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Responding to Shareholder-Approved Precatory Proposals

Shareholders, many of them small holders, continue to submit precatory proposals under SEC Proxy Rule 14a-8 for consideration at public company annual meetings and these proposals continue to receive significant support from proxy advisors and institutional holders. As many public companies are entering the period of time when they may receive a precatory proposal for their 2015 annual meetings, we want to (a) review the duties of directors of Maryland corporations regarding precatory proposals approved by stockholders, (b) discuss the policies and recent practices of Institutional Shareholder Services Inc. ("ISS") relating to approved precatory proposals and (c) review a recent SEC Staff Legal Bulletin that may affect the 2015 proxy season.

Statutory Duties of Maryland Directors

We are often asked, especially following annual stockholders meetings, to advise boards of directors of Maryland corporations on their duties in connection with a precatory proposal approved by shareholders. For many years, we have consistently advised that Maryland law does not require a board to take an action that is the subject of a shareholder proposal approved by a majority – even a significant majority – of the votes cast or even the votes entitled to be cast.

Section 2-401(a) of the Maryland General Corporation Law (the "MGCL") provides that "[t]he business and affairs of a [Maryland] corporation shall be managed under the direction of a board of directors." Section 2-401(b) confers on the board "[a]ll powers of the corporation . . . except as conferred on or reserved to the stockholders by law . . . ." In discharging his or her duties as a director of a Maryland corporation, Section 2-405.1(a) of the MGCL requires each director to act "[i]n good faith," "[i]n a manner he [or she] reasonably believes to be in the best interests of the corporation," and "[w]ith the care that an ordinarily prudent person in a like position would use under similar circumstances." Further, Section 2-405.1(e) unambiguously provides that: "An act of a director of a corporation is presumed to satisfy the standards of subsection (a) . . . ." This presumption has been recognized and applied by Maryland courts and also applies to acts of trustees of Maryland real estate investment trusts. *Allyn v. CNL Lifestyle Properties, Inc.*, 6:13-CV-132-ORL-36, 2013 WL 6439383 (M.D. Fla. Nov. 27, 2013); *Sadler v. Retail Properties of Am., Inc.*, 12 C 6743, 2014 WL 2598804 (N.D. Ill. June 10, 2014); *Werbowsky v. Collomb*, 362 Md. 581 (Md. 2001).

The United States District Court for the District of Maryland has held that there is no duty for directors of a Maryland corporation to follow the wishes of holders of a majority of the shares. *See Martin Marietta Corp. v. Bendix Corp.*, 549 F. Supp. 623, 633 n.5 (D. Md. 1982), *quoted in Mountain Manor Realty, Inc. v. Buccheri*, 55 Md. App. 185, 197-98, 461 A.2d 45, 52-53 (1983). The court in *Martin Marietta* rejected the contention that an earlier Maryland case, *Cummings v. United Artists Theatre Circuit, Inc.*, 237 Md. 1, 204 A.2d 795 (1964), prohibits the board of directors of a Maryland corporation from taking actions that it knows are disapproved by a majority of the stockholders. *Martin Marietta*, 549 F. Supp. at 633 n.5. Instead, the court held that "there is no reason to believe that a Maryland corporation's directors, even [when] faced with

a request from a majority shareholder, must always accede to that request." *Id*. Moreover, the Court of Appeals of Maryland, our highest state court, has stated: "As a general rule, the stockholders cannot act in relation to the ordinary business of the corporation, nor can they control the directors in the exercise of the judgment vested in them by virtue of their office." *Warren v. Fitzgerald*, 189 Md. 476, 489, 56 A.2d 827, 833 (1948) (*quoting People ex rel. Manice v. Powell*, 201 N.Y. 194, 201, 94 N.E. 634, 637 (1911)). Even earlier, the Court of Appeals held that a resolution purporting to express "the will of the members" is not binding on the directors. *Mutual Fire Ins. Co. v. Farquhar*, 86 Md. 668, 674-75, 39 A. 527, 529 (1898). *See also* JAMES J. HANKS, JR., MARYLAND CORPORATION LAW §§ 6.1a and 7.1 (Wolters Kluwer Law & Business Supp. 2013).

We believe that these cases follow, almost necessarily, from Section 2-401(a)'s delegation of power to the board to oversee the management of the corporation's business and affairs and would be relevant in the shareholder-proposal context. We emphatically reject any claim that the board of a Maryland corporation has a legal *obligation* to implement a shareholder-approved precatory proposal.

We recommend that directors of Maryland corporations, as part of their ordinary prudence duty quoted above, give appropriate consideration at an ensuing board meeting to the merits of a proposal approved by stockholders. Depending on the nature of the proposal, it may be appropriate to refer the matter to a committee of independent directors and to seek expert advice on the matter. In the end, however, as stated above, it is each director's duty to act in a manner that he or she reasonably believes to be in the best interests of the corporation.

ISS Practice Regarding Precatory Proposals

ISS has become so influential that its recommendations as to shareholder proposals are often outcome-determinative. Unfortunately, ISS's recommendations are generally so formulaic, rarely allowing room for company-specific considerations, that the utility of the vote result to the company's board is greatly diminished.

Furthermore, because ISS relies on selling consulting services promoting its definition of "best practice" corporate governance, it has a vested interest in the outcome of these proposals, and making sure there is an ever-evolving definition of best practice that accords with ISS's own policies, as indicated by ISS's annual reboots of its governance scoring system. See our memorandum, *ISS Releases QuickScore 3.0*, dated November 6, 2014.

Nevertheless, ISS continues to enjoy significant influence with regard to approved shareholder proposals. ISS will consider recommending against directors, committee members or the entire board if the board fails to act on *even just one* shareholder proposal that received the support of a majority of the votes cast in the previous year. If the board does not implement such a proposal, ISS will examine, *inter alia*, the outreach efforts of the board and any disclosure regarding why the proposal was not implemented. Despite the fact that ISS says its evaluation is case by case, we are not aware of any instance when ISS did not subsequently recommend against incumbent nominees of a board that did not implement a shareholder-approved proposal.

We consider ISS's "one-strike" policy unnecessarily and disproportionately harmful to the corporation and its stockholders. The problem is further compounded by the increasing popularity, and occasional passage, of social, environmental and political proposals that encroach on the board's traditional oversight and decision-making functions. We suspect that ISS will continue to expand the types of proposals that it will consider supporting. It is not hard to foresee a governance climate in a few years where ISS routinely recommends in favor of such proposals, leading to an internally-reinforcing increase in the number and approval of such proposals. This would leave boards with the dilemma of choosing to (a) implement the proposal, which would erode the board's traditional oversight and decision-making functions and likely be time-consuming and/or expensive for the company, or (b) ignore the proposal, leading to ISS recommendations against directors at the next annual meeting and, thus, failed elections at companies with majority voting.

While ISS's policy and influence are frustrating, directors of Maryland corporations should remember that taking or refraining from taking any action solely because of its possible impact on their reelection or the recommendation of a proxy advisory service may not be consistent with their statutory duties discussed above.

SEC Guidance

On June 30, 2014, the Division of Investment Management and the Division of Corporation Finance of the SEC issued a Staff Legal Bulletin (the "SLB") providing guidance on the proxy voting responsibilities of investment advisors, which will be relevant for matters submitted to a shareholder vote, including precatory proposals, in the 2015 proxy season. We have summarized here some of the most important topics from the SLB.

The SLB clarified that, in order to confirm that proxies are authorized in accordance with clients' best interests and the advisor's own policies, investment advisors should review their own voting policies and procedures at least annually. We hope that more frequent review of the advisor voting policies will result in more company-specific voting policies that rely less heavily on ISS recommendations. Additionally, an increased focus on the best interests of advisors' clients should result in more investment advisor willingness to engage with companies directly to discuss voting issues.

For investment advisors that subscribe to proxy advisory services, the SLB clarified that the investment advisors must conduct an ongoing review of the adequacy and quality of these services. We hope that the SLB will encourage more investment advisors to take a proactive role in voting and result in greater willingness to deviate from proxy advisors' recommendations. The SLB also gives investment advisors leverage to demand higher-quality proxy voting reports.

The SLB further states that investment advisors may agree on plans with clients in advance to vote in accordance with the recommendation of any party (such as the board of directors or a proxy advisory service) or to abstain generally from one or more types of proposals. While this may lead to creation of plans where shares are always abstained or voted as ISS recommends, it also opens the possibility that investment advisors and clients will agree to a plan

for voting shares in accordance with the recommendation of the board of directors. Further, directors of institutional holders should consider carefully whether delegating their voting responsibilities to ISS (or anyone else) complies with their duties under federal and state law.

Finally, the SLB calls for proxy advisory services to affirmatively disclose any material conflicts of interests regarding the matter on which they are providing a recommendation. It is unclear how this will affect future proxy voting reports, because proxy advisory services often have at least two conflicts: First, many companies pay consulting fees to proxy advisory services. Second, proxy advisory services may have a vested interest in the outcome of certain governance-related proposals. For example, a proxy advisory service that relies heavily on promoting its own viewpoint of what constitutes "best practice" governance may have a vested interest in seeing favorable outcomes on related proposals. In any event, any disclosure in a proxy voting report that underscores a potential lack of objectivity may discourage subscribers from blindly following the recommendations contained therein – clearly a positive development.

We believe that the SLB creates an important opportunity for next year's proxy season. Investment advisors, in an effort to comply with this guidance, may be more willing to depart from ISS recommendations in 2015. Focused stockholder outreach, especially for companies that have received proposals in the past and who have received or expect to receive proposals for 2015, may be productive. In light of the SLB, institutional stockholders may be more willing to listen than in the past. Detailed disclosure in proxy statements on governance decisions and responses to shareholder-approved precatory proposals is advisable. These actions would also be considered by ISS when making future director nominee recommendations, should any shareholder proposal eventually pass. Ultimately, we hope to see a 2015 proxy season where ISS recommendations are less outcome-determinative for shareholder precatory proposals.

Finally, ISS and Glass Lewis recently released their 2015 policy updates. These policy updates include the changes to how these proxy advisory services will evaluate director nominees during the 2015 proxy season. We shall be writing to you separately regarding these policy changes.

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As always, we and our colleagues are available at any time to discuss these or other matters.

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