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Living with Corporate Governance:
Maryland Law Issues

The fifth anniversary earlier this summer of the signing of the Sarbanes-Oxley Act has furnished the opportunity for reflecting not only on the Act but also on the continuing preeminence of corporate governance as an issue for public (and many private) companies, boards of directors and managements. Among the developments that we have seen over the past five or so years are the following:

1. *The sources of corporate governance rules and principles have mushroomed.* Some of these sources are external, including federal securities laws, rules, regulations and proposals; state laws; court decisions; stock exchange rules and listing standards; proxy adviser voting guidelines; institutional shareholder corporate governance principles and voting guidelines; corporate governance scoring systems; shareholder proposals; and academic and media commentary. Other sources are internal (although they may have been externally imposed or influenced), including charters; bylaws; corporate governance principles; audit, nominating and compensation committee charters; and codes of conduct. This proliferation of rules and principles means that companies, directors and advisers should carefully review a wide range of external and internal sources (a) when considering a particular matter and also (b) when adopting or modifying an internal rule or principle.

2. *More players are getting into the act* – not just traditional rule makers like the Securities and Exchange Commission, state legislatures, courts and stock exchanges but also, more and more, Congress; institutional shareholders; small but determined activist shareholders; proxy advisers; corporate governance scorekeepers; a growing number of academics, some of whom do not confine their activities to writing articles; rating agencies; and corporate governance "monitors," who are brought in, typically after some scandal, and write reports making corporate governance recommendations for a particular company, many of which are then picked up and amplified in the corporate governance echo chamber. This multiplicity of players means that companies, directors and advisers should be aware of and sensitive to a variety of different constituencies, many of which share common goals but not always and not always in the same way.

3. *Many of the corporate governance activists have a pretty much fixed view on many corporate governance issues.* They are for more independence of both directors individually and the board as a group but they want to give the board less power and the shareholders more. They are against classified boards and takeover defenses. They are for confidential voting, cumulative voting and "majority voting" in the uncontested election of directors. They are also for separation of the board chair and chief executive officer positions. The two most important results of these and other positions are (a) more shareholder power at the expense of the board and (b) more exposure of the company to unsolicited takeover bids.

4. *The board of directors as an institution is under attack.* Many of the corporate governance activists tend to minimize the historic role of the board as an intermediary between management and the shareholders, even though the board generally has access to more information than any single shareholder. These investors typically feel that they have as much relevant information as the board, or at least enough to enable them to make or recommend decisions previously left exclusively to the board. Allied with these activists are hedged investors, derivative security holders, arbitrageurs and other short-term investors who have little interest in long-term performance. This means that companies and boards are often confronted with corporate governance measures advanced by proponents with very different economic interests from traditional long-term shareholders.

These developments are not going away any time soon. As corporate America accedes to one corporate governance measure, the activists advance others. Some of these measures are beneficial, some are neutral and some may not be in the best interests of a particular corporation. What, then, does all of this mean for directors of a Maryland corporation, both in considering corporate governance proposals and in running the business? We advise directors to bear in mind the following:

First, the *primary duty* of the board under the Maryland General Corporation Law ("MGCL") is to *oversee management*. Section 2-401(a) of the MGCL provides that "[t]he business and affairs of a corporation shall be managed by or under the direction of a board of directors." Section 2-401(b) further provides that except as otherwise provided by law or the charter or bylaws, "[a]ll powers of the corporation may be exercised by or under the authority of the board of directors . . . ." Both of these provisions are similar to provisions in the Delaware General Corporation Law and the Model Business Corporation Act. When the board is asked to give up some of its power, *e.g.*, to agree not to adopt a shareholder rights plan or to limit the amount of stock options or other executive compensation, it should remember that doing so may not comply with its primary duty to direct the management of the company's business and affairs. As in Delaware, the board of a Maryland corporation is entitled, absent a contrary provision in the charter, to direct the management of the corporation *for the long term*.

Second, the MGCL requires that each director perform his or her duties in a manner that the director "reasonably believes to be in the *best interests of the corporation*." This means that a director must have some rational basis for believing that his or her action is the best interests of the *corporation* as a continuing entity. Note that the statute, which was taken from the Model Business Corporation Act, does not mention *shareholders*, who are, of course, a constantly changing body with widely differing (and changing) interests; certainly, the statute does not mention corporate governance scorekeepers or activists.

Third, the MGCL requires each director to act "[w]ith the *care that an ordinarily prudent person* in a like position would use under similar circumstances." This means, most importantly, adequate information, which may include expert advice and the views of key shareholders and management, as well as sufficient time and deliberation upon which to make a decision. Even if corporate governance activists advocate, or other companies have adopted, a measure, such as board declassification or majority voting in the election of directors, a director should make sure that he or she has received adequate information as to the advantages and disadvantages of any potential decision, including its potential effects on the company. As well, because of the multiplicity of internal and external corporate governance rules and players, each director should be aware of existing or proposed corporate governance rules or policies at the company and in the market that may impact, or be affected by, an existing or proposed measure.

Fourth, the MGCL's standard of conduct for directors *applies individually, director by director*, not collectively to the board. It applies also to a director's actions as a member of a board committee. Each director may be liable for failure to perform his or her duties even if the other directors are not liable -- and *vice versa*.

Fifth, the fundamental purpose of the corporation is *wealth creation and enhancement*, not corporate governance. In the long (and maybe not so long) run, the market is more concerned with a company's performance than with its corporate governance score. If, after exercising ordinary prudence, a director reasonably believes that a particular corporate governance proposal – or any other proposal -- is not in the company's best interests, then he or she should vote against it. There is nothing wrong with a less than unanimous vote. A director should not vote for something just because others are for it.

Finally, directors should be prepared for *receiving a higher number of votes withheld* from his or her election than previously. Institutional Shareholder Services, Inc. ("ISS"), the influential proxy adviser, has a long and growing list of things that will cause it to *recommend withholding* a vote from a director nominee. With so many companies adopting majority voting in uncontested election, ISS may try to leverage its power to recommend withholding votes for director nominees to influence board decisions not only on matters of corporate governance but on business matters as well. While it is certainly proper to consider the views of shareholders and their advisers, it is, as noted above, the board – not the shareholders or others – who have the statutory power and duty to direct management of the company.

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

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