LATHAM & WATKINS LLP

Corporate Governance Commentary

November 2010

Private Ordering in the Brave New World of Proxy Access

Highlights

- The SEC has stayed the effectiveness of its proxy access rules during the pendency of litigation challenging their validity on administrative law procedural grounds.
- The stay has effectively bought public companies a year to prepare fully for the advent of SEC-mandated proxy access.
- The existing SEC proxy access rules do not purport to preempt state law governed bylaws establishing reasonable conditions to the right to make nominations and reasonable qualifications for directors to be seated on a board. We don't think it likely that, even if required to rectify procedural errors by an adverse court decision, the SEC will vary this aspect of its rules.
- We recommend that companies take advantage of the one year "grace" period and review their bylaws carefully to determine if they should be amended in light of the likely advent of proxy access. In doing so, companies should be mindful that, no matter the outcome of the SEC's proxy access rules, traditional proxy contests and corporate governance activist pressure to reshape board composition will increasingly diminish the ability of nominating committees to be the sole arbiters of nominees for director.
- The types of private ordering a company should consider to prepare for proxy access and corporate governance activist intrusion into the nomination process include:
  - Revision of advance notice bylaws to deal with the proxy access process.
  - Adoption of appropriate conditions on the right to nominate directors and qualifications for directors to be seated.
  - Review and revision of board governance and informational policies.
  - Review and revision of bylaw provisions governing conduct of shareholder meetings.
  - Review of nominating committee charter and processes.
- The goal of the private ordering process should be to help ensure that the proxy access process is appropriately reflected in a company's bylaws and, more broadly, that all directors, including any shareholder nominated directors, will know and play by a uniform set of "rules" intended to promote the best interests of the company and its shareholders.

Introduction

The SEC's proxy access rules, which had been slated to take effect on November 15, 2010 — in time for the 2011 proxy season — have been stayed by the SEC during the pendency of a court challenge to the rules based on alleged violations of administrative procedure laws. In light of the timing of the court case, it seems clear that, even if the court rejects the challenge to the SEC rules, proxy access will not become effective prior to the 2012 proxy season.

If the court were to find flaws in the SEC's administrative process, we think it is highly likely that the SEC would seek to correct those flaws and reissue valid proxy access rules. This process might further delay the effective date of the reissued rules, so that they would not be operative for some or all of the 2012 proxy season.

Notwithstanding the delay in implementation of the proxy access rules, we recommend that companies start now in their consideration of possible changes in their bylaws and other governance documents to take into account the almost certain advent of proxy access in the next year or so.

Why Worry Now?

A conventional response to planning for proxy access might be: "Why worry now? Our company is not a likely target for proxy access and, in any event, there will be time enough to deal with proxy access if and when it becomes effective and we are concretely threatened."

This response ignores three important realities:

- When the SEC adopted its proxy access rules in mid-August with an anticipated effective date in November, companies began scrambling to deal with the rules and quickly realized that acting in a timeframe of only several months would be extremely challenging. The desirability of bylaw and other governance policy revisions needed to be investigated and thought through. Senior management needed to be educated with respect to proposed private ordering responses. Boards had to be brought into the process and given time to understand the issues and consider appropriate company responses. Suddenly, the 90 or so days between adoption and effectiveness seemed very challenging for an orderly and thoughtful process. Waiting for a court decision not expected until the summer of 2011 invites a repetition of a similar stressful timeframe for companies to get their acts together.
- Waiting even longer until a tangible proxy access threat emerges after effectiveness of the rules will almost certainly be too late to deal with a number of structural governance issues. History of election contests (and a proxy access nomination creates an election contest) teaches that bylaw or other governance policy changes after a proxy contest has been signaled present significant issues under Delaware law and the Chancery Court's avowed protection of the shareholder franchise.[1] Moreover, whatever a Delaware legal challenge does not accomplish, an active public relations campaign by the opposition is likely to. Changes to governing documents once a proxy contest is in sight will be perceived by many institutional shareholders as defensive and an unfair, last-minute tilting of the playing field. This reaction will not only hand the proponents of the proxy access nomination an appealing campaign issue, but also may cause many in the corporate governance community to vote for the access nominee as a means of disciplining what they will perceive as the company's affirmatively bad corporate governance.
- Finally, it is important to realize that the historical regime of board hegemony over selection and election of directors has been under attack by corporate governance activists for many years and will continue to erode. Conventional proxy contests may not worry most companies, and the same may be true of proxy access nominations. However, the threat of proxy access nominations, "say no on pay" campaigns and withhold vote campaigns by corporate governance activists is an increasing reality for public companies. Corporate governance activists will continue their unrelenting pressure for what they characterize as corporate governance reform, and the leverage provided by their victories, including mandatory "say on pay" votes and the proxy access rules, will give these activists far greater sway over director nominations. There will be an increasing number of "strangers" in the board room, products not of the traditional board-driven search process for new directors but of corporate governance activist pressure. Companies need to be prepared for the advent of a new regime for director selection that may threaten traditional board cohesion and collegial values.

In light of these realities, the right question is not "why worry now?" It is "if not now, when?" This does not mean that companies should act precipitously or enact private ordering initiatives on a rush basis. We believe, however, that it is not too soon to begin consideration of bylaw and other governance revisions with a view toward adoption of appropriate private ordering

initiatives in 2011, well before the likely 120–150 day window for proxy access nominations for 2012 that would open in the late fall of 2011 for year-end reporting companies.

The Scope of Private Ordering: In Search of Boundaries Under the Proxy Access Rules

On their face, the proxy access rules do not preclude any form of private ordering under state corporation laws. Companies, in theory, can adopt bylaws that provide a very different proxy access regime from the one prescribed by the SEC. However, those bylaws cannot change the availability of the SEC-mandated proxy access regime; they can only establish a parallel regime. Accordingly, as a practical matter, companies do not have the practical ability to "opt out" of the SEC version of proxy access, in whole or in part. The only effective method for changing the effect of the SEC's proxy access regime is to adopt bylaws that make proxy access easier to accomplish. It is safe to assume that very few companies will want to do that.[2]

There is, however, a different arena for private ordering in the context of proxy access and other formal or informal shareholder nomination of directors — namely, revision of advance notice bylaws to accommodate the proxy access regime (including adding new conditions to the right to nominate candidates at a shareholders' meeting) and review and revision of bylaws establishing qualifications for the seating of directors and rules for the conduct of shareholder meetings. Other important areas for private ordering include adoption or revision of board informational and governance policies, revision of nominating committee charters and processes, consideration of the size of the board and review of board quorum, voting and notice standards.

Although the SEC's Adopting Release for proxy access is hardly a model of clarity in this regard, it seems clearly to contemplate that the SEC's rules operate solely in the realm of disclosure in proxy materials. If the rules' requirements are met, the candidate's name must be included in the proxy statement and on the company's proxy card, accompanied by up to a 500-word supporting statement. The proxy access rules, on the other hand, do not purport to operate in the traditional state law regulated area of director nominations and qualifications or conduct of shareholder meetings.

Evidence of the SEC's conscious separation of the scope and function of its proxy access rules and the traditional state law based rules for the election and seating of directors can be found in the Adopting Release and the rule itself. For example, the Adopting Release states in the context of discussing whether and what type of independence is required of a proxy access nominee:

"Accordingly, although we have not revised the rule to allow exclusions [from the proxy statement and proxy card] of nominees who do not meet any director qualification requirements, we have adopted a requirement that a nominating shareholder…disclose…whether, to the best of [its] knowledge,…the nominee meets the company's director qualification standards…set forth in the company's governing documents. The company may also chose to provide disclosure…about whether it believes a nominee satisfies the company's director qualifications….Where a company's governing documents establish qualifications for director nominees that, consistent with state law, would preclude the company from seating a director who does not meet these qualifications, we believe this would be important disclosure for shareholders (footnotes omitted)."[3]

Recognizing that there is a penumbra surrounding the proxy access rules in which private ordering under state law may operate is, unfortunately, the easy part of the enterprise. The harder part, as we will see, is delineating the dimensions of that penumbra. The next several sections of this *Commentary* focus on this harder part.

Nature and Effect of Conditions on Right To Nominate Candidates vs. Qualification for Seating Directors

As implicitly recognized by the SEC, a prime source of state law authority for private ordering in the context of the proxy access rules, and shareholder nominated or designated directors more broadly, lies in company bylaws. This observation, however, masks an interesting and potentially important distinction between two types of bylaws affecting the election and seating

of directors — qualifications on the right to nominate candidates for director and qualifications on entitlement of elected nominees to be seated as directors. While the end result of these two types of bylaws may be similar, their implications are not the same.

- A valid bylaw establishing conditions or qualifications on the right to nominate candidates for director would ordinarily operate at the time nominations are actually made at a shareholders' meeting and, if not satisfied, would justify declaring the nomination out of order and excluding the nominee from the ballot for election of directors.[4] Qualifications for valid nominations appear to be recognized under state law and should be upheld if reasonable and equitable in their operation and reasonably related to a proper corporate purpose.[5] The result of invocation of a nomination qualification is that the candidate would not be voted upon by shareholders and would not be elected as a director. Proxies to vote for the proposed nominee would be ineffective, because the candidate would not in fact have been nominated.
- A qualification for seating an elected nominee on the board does not operate until the candidate is elected. While its legality would likely be subject to the same tests as a nomination qualification — that it be reasonable and equitable in its operation and reasonably related to a proper corporate purpose — its operation raises more challenging public relations and legal issues than a qualification for nomination.
- The difference is most easily seen in the fact that, in the case of disqualification of a nomination, there would be no vote and therefore no easy characterization of a board wrongfully "snatching victory from the jaws of defeat." In the case of a seating disqualification, the nominee will have been elected and will have the moral mantle of "victor" to his or her benefit. Moreover, if found wrongful, a failure to seat an elected director may have implications regarding the validity of board actions taken during the time the director was improperly denied a seat on the board and excluded from board information flows and board meetings. These issues presumably would not arise if it were subsequently determined that a candidate had been wrongfully excluded from the voting, because votes would not have been cast.

Based on the potential issues and lack of clarity in state law regarding a seating condition, the safer position would be to frame the standard as a condition on the right of nominations, and then (invoking the time honored lawyers' drafting expedient of adding "suspenders" to the proverbial "belt") to further provide in the bylaw that a candidate not meeting the stated standard is also not qualified to be seated as a director.[6]

Conventional Advance Notice Bylaws

Although most of the opportunities for private ordering in the context of proxy access are optional, revision of advance notice bylaws are not. As the corporate law and M&A bar learned in 2008, an ambiguous advance notice bylaw is problematical or worse, at least in the Delaware courts.[7]

Conventional advance notice bylaws set a window of either 60–90 or 90–120 days preceding the prior year's annual meeting date for valid notice of a shareholder nomination of a director candidate (as well as for any other motions a shareholder might want to make) at the coming year's annual meeting. This window occurs later in the proxy season cycle than the 120–150 day anniversary of the mailing of the prior year's proxy statement for a proxy access nomination. In light of the permissibility under proxy access for bylaws relaxing the qualifications for a proxy access nomination, it is not hard to envision a court holding that a later advance notice bylaw nomination window supersedes the proxy access window period. This would drastically curtail notice to a company of a proxy access nomination.

Many advance notice bylaws also contain minimum informational requirements for a valid director nomination. In some cases, the informational requirements will be less extensive than the proxy access rules, with the result that the bylaw could be interpreted as superseding the more stringent proxy access rule informational requirements.

Avoidance of these and other possible interpretative issues requires careful review and appropriate revision of every company's advance notice bylaw. The question, then, is how to revise the advance notice bylaw.

An obvious and simple option is to make explicit that the advance notice bylaw is not intended to apply to proxy access nominations. This approach would establish two entirely separate regimes for advance notice, one for proxy access nominations and the other for conventional proxy contests where the insurgents issue their own proxy card. Administering the two advance notice regimes could be challenging, particularly if the company is facing simultaneous election contests, one under proxy access and the other of the conventional, old-fashioned variety. More important, carving proxy access wholly out of advance notice bylaws would preclude using the advance notice bylaws as a vehicle for provision of information appropriately sought by the company from every candidate for director.

In light of explicit staff comments that the proxy access rules would not preempt otherwise valid advance notice bylaws, carving proxy access out of the advance notice bylaw cedes what might be very important informational and other provisions that would otherwise be properly applicable to a proxy access nomination. Moreover, addressing advance notice bylaws sooner, rather than later, should make it harder for a would be proxy access nominating shareholder to argue that the amendments to a company's advance notice bylaw are not general, but rather targeted solely against proxy access candidacies, and thus not reasonable or equitable as a matter of state law. For these reasons, we urge companies not to procrastinate in their consideration of amendments in light of proxy access until the validity of rules has been fully established.

The other drafting choice, which would be more advantageous to most companies, would be to revise the company's existing advance notice bylaws to include all shareholder nominations including proxy access nominations. While the challenge of integration will vary depending on the details of the company's existing advance notice bylaw, there are two key decisions that will influence much of the drafting.

- First is creating a unified informational standard for all shareholder nominated candidates. Here the drafting choice is to limit the informational requirements to those required under the proxy access rules or to impose greater informational requirements as a qualification for valid shareholder nominations.
    - Limiting the informational requirements for all shareholder nominations to those set forth in the proxy access rules has the obvious merit of not testing the private ordering penumbra surrounding proxy access. Moreover, the proxy access rules require the nominating shareholder or shareholder group to provide all of the information about itself and the nominee that would be required in a conventional proxy contest, as well as limited additional information. While not as extensive as the information called for in some advance notice bylaws, the disclosure requirements for proxy access implicitly represent the SEC's judgment as to what information is material to shareholders in the context of all election contests.
    - There are, however, good reasons for going beyond SEC mandated disclosures in an integrated advance notice bylaw. For example, the company and its board will need to evaluate the independence of a proxy access candidate under the subjective rules of the relevant stock exchange, as well as under more stringent standards of independence imposed by Sarbanes Oxley for audit committee membership or voluntarily adopted by the company for other committees or the board as a whole.
    - Going beyond the informational requirements for proxy access, however, raises two critical legal issues.
        - The first issue is the legality of the informational standards under state law. Are the increased informational requirements reasonable and equitable in content and reasonably related to a proper corporate purpose?
        - The second issue is whether the informational standard is permissible as a matter of federal law — do the additional informational requirements differ sufficiently from the proxy access standards to be preempted on the basis of "conflict" with the SEC's rule?
    - An informational qualification standard requiring all candidates to provide information sufficient to permit determination of the candidate's independence under all standards applicable to the company's directors should easily pass muster as a matter of state law, so long as the timing of adoption of the qualification is not inequitable (for example, by being adopted only when a proxy access nomination seemed imminent). The same

should be true of other information going, for example, to the substantive qualifications and history of the proposed candidate, the proposed candidate's relationships with the nominating shareholder and the proposed candidate's and nominating shareholder's involvement with the company or with other insurgents. Certainly, many companies have long had advance notice bylaws that call for information beyond the scope of that required by the proxy rules and beyond the subject of a candidate's independence from the company. Explicitly or implicitly, these companies and their counsel have concluded that the informational requirements pass muster as a matter of state law. Proxy access should have no effect on these conclusions.

- We do not believe that providing additional informational requirements as a condition for nomination would be preempted by the SEC proxy rules. We base our conclusion on a number of considerations.
  - The SEC in its Adopting Release clearly contemplates a director qualification standard imposing more stringent independence standards than the objective standards of the relevant stock exchange. If such a qualification standard is not preempted by the proxy access rules, it is hard to see how a condition to nomination standard that only requires provision of information in order to make the determination could be successfully challenged.
  - Moreover, the proxy access rules and Adopting Release also clearly contemplate disclosure by the company concerning the candidate's inability to meet more stringent independence standards. An advance notice bylaw seeking the information necessary to make such a disclosure is obviously in furtherance of the SEC's contemplated disclosure-based solution to the issue of independence of proxy access candidates and for this reason also unobjectionable.
  - Finally, as noted above, the SEC staff has indicated that it does not believe an advance notice bylaw that is valid under state law would be preempted by the proxy access rules, even if it requires information (including information beyond that relating to independence) in addition to that called for by the proxy access rules. The SEC staff's position, with which we agree, apparently is that the proxy access rules do not preempt or purport to preempt otherwise valid state law based conditions for nominations and director qualifications.
- This, of course, is not to say that a company has a free hand in drafting advance notice bylaws. As a matter of state law, it obviously does not. For example, if the information required in the bylaw is already in possession of the company, a requirement of disclosure might not be reasonable and equitable as a matter of state law. After all, what point would be served by the required disclosure, except to provide a basis for the company to assert the disclosure was incomplete or misleading?
- Another potentially contentious nomination requirement under state law would be a bylaw provision requiring a nominating shareholder under the proxy access regime to demonstrate at the time of the meeting continuous compliance with the qualifications for proxy access from the date of its original notice of intention to make a nomination some five or six months earlier. What state law purpose, it might be asked, would be served by a company bylaw intended to vindicate a federal rule for proxy access, particularly when the SEC didn't see fit to require such evidence as of the meeting time?
- The point, of course, is that drafting an integrated advance notice bylaw that imposes informational requirements in addition to those contained in the proxy access rules will require fine judgments of reasonability and equitability as a matter of state law. Not everything will pass this test. In the absence of meaningful precedent under state law, the boundaries are difficult to map out with total confidence.

- The second principal drafting decision for successful integration of advance notice bylaws with proxy access is whether to leave intact the totally separate advance notice calendars for conventional election contests and for proxy access contests.
  - The former does not pose any difficult legal judgments, but does expose the company and its board to a double jeopardy type of process. They may have to cope with a decision (typically following a negotiation) to accept a proxy access nominee as a member of the board's slate to avoid an election contest, only to have to confront the

same need for negotiation and decision several months later in the context of a threatened conventional election contest.

- This double jeopardy like situation could be avoided by postponing any decisions regarding the proxy access nominee until after the separate advance notice deadline has passed for conventional election contest nominations. However, doing so could adversely affect the negotiation and decisional process to the detriment of the company and/or the shareholders nominating the proxy access candidate.
- The double jeopardy risk could also be avoided by requiring conventional election contest nominees to comply with the advance notice requirements of the proxy access rule.
  - Under this approach, all shareholder notices of nominations for director, proxy access or otherwise, would be confined to the 120–150 window specified in the proxy access rules.
  - But would this be viewed as reasonable under state law? It certainly could be argued to have a "chilling" effect on conventional election contest nominations, one that would allegedly be unreasonable because it would require potential insurgents to decide on their strategy some five or six months prior to a shareholders' meeting. Nor could the company justify the truly advanced notice by citing the SEC's elaborate calendar for dispute resolution under proxy access, which would not be relevant to conventional election contest nominations.
- The balance of considerations in deciding between one uniform or two different notice windows is very close, too close in our view to predict with any certainty. On a more practical note, however, what would be the downside to providing a single window period for all nominations based on the proxy access calendar? If the proxy access window was not challenged the company would have the benefit of the additional advance notice. If, on the other hand, the single shareholder notice window based on the proxy access calendar were successfully challenged by a conventional insurgent, would the company be appreciably worse off than if it had been more conservative and provided two separate windows? The litigation over the validity of the one window bylaw would effectively provide the company with sufficient advance notice to accomplish the basic purpose of the conventional advance notice window period. So long as the advance notice bylaw contained an effective savings provision to protect the validity of all of its other requirements, would the company be truly disadvantaged if the aggressive window period were ultimately struck down?

Other Qualification Bylaws

Advance notice bylaws do not exhaust the potential field of qualifications for directors. Some companies have bylaw provisions dealing with qualification of directors, but many do not. Even those that do probably have not thought hard about them, particularly in the context of the shift of power toward corporate governance activists. To date, as a practical matter, most boards have relied on their control over the recruiting of candidates for the board to deal with all but the most obvious qualification issues. Doing so may no longer be prudent in light of the expanding role corporate governance activists are seeking in director nominations and board composition.

Traditional director qualification standards. There are a number of traditional director qualification standards that companies have used, including:

- Age
- Term limits
- Not serving on more than a specified number of company boards
- Citizenship for certain regulated entities
- Ownership of a minimum amount of company stock
- Independence qualification under appropriate stock exchange and, where applicable, additional company specific standards

All of these qualifications are presumptively valid under state law, unless of course they establish unreasonable conditions or are not reasonably related to a valid corporate purpose or are applied in a discriminatory manner. All are presumably also valid in the context of their application to a proxy access candidate. The only one that might give pause in terms of preemption would be the imposition of more stringent independence standards on all candidates, including proxy access candidates. However, as we discussed above, while the SEC specifically declined to make all independence requirements applicable for purposes of the rule's requirements, the Adopting Release and the rule itself clearly contemplate that a company may have a valid director qualification imposing more stringent independence standards.

Written Agreement to Comply with Board Governance and Informational Policies as Condition to Nomination. Typically, boards have assumed that directors will comply with board governance and informational policies. Indeed, in many cases, those policies may not be spelled out completely, but are assumed to be known and understood. A classic example of such an assumed policy is maintenance of confidentiality of board discussions in and out of the board room. As we have explained in greater detail elsewhere,[8] we believe it is highly desirable that a board adopt an explicit policy requiring total confidentiality of board room and other director communications. Our views in this regard are reinforced by the growing recognition that board composition is ceasing to be the exclusive purview of the board and that "strangers" in the board room is going to become more, not less, frequent.

While a nominating committee can introduce a board confidentiality policy to committee-selected candidates that have not previously served on the board and rely on an implicit agreement to adhere to the confidentiality policy, it should not assume a proxy access nominee or conventional proxy contest nominee will share the other directors' assumptions about the need for confidentiality or necessarily feel bound to observe the policy, especially if the nominee considers himself or herself to be a "representative" of a particular interest group, be it a hedge fund or an activist corporate governance proponent. Accordingly, we recommend that boards consider adoption of a bylaw requiring every candidate, board or shareholder nominated, to agree in writing to be bound by all governance and informational policies applicable to directors as a condition to the right of nomination.

In this regard, we further recommend that all boards review their other governance and informational policies to make sure they are complete and explicit. This would include codes of conduct, compliance with insider trading rules and regulations, adherence to company policies restricting trading in company securities, adherence to company policies regarding reporting under Section 16 of the 1934 Act, prompt completion of director questionnaires and the like. Companies in regulated industries should consider also codifying director responsibility with regard to regulatory compliance issues.

Conduct of Meeting Bylaws

The advent of proxy access also serves as a good reminder to companies to review and, if appropriate, revise their conduct of meeting bylaw. Here again is an area in which many companies have outmoded or incomplete bylaws, particularly with respect to proxy contests. It is important to recognize that proxy contests in today's world are not limited to election contests, but may also include the now mandatory "say on pay" vote (if there is any form of a "say no on pay" campaign, overt or otherwise), as well as shareholder proposals under Rule 14a-8 that are contested by the company.

Conduct of meeting bylaws should cover such matters as:

- Qualifications required to make a valid motion (*e.g.*, proof that the moving party is a shareholder of record or holds a valid proxy from a shareholder of record)[9]
- Authority of the chair of the meeting to rule shareholder motions, including nominations, out of order for failure to meet advance notice or other nomination qualification bylaw provisions
- Authority of chair to open and close the polls
- Process for postponement and adjournment of meetings, including (if permissible under state law) to vest authority solely in the chair of the meeting
- Process for selecting chair of meeting, inspectors of election and other meeting officials

- Identification of other applicable rules of order for the meeting (*e.g.*, Roberts Rules of Order or similar recognized source)
- Authority of chair to make definitive rulings on all points of order
- Limitations on right of speech at meeting

Nominating Committee Responsibilities and Procedures

Companies should review their nominating committee charter in at least two respects.

- It would be desirable to include in the nominating committee charter an explicit delegation to the committee to review the credentials and qualifications of all shareholder proposed candidates for the board, whether as a result of proxy access or of a conventional election contest process. It is important that the board pursue a formal process of investigation and consideration before it decides to recommend that shareholders vote against shareholder nominees. Formalizing the committee's responsibilities will also serve the board if it engages in settlement discussions with the nominating shareholder or shareholder group, which almost invariably will raise the issue of putting the shareholder nominee or a replacement nominee on the board slate.
- We also recommend that companies consider formalizing a nominating committee schedule that would contemplate the committee evaluating the performance of sitting directors and the credentials of potential nominees (including any proxy access nominees)[10] in the late fall or early winter, followed by its decision regarding the composition of the board slate of nominees during the winter months, and culminating in a presentation of that slate to the full board for approval at a meeting preceding finalization of the proxy materials for the forthcoming shareholder meeting.
    - Among the reasons for such a timetable is a provision in the proxy access rules that, if a company engages in a discussion with a nominating shareholder or group before it files its Schedule 14N and subsequently the company puts the proxy access candidate on the board slate, the candidate is not considered a proxy access director for purposes of the 25 percent cap on access nominees. On the other hand, if there is no prior discussion and the candidate is put on the board slate after the Schedule 14N is filed, that candidate retains his or her status as a proxy access candidate for purposes of the 25 percent cap.
    - One way a company can preserve its flexibility to add a proxy access nominee to the board slate while retaining that nominee's proxy access status would be to refuse to discuss the candidacy before the Schedule 14N deadline. Simply refusing to do so may be awkward and counterproductive and would, at the least, tip the board's hand in terms of application of the 25 percent cap on access nominees. However, the company may be spared negotiating embarrassment if it can credibly point to the nominating committee's responsibility under its charter and an established nominating committee process that makes it inappropriate to consider composition of the board's slate so early in the nominating committee process.
    - The suggested timeline for the nominating committee process would also preserve flexibility for the company in the circumstance where a proxy access nominee has been elected to the board and the board will have to decide whether to re-nominate that director as part of the board's slate for the forthcoming year.
        - The proxy access director and the shareholder or shareholders who nominated the director usually will want to know if the board will re-nominate the director well before the deadline for notice of proxy access nominations for the next year. However, at that point of time, the proxy access director will have served for only six months or so, a very short period for a meaningful evaluation, particularly for boards that meet quarterly. Requiring a nominating committee and board to act on such a limited basis is hardly a model of good corporate governance and would undermine the credibility of the nominating committee's review process.
        - Moreover, any discussion between the company and the access nominee or his or her supporters before the Schedule 14N filing deadline could well have the result of ensuring that the director would not count as a proxy access nominee for the

forthcoming year. This could lead to what a number of commentators have called "proxy access creep," in which consistent successful annual proxy access nominations could lead to a major shift in the composition of the board and make the 25 percent cap illusory in practice.

- Having in place an established schedule for the nominating committee could fairly justify a refusal to engage in discussions about re-nomination prior to the Schedule 14N deadline. Postponing any consideration of re-nomination until after the Schedule 14N deadline would put the nominees supporters to the test of having to file a Schedule 14N for that nominee, in which case the access director, if subsequently re-nominated by the nominating committee, would be included as an access candidate for purposes of the 25 percent cap.

- We should emphasize that our recommendation of the suggested timeline for the nominating committee process is not a recommendation that companies not engage in discussions about a proposed proxy access nominee or re-nomination of a proxy access director prior to the Schedule 14N filing deadline. Rather, we think our recommendation is appropriate as a matter of good corporate governance and would be helpful in giving a board and nominating committee a reasoned basis for declining engagement on proxy access nominations prior to 14N the filing deadline. It does not bar prior negotiations, but it does help give a company a choice in its tactics for dealing with the potential for proxy access nominations.

Other Bylaw Issues Under the Proxy Access Regime

Size of Board. Most companies have the ability through bylaw amendment or director action to vary the size of their boards. In light of the operation of the 25 percent cap on proxy access nominees (rounded down to the next whole number), board size can have an impact on the percentage of proxy access nominee seats. For example, a four person board would have one proxy access seat. A seven person board would likewise have one proxy access seat by reason of the rounding down principle. Similarly, an eight person board and an 11 person board would have a cap of two proxy access nominees. Accordingly, companies may wish to consider adjusting the size of their board to take into account the operation of the proxy access cap. While proxy access should not be the only consideration in determining board size, it could be a relevant one.

Another size of board issue is making sure that there are no unfilled vacancies on the board that could be filled by a proxy access (or other shareholder) nomination. Too many companies do not bother to adjust board size to fit the actual number of board nominees. If there are no other nominations, no harm and no foul. However, if there is a vacancy of this type, a shareholder-nominated candidate would automatically go on the ballot to fill the vacancy. This would be tantamount to election because the shareholder nominee would be unopposed.

Quorum and Voting Percentages. Companies should review their board quorum and voting structures to take into account the higher possibility of having one or several shareholder nominated directors who may act as dissidents. Higher percentages for quorums and votes than required by statute and the charter could be disadvantageous in these circumstances.

Conclusion

We believe that the delay in implementation of the proxy access rules has provided an important "grace" period for companies to consider changes to their bylaws in response to proxy access. Regardless of the timing of implementation of the proxy access rules, extrinsic forces such as corporate governance activist pressure will increasingly affect the director nomination process for many companies. In light of these realities, companies should be reviewing and considering the private ordering initiatives discussed in this *Commentary* with a view toward amending their bylaws and corporate governance policies by no later than the summer of 2011.

Areas of focus should include:

- Advance notice bylaws, particularly the windows for notice of nominations for proxy access and for conventional election contests and the informational requirements for both types of nominees

- Traditional director qualifications such as age, term limits, citizenship and ownership of minimum amount of stock
- Additional director qualifications such as written adherence to board governance and informational policies
- Conduct of shareholder meetings
- Size of board
- Nominating committee processes and procedures

Postponing review and action beyond the summer of 2012 would, in our view, be imprudent because we have now learned that this task is neither simple, nor fast for many companies. Acting now in an orderly and thoughtful fashion is far better than waiting for a court or subsequent SEC decision establishing proxy access for the 2012 proxy season and risking a hasty process or, worse, a lack of time for effective board action.

Endnotes

[1] *See*, *e.g., Lerman v. Diagnostic Data, Inc.*, 421 A.2d 906 (Del. Chan. 1980), at 914, holding a bylaw amendment proposed by management in the face of a proxy contest was "inequitable (in the sense of being unnecessary under the circumstances) and had the accompanying dual effect of thwarting shareholder opposition and perpetuating management in office." *See also, MM Companies, Inc. v. Liquid Audio, Inc*., 813 A. 2d 1118, 2003 Del. LEXIS 5

[2] A real rub in the SEC proxy access rule structure is the ability of shareholders to propose bylaws under revised Rule 14a-8 that will ease the path to proxy access, for example by lowering the 3 percent ownership threshold, lessening or eliminating the three year minimum holding period or removing the no control intent requirement. This commentary does not deal with shareholder proposed private ordering of this sort.

[3] Facilitating Shareholder Director Nominations, Exchange Act Release No. 33-9136, at 131-32 (August 25, 2010).

[4] The ballot is separate from the proxy. The proxy conveys authority to cast a ballot, as agent for the record holder; it is not the vehicle for the actual vote. The actual vote is conducted through submission of ballots completed by eligible voters — that is record holders and proxy holders present in person at the meeting.

[5] *Stroud vs. Miliken Enters, Inc.*, 585 A. 2d 1306, 1308 (Del Ch. 1989), appeal dismissed, 552 A. 2d 476 (Del. 1989) (ruling that the Delaware General Corporation Law expressly authorizes qualifications for directors if such qualifications are reasonable).

[6] Many advance notice bylaws employ this drafting expedient.

[7] *JANA Master Fund, Ltd. v. CNET Networks, Inc.*, 2008 WL 660556 (Del. Ch. March 13, 2008), *aff'd* 2008 WL 2031337 (Del. S. Ct. May 13, 2008) and *Levitt Corp. v. Office Depot*, 2008 WL 1724244 (Del. Ch. April 14, 2008). *See also*, the Latham & Watkins Corporate Governance Commentary "*Responding to JANA and Levitt Corp. and the Shadow Interest of Activist Investors,"* which can be found at http://www.lw.com/upload/pubContent/_pdf/pub2203_1.pdf.

[8] See Latham & Watkin's Corporate Governance Commentary "*Board Confidentiality,"* which can be found at http://www.lw.com/upload/pubContent/_pdf/pub2916_1.pdf.

[9] Rule 14a-8 is of particular concern in this regard because of the staff view that an authorized representative of the shareholder which submitted the proposal may act at the meeting in place of the shareholder. Query if that position would override a bylaw requiring that the moving party actually have legal authority to vote at the meeting in the form of a valid proxy from a record holder.

[10] If a company amends its advance notice bylaws to provide a single window period for all shareholder nominees, proxy access and conventional, including conventional election contest nominees in the nominating committee's articulated review process would not only be appropriate, but should also reinforce the corporate purpose and reasonableness arguments in favor of the single window period.

If you have any questions regarding this *Commentary*, please contact one of the Latham & Watkins LLP attorneys listed below or the Latham attorney with whom you normally consult.

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