Director Qualification Requirements, Nominations & Proxy Access

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As discussed in this earlier post, the SEC's proxy access rule amendments will soon require many publicly traded companies to include shareholder nominees in their proxy statement and proxy cards. This rule may reignite old questions about how to handle director qualification requirements.

Some 131 pages into the 451 page adopting release, the SEC makes the following assertion: "Under state law, shareholders generally are free to nominate and elect any person to the board of directors, regardless of whether the candidate satisfies a company's qualification requirement *at the time of nomination and election*." In support of this proposition, the SEC cites an 80 year old Delaware case, *Triplex Shoe Co. v. Rice & Hutchins, Inc.*, 152 A. 342, 375 (Del. 1930) ("He may be elected a director, but must qualify as such by becoming a stockholder before he can enter upon the duties of director.") and a Delaware law treatise that cites the same case. The SEC cites no authority from any of the 49 other states.

It so happens that here in California, a court has addressed the same question and arrived at an opposite conclusion:

> *Appellant contends that by the acquisition of the additional shares of stock on December 2, 1908, he qualified prior to the meeting of the directors to organize, and therefore that he was the holder of the requisite number of shares of capital stock at the time of the organization of the board and entitled to be declared elected, although admittedly he was not such holder at the time of the election. This contention cannot be sustained, as the by-laws provide that the directors "shall serve for one year from the date of their election and until their successors are elected," etc. There was, then, no intervening time between the election and the beginning of the term within which plaintiff could have qualified, and in this regard the case differs from those in which a distinction is drawn between eligibility for election and the qualification to hold the office. The plaintiff was not qualified to fill the office at the time the term began, and it cannot well be contended that by qualifying later he could oust the member who was qualified at the time of the election.*

Waterbury v. Temescal Water Co., 11 Cal. App. 635 (1909). I haven't surveyed the remaining 48 states but I'm willing to guess that the SEC didn't either and merely assumed that Delaware speaks for all of them.

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Conceptually, a qualification requirement may be substantive (*e.g.,* a director must be a stockholder) or procedural (*e.g.,* an advance notice bylaw). Should satisfaction of a director qualifications be determined at the time of election or before the director begins service? It seems to me that the answer should turn on how the bylaws are drafted. For example, a bylaw might provide: "No person is eligible for nomination for election as a director unless . . .". This provision clearly contemplates that any qualifications (whether substantive or procedural) must be met at the time of nomination. Alternatively, a bylaw might provide: "No person is eligible to serve as a director unless . . .". This provision contemplates that any qualifications must be met before the individual begins service as a director.

The latter provision and the Delaware court's holding has the potential for a great deal of mischief. Section 141(b) of the DGCL and Cal. Corp. Code § 301(b) each provide that a director holds office until his or her successor is elected and qualified. Thus, if a nominee is "elected" but isn't qualified, there will be a holdover director. Moreover, it isn't entirely clear if there is a deadline for meeting the qualification requirement. In fact, I recently came across a suggested amendment to an advance notice bylaw that would allow a nominee under the SEC's new proxy access rules to provide information "prior to the time such person is to begin service as a director". This may be no deadline at all.

In general, I think it makes sense to require satisfaction of any director qualification requirements at the time of election. First, this is efficient. Time and energies aren't wasted on individuals who may not ever qualify. Second, it creates a time certain for all concerned. Third, it avoids holder over directors. Finally, neither California nor Delaware provide any statutory mechanism for "seating" directors.

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