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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 boards of public companies may be considering acting on precatory proposals approved at 2016 annual meetings, we want to review (a) the duties of directors of Maryland corporations regarding precatory proposals approved by shareholders and (b) the policies and recent practices of Institutional Shareholder Services Inc. ("ISS") relating to approved precatory proposals.

Statutory Duties of Maryland Directors

We are often asked 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) . . . ." These standards also apply to acts of trustees of Maryland real estate investment trusts. *See* MD. CODE ANN., CORPS. & ASS'NS §8-601.1 (effective Oct. 1, 2016, as amended).

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 shareholders. *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)). "Shareholders are not ordinarily permitted to interfere in the management of the company; they are the owners of the company but not its managers." *Werbowsky v. Collomb*, 362 Md. 581, 591, 766 A.2d 123, 133 (2001). 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 (Supp. 2015, updated annually).

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 are 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 shareholders. 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 on shareholder proposals, as well as on other 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 version of "best practice" corporate governance, it has a vested interest in the outcome of these proposals, and in making sure there is an ever-evolving definition of best practice that accords with ISS's own policies, as indicated by ISS's frequent reboots of its governance scoring system.

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, any disclosure regarding why the proposal was not implemented, the subject matter of the proposal, the level of support for and opposition to the proposal in past meetings, action taken by the board in response to the vote (including its engagement with shareholders) and the continuation of the underlying issue as a voting item on the ballot. Despite the fact that ISS says its evaluation is case by case, we are not aware of any instance where a board decided not to implement a majority shareholder-approved proposal and ISS did not subsequently follow with a recommendation against the incumbent nominees.

This ISS practice is especially concerning when it comes to social, environmental and political proposals that may impact a company's operations. These proposals are increasingly popular and several have passed in 2016. ISS has often supported such proposals, even though they encroach on the board's traditional oversight and decision-making functions. ISS's support, combined with its almost inevitable recommendation against incumbent directors on boards that do not implement a majority shareholder-approved proposal, places directors in a dilemma: They must decide either to implement a proposal that they believe is not in the company's best interests or ignore the proposal and face the possibility of not being re-elected.

While ISS's policy and influence are frustrating, directors of Maryland corporations should be wary of taking or refraining from taking any action solely because of its possible impact on their re-election or the recommendation of a proxy advisory service.

Shareholder Outreach

If a company received a shareholder proposal that was approved at its 2016 annual meeting, it may be useful to conduct shareholder outreach before the board makes a final decision on implementation, as conversations with shareholders, especially large shareholders who voted in favor of the proposal, may provide more insight than just the vote result. If a board decides against implementing a shareholder-approved proposal, we believe that its decision should be reached after at least some, preferably significant, shareholder outreach and that outreach should continue after the decision in order to explain the board's thinking on why the proposal was not implemented, discuss any other responses the board may be considering and get a sense of any possible voting or other shareholder reactions at the next annual meeting. Often, shareholders will be satisfied with a thoughtful response even if it is not a full implementation of the proposal. In addition, it is our experience that it is helpful to be able to describe shareholder outreach in the next year's proxy statement, especially if the company can say that holders of a substantial percentage of shares expressed satisfaction with the board's response.

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

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