as a supposed antidote to "entrenchment" or as promoting "accountability." Entrenchment, of course, is a loaded label and accountability sounds good but the result of depriving the board of the opportunity for limited protection of its business plan is exposure to attacks by holders with very different economic (or other) goals than shareholders generally. Take, for example, arbitrageurs, hedgers and "underweight" holders who openly pursue investment strategies very different from the value maximization sought by most shareholders. Indeed, one labor organization whose primary interest is organizing employees, not shareholder value, Unite Here, typically a small holder in its target companies, has

successfully proposed opting out of the Subtitle 8 classified board provision at several lodging REITs.

5. *A classified board will not prevent a takeover*. It is now common for a bidder in a hostile tender offer to reinforce its tender offer with an announcement of intention to file a competing slate of director nominees at the next annual meeting of shareholders. A classified board will give the incumbent directors additional time to consider the bidder's proposal, explore alternatives and, often, negotiate with the bidder. Because the board has the power to declassify (if it has classified itself under Subtitle 8) or to initiate declassification (if the board is already classified in the charter) and to remove other defensive measures, it has leverage in negotiating with an otherwise hostile bidder, who will almost always prefer paying more for a sure deal today than running proxy contests of uncertain outcome at two annual shareholders meetings.

In summary, it is difficult to see how a board maximizes value for the shareholders – the ultimate goal of any for-profit enterprise – by tying the hands of future boards by surrendering, effectively forever, a valid choice, like the power to classify, specifically conferred by statute, in return for no economic benefit for the REIT. Directors should be especially careful that they do not fall into the trap, of which they are so often unjustly accused, of appearing to act in their own self-interest by yielding to pressure, especially from unelected activists with little or no skin in the game, to opt out of Subtitle 8, in order to avoid a recommendation by ISS or Glass Lewis & Co. to withhold or vote against directors in a subsequent election.