Changes in the Model Business Corporation Act—Proposed Amendments to Section 8.02 Relating to Qualifications for Directors and Nominees for Directors

By the Corporate Laws Committee, ABA Section of Business Law*

The Corporate Laws Committee of the ABA Section of Business Law (the “Committee”) develops and from time to time proposes changes in the Model Business Corporation Act (the “Act” or “Model Act”).

The Committee has approved the changes described in this report on second reading and invites comments from interested persons. Comments should be addressed to A. Gilchrist Sparks, III, Chair, Corporate Laws Committee, 1201 Market Street, Wilmington, Delaware 19801-1147, or sent to him by e-mail at asparks@mnat.com. Comments should be received by September 1, 2013, in order to be considered by the Committee before adoption of the amendments on third reading.

The Model Act historically has provided that qualifications for directors may be set forth in the articles of incorporation and bylaws, but the standards for content and timing of application of qualifications have not been meaningfully addressed.

Until recently, little attention was paid to director qualifications or to the applicable provision in Section 8.02 of the Model Act. Attention to qualifications to be directors or nominees has now increased, however, for a number of reasons, including the following:

1) Increased attention to board composition by corporations, nominating committees, boards, and shareholders;

2) Increased numbers of contested elections for directors; and

3) The enhanced ability of shareholders to nominate candidates for director, as evidenced, for example, by Section 2.06 of the Act, which clarifies that corporations may adopt bylaws providing for shareholder nominations for directors, and by the amendment by the Securities and Exchange Commission of Rule 14a-8 under the Securities Exchange Act of 1934, as amended, in respect of shareholder proposals regarding nomination of directors by shareholders.

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Qualifications as addressed in Section 8.02 as proposed to be amended would be in the nature of eligibility requirements. They may thus be distinguished from the consideration given by nominating committees, boards, and shareholders to issues of board composition and the desired skills and combinations of skills of members of a board of directors.

The proposed amendments would provide that qualifications must be reasonable as applied to the corporation and lawful. Qualifications based on action or expression of an opinion that would restrict a director’s ability to discharge his or her duties as a director would not be permissible. The proposed amendments would also add provisions with respect to the timing of application of qualifications.

The proposed amendments are set forth below. Changes to the current act are marked, with new language indicated by **underscoring** and deletions shown by *strikeout*.

§ 8.02. QUALIFICATIONS OF DIRECTORS

(a) The articles of incorporation or bylaws may prescribe qualifications for directors or for nominees for directors. Qualifications must be reasonable as applied to the corporation and must be lawful.

(b) A requirement that is based on a past, current or prospective action, or expression of an opinion, by a nominee or director that could limit the ability of a nominee or director to discharge his or her duties as a director is not a permissible qualification under this section. Notwithstanding the foregoing, qualifications may include not being or having been subject to specified criminal, civil or regulatory sanctions or not having been removed as a director by judicial action or for cause.

(c) A director need not be a resident of this state or a shareholder of the corporation unless the articles of incorporation or bylaws so prescribe.

(d) A qualification for nomination for director prescribed before a person’s nomination shall apply to such person at the time of nomination. A qualification for nomination for director prescribed after a person’s nomination shall not apply to such person with respect to such nomination.

(e) A qualification for director prescribed before the start of a director’s term may apply only at the time an individual becomes a director or may apply during a director's term. A qualification prescribed during a director's term shall not apply to that director before the end of that term.

OFFICIAL COMMENT

The elimination of mandatory special qualifications for directors is now nearly universal. The articles of incorporation or bylaws, however, may prescribe special qualifications, an option that is most likely to be utilized in closely
Some corporations have adopted qualifications for individuals to be directors or to be nominated as directors. One use of qualifications may be by closely held corporations, to ensure representation and voting power on the board of directors. Other provisions of the Act also are designed to accomplish these purposes. See, for example, section 7.32 providing for shareholder agreements prior to the time that a corporation becomes a public corporation. See also section 2.02(b).

Qualifications may apply to all board members or to a specified percentage or number of directors. An example of a qualification applying to fewer than all directors would be a requirement that at least two directors must have specified business or professional experience or a particular educational degree or background. Careful consideration should be given to the intended effect of the application of any qualification that applies to fewer than all directors in the context of an election contest in which only some of the nominees satisfy this qualification. In the event that specified qualifications for some or all directors are not satisfied, remedial steps could be addressed in the articles of incorporation or bylaws, or can be left to other mechanisms available to a corporation and its board and shareholders, such as the provisions permitting changes in the number of directors and providing for the filling of vacancies on the board. See sections 8.03 and 8.10.

The purpose of section 8.02(a) is to permit qualifications that may benefit the corporation by enhancing the board’s ability to perform its role effectively. However, this needs to be balanced against the risk that qualifications could be misused for entrenchment purposes by incumbents or for other improper purposes. To address these concerns, this section requires that qualifications must be reasonable as applied to the corporation and must be lawful. For example, a qualification that seeks to favor incumbent directors or distinguish between a director elected from the slate nominated by a corporation’s board and a director elected as the result of being nominated by one or more shareholders, including under a bylaw adopted pursuant to section 2.06(c), would not ordinarily be reasonable and thus not authorized by section 8.02(a). An example of a qualification that would not be lawful would be a requirement that is impermissibly discriminatory under the Civil Rights Act of 1964.

1. **Scope of Permitted Qualifications**

Examples of qualifications that may be permissible under section 8.02 are eligibility requirements based on residence, shareholdings, age, length of service, experience, expertise and professional licenses or certifications.

Under Section 8.02(b) a qualification that is based on a past, current or prospective action, or expression of opinion, by a nominee or director that could limit the ability of a nominee or director to discharge his or her duties as a director is not a permissible qualification. The discharge of duties of a director is referenced in section 8.30. For example, a requirement based on a director’s having voted for or against, or expressed an intent to vote for or against, a particular
type of resolution, such as a resolution in favor of or against a bylaw pursuant to section 2.06(c) or a resolution in favor of or against a shareholder rights plan, would be impermissible.

A shareholder agreement that meets the requirements of section 7.32 could override the terms of section 8.02, including with respect to the requirement of reasonableness in section 8.02(a) and the limitation on permitted qualifications in section 8.02(b).

2. Timing and Applicability of Qualifications

Sections 8.02(d) and (e) prohibit “springing” qualifications. A qualification for a nominee that is prescribed after an individual becomes a nominee shall not apply to that individual with respect to that nomination, and a qualification for a director that is prescribed during the term of a director shall not apply to that director before the end of that term. A qualification for a director that is prescribed during the term of that director shall, assuming it remains in effect, apply to that director upon the start of any additional term of that director.

To avoid ambiguity as to whether a qualification for director only applies at the start of a term or applies during the term, a qualification provision should provide clearly when it applies. In the event that a qualification provision does not so specify, customary principles of interpretation and construction will apply. Examples of qualifications the nature of which would generally indicate an intent that they apply throughout a term would be a citizenship or residence qualification or a qualification that a director have a particular license or government clearance.

A director who ceases to meet a qualification that applies during a term will not satisfy that qualification at that time. For example, if a bylaw provision that is in effect at the start of a director’s term requires that all directors be residents of state X during their terms, and that director at the start of his or her term is a resident of state X but during the term becomes a resident of state Y, then that director would cease to satisfy the qualification and, therefore, cease to be a director at the time the director becomes a resident of state Y.