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Addressing Board Exclusive Control of the Bylaws: Stop, Look and Wait

Unlike Delaware, Maryland corporation law permits Maryland corporations (and Title 8 REITs as well) to provide for the board to have exclusive power to amend or alter the bylaws. For decades, this has been viewed as an advantage for Maryland corporations and Title 8 REITs (hereinafter "companies"). The bylaws of an overwhelming majority of REITs formed under Maryland law in the past 20 years give the board of directors or trustees "the exclusive control of the bylaws."* Recently, Institutional Shareholder Services Inc. ("ISS") and a few others have attacked this provision and are urging boards of Maryland-chartered companies to abandon it and immediately give concurrent control over the bylaws to shareholders. ISS has said it will recommend against incumbent members of a board's nominating and governance committee if shareholders do not have a concurrent right to amend the entire bylaws. Glass, Lewis & Co. currently does not penalize companies where the board has the sole right to amend the bylaws, but we would not be surprised if it changed its policy to follow ISS.

We urge boards to weigh this issue carefully before taking action for the following reasons:

1. Exclusive board control of the bylaws has been in the bylaws of most Maryland public companies since their formation, which means that every shareholder of these companies has invested with this provision as part of the company's governance.

2. Giving the shareholders the concurrent power to make binding amendments to the bylaws is effectively a *one-way ratchet*. Once given, the power to amend the bylaws directly may be viewed by a court as a right that may not be taken away from shareholders without their consent. This alone suggests the wisdom of not rushing to judgment but waiting and seeing how this still-unfolding issue develops.

3. Most bylaws address matters such as quorums for board, committee and shareholders meetings; share certificates; inspectors of election; corporate seals; checks, drafts and deposits; written consents of directors and committees as well as advance notice of shareholder nominations and proposals, shareholder-requested special meeting procedures and indemnification and expense advance for directors and officers. These provisions have historically not been regarded as partisan or contentious; but someone or some group has to

* According to data we have gathered, 144 Maryland REITs have exclusive board control of the bylaws (19 with some provisions requiring shareholder participation in any change) and 35 Maryland REITs have concurrent power for both the board and shareholders.

address them. The board of directors (or trustees) is best suited to address these issues because under Maryland law each director (or trustee) has (a) enforceable legal duties to the company, (b) access to more information (including the views of other directors/trustees) than any single shareholder or group of shareholders and (c) the legitimacy of having been elected (every year, in the case of a non-classified board) by the shareholders.

4. Most importantly, Maryland law requires each director/trustee to act with a reasonable belief that his or her action is "in the best interests of the corporation" as a continuing entity rather than in the varying interests of the shareholders, who are a constantly changing group, none of whom has any duty to the company. Shareholders can and do act in what they perceive to be their *own* interests, which may be very different from what the board determines to be the best interests of the company. If shareholders disagree with the board, they have the power to replace the board, either annually (in the case of a non-classified board) or even in between annual meetings.

5. While boards are considering this issue, we believe that the burden should be on proponents of giving shareholders the concurrent right to amend the bylaws to explain how taking this effectively irreversible step is in the "best interests" of the company. We have not seen any data supporting a correlation – much less a causative link – between concurrent shareholder power to amend the bylaws and economic performance by the company.

6. We do not know yet how giving shareholders the concurrent power to amend the bylaws will develop. Shareholders of Delaware corporations have had this power for many years without significant disruption but in many cases Delaware corporations require a supermajority vote of two-thirds or more of the votes entitled to be cast on the matter for the shareholders to amend the bylaws; so, this requirement may have minimized the number of bylaw amendment proposals by shareholders. (Approximately 43% of the Russell 3000 and 29% of the S&P 500 have supermajority vote requirements for shareholder amendments to the bylaws.) Unfortunately, according to information available to us, ISS has already indicated that it will not accept a provision that requires a shareholder vote requirement of more than a majority of the votes entitled to be cast. It will be interesting to see whether ISS grandfathers the Delaware companies with two-thirds vote requirements, especially because ISS is apparently unwilling to grandfather the many Maryland companies that have had exclusive board control of the bylaws since their IPOs.

7. A majority-of-the-outstanding vote requirement to give shareholders, effectively forever, the power to amend the bylaws may make it attractive to more activists to file mischievous and potentially destabilizing bylaw amendment proposals that could, for example, limit the company's borrowing power; dictate compliance with environmental, social and governance (ESG) sustainability; reduce the indemnification and/or expense advance for directors and officers; eliminate the advance notice informational requirements for shareholder nominations for director/trustee; or limit the power of the board to adopt a shareholder rights plan. The list of disruptive proposals, especially in the hands of shareholders with interests not

shared by the board or other shareholders generally, is almost endless. Even if defeated, these proposals could inflict damage on the regular conduct of a company's business.

8. In addition to shareholder proposals of bylaws opposed by the board as not in the company's best interests, there is the very real possibility that the shareholders would adopt proposals that conflicted with existing provisions in the charter or elsewhere in the bylaws. For example, every charter gives the board the power to issue up to a fixed number of shares. Indeed, many Maryland charters give the board the power to increase the number of shares that the company may issue without a shareholder vote. What would be the effect of a shareholder amendment to the bylaws purporting to limit the board's exercise of its power to issue additional shares or create new authorized shares? ISS does not address this issue.

9. Another question is who would have the power to amend what bylaws. If shareholders may amend bylaws adopted by the board, may the board amend bylaws adopted by the shareholders? The possibility for conflict among groups with the right to exercise the same power is not remote or theoretical. ISS does not address this issue either, although it does say that it will not accept "ringfencing" certain bylaws from shareholder amendment.

10. Effective means already exist for the shareholders to achieve responsible desired ends, principally through SEC Proxy Rule 14a-8, which requires the board, subject to certain limited exceptions, to include in the company's proxy statement proposals by shareholders (even holders with as little as $2000 invested in the company) and a supporting statement by the proponents. If the proposal is approved by the shareholders and not implemented by the board in the following year, ISS will almost certainly recommend against all incumbent members of the board (regardless of the company's economic performance) at the next election. Whatever one may think of this ISS policy, it has proven effective in focusing directors' attention on carefully considering and reacting to shareholder proposals.

11. There are intermediate steps that a fully informed board carefully considering the matter may want to test. For example, as suggested above, a board may want to establish a voting requirement for a shareholder amendment of the bylaws of more than a bare majority of the votes entitled to be cast. Notwithstanding ISS's majority-only position, a two-thirds vote requirement, already in place for dozens of public companies (see 6 above), may be acceptable to major shareholders as a reasonable requirement for amending a fundamental governance document. As another example, a board may want to require some minimum ownership threshold for proponent/s of a shareholder amendment to the bylaws that is similar to the three percent/three years ownership requirement that has already become market standard for proxy access. ISS has said that it will accept the Rule 14a-8 ownership/holding minimum, which in our view is not sufficient to screen out gadflies and other proponents with little or no economic interest in the company.

12. Thus, at this still early stage in the development of this issue, we urge boards to defer an immediate decision to take action that would be effectively undoable and instead see how the

issue plays out this year. One of the key elements in this regard are the views of major shareholders and we further urge boards to communicate with these holders to get their sense of the issue, including the ramifications discussed above. Adopting, at least for now, a "wait and see" approach avoids the pitfalls discussed above and preserves the board's flexibility in two key scenarios: Scenario One – the members of the nominating and governance committee do not receive the support of major shareholders and ISS. The board may change its mind at that point, even before the annual meeting and votes are cast and counted, and agree to adopt concurrent amendment of the bylaws, perhaps with some negotiated terms (see 11 above). Scenario Two – even if members of the nominating and governance committee do not receive the requisite vote in an uncontested election, they will, under most current bylaws, typically hold over, offer to resign and (if their offers are not accepted) remain on the board. This will give the board further time and opportunity to see how the matter develops over the next several months. If the board decides to follow this course, it may want to issue a statement that it has considered the matter carefully and that, as the issue and its ramifications are still developing, not all relevant information is known yet and, therefore, the board will continue to monitor and consider the issue over the coming several months, consult with major investors, take the advice of advisers and gather other information, including the decisions of boards and shareholder of other companies this year.

In summary, a decision not to give concurrent power to the shareholders to amend the bylaws may always – and easily – be changed; but a decision to give away this power may not. A prudent board may want to gather more information and assess developments later this year before making a decision that could be irreversibly binding on future boards.

My colleagues and I are glad to respond further.

Jim Hanks