Shareholder Proposals For Reimbursement Of Expenses Incurred In Proxy Contests:

Recent Guidance From The Delaware Supreme Court

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There has been considerable academic discussion of the struggle for control of public corporations waged between shareholders (as the owners) and boards of directors (who are the managers and agents of the shareholders). In recent years, shareholders have become more assertive (or "activist") and have attempted to assert their views and implement change at corporations, particularly in matters relating to corporate governance.[2] For example, with increasing frequency shareholders have submitted proposals to limit executive compensation by linking it to company performance, limiting or eliminating golden parachutes and clawing back executive pay.[3] Shareholders also have proposed bylaws that seek to achieve a higher level of director accountability, by enhancing the shareholders' most powerful right — the right to elect directors. This article discusses one such bylaw — requiring the board to reimburse expenses incurred by shareholders conducting a proxy contest — and a recent decision by the Delaware Supreme Court addressing the legality of such a bylaw under Delaware law.

Rules Governing The Relationship Between Shareholders and Directors

In Delaware (as in most other states), shareholders are the equitable owners of the corporation's assets, while the corporation is the legal owner of its property. Shareholders have a right to share in the profits of the corporation and in the distribution of its assets upon liquidation. Shareholders are deemed to have contracted with each other and their agents — the directors and managers of the corporation — who are charged with faithfully managing the corporation in a manner that advances the interests of the shareholders.[4] Although it is the shareholders who have committed their capital to the corporation, it is impractical for that amorphous group to make everyday business decisions necessary to run the corporation. Therefore, the corporation's board of directors is provided with the power to manage the business and affairs of the corporation, subject to certain limitations. For Delaware corporations, Section 141 of the Delaware General Corporation Law ("DGCL")[5] specifically provides directors with the power to manage, or direct the management of, the "business and affairs" of the corporation.[6]

Shareholders agree in making their investment that the directors will make the day-to-day business decisions necessary to run the company. It is well established that in assuming this responsibility, the directors also assume fiduciary duties to the corporation and its stockholders.[7] Shareholders also agree to be bound by a hierarchy of laws and other provisions defining the rights and responsibilities of the corporation, its shareholders and directors and its managers. This hierarchy includes state constitutions, statutes and common law and the corporation's certificate of incorporation and bylaws.

The certificate of incorporation (sometimes called the corporation's "charter") sets forth the most fundamental rules for the governance of a corporation not defined by statute or other law (typically any lawful endeavor intended to make a profit for shareholders) and the basic provisions for the management and governance of the business. Once provisions are in the certificate, they are difficult to change or remove — the certificate cannot be amended absent a resolution by the corporation's directors and approval by at least a majority of the shareholders.[8]

The bylaws establish the rules for the internal governance of the corporation in the management of its own affairs. Since amendments to a certificate of incorporation require board resolution, bylaws are viewed as the primary mechanism for shareholder initiatives to shape corporate governance without board approval. Bylaws constitute a "contract" between the corporation and its stockholders[9] and are subordinate to the certificate of incorporation and statutory law.[10]

Bylaws of Delaware corporations must be reasonable in their application[11] and "may contain any provision not inconsistent with law or with the certificate of incorporation relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, affairs or employees."[12] Although the corporate charter may provide the directors with the power to amend or repeal the bylaws, in Delaware, the shareholders retain the right to do so as well.[13] As explained below, determining whether a shareholder sponsored bylaw is permissible involves balancing the shareholders' statutory rights to propose and adopt bylaws against the statutory and fiduciary obligations of the directors to manage the business of the corporation.

The SEC's Shareholder Proposal Rule

There is a long history of shareholders seeking to propose alternative courses of corporate action or inform management of their concerns through proposals for new or revised bylaws. In order to provide shareholders with an economically feasible means to communicate with each other on matters of great importance to the corporation, the SEC has established what is now known as the "town-hall meeting" rule requiring companies to include in their proxy materials proposals submitted by shareholders that meet certain procedural and eligibility requirements. Rule 14a-8 of the Securities Exchange Act of 1934 provides a stockholder owning a rather small amount of a company's securities with the ability to have its proposal included in a company's proxy materials (presented with those of management) for submission to the shareholders for approval at the annual shareholders' meeting, thus reducing the costs borne by the proposing stockholder.[14]

In its original incantation in 1942, Rule 14a-8 "only required inclusion of proposals that were 'a proper subject for action by the security holders.'"[15] Over the ensuing years, the SEC has amended the rule several times to clarify those subjects

that are inappropriate for shareholder proposals, and confirmed that state law controls what constitutes a proper subject for shareholder proposals.[16] The rule now includes thirteen specific categories of proposals which companies may exclude from their proxy materials, including: (1) "[i]f the proposal is not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization"; and (2) "[i]f the proposal would, if implemented, cause the company to violate any state, federal, or foreign law to which it is subject…"[17] The rule permits a company to exclude proposals that fall within any of the thirteen enumerated exceptions, but does not require a company to do so — the rule provides the company with discretion as to whether to exclude or include the proposal.[18]

When a company believes a proposal is inappropriate and "intends to exclude a proposal from its proxy materials," it may utilize a procedure to obtain SEC sanction for the exclusion of the shareholder proposed bylaw. The corporation may submit a request, commonly referred to as a "no-action" request, to the SEC's Division of Corporation Finance for the Division's confirmation that it will not recommend an enforcement action by the SEC against the company for excluding the shareholder proposal.[19] That request must include a copy of the proposal, an explanation why the company may exclude the proposal, and if those reasons are based on state or foreign law, a supporting opinion of counsel.[20] The proposing shareholder may submit a reply to the Division, and the Division either issues the requested no-action letter or a statement that it will not do so.[21]

In past instances where the Division received conflicting legal opinions on matters of state law raised in such Rule 14a-8 requests, the Division typically denied the corporation's request for failure to carry the burden of persuasion to show that a provision in the rule applied to the shareholder proposal and permitted the company to exclude it from the proxy materials. Absent permission to exclude from the SEC, corporations believed they had no choice but to include the challenged bylaw proposal in their proxy statement, and typically did so.

In order to avoid the stalemate resulting when conflicting legal opinions are presented to the Division, and allow resolution of issues of Delaware corporation law by the Delaware Supreme Court (rather than the SEC or federal courts), the Delaware legislature amended the Delaware Constitution to provide the SEC with direct access to Delaware's highest court to request rulings on questions of Delaware law. Specifically, in 2007, Article IV, Section 11(8) of the Delaware Constitution was revised to allow the Delaware Supreme Court to hear and resolve questions of law certified to it by (in addition to the tribunals already specified in that section) the SEC.[22] This new procedure comports with the SEC's repeated statements that state law controls what constitutes a proper subject for shareholder proposals. Last year saw the first instance in which this new procedure was utilized.

CA, Inc. v. AFSCME Employees Pension Plan

In 2008, the Delaware Supreme Court agreed to entertain a question certified to it by the SEC concerning the propriety of a shareholder proposal requiring a company to reimburse a shareholder's reasonable expenses incurred in waging a successful proxy fight for at least one board seat.[23] The AFSCME Employees Pension Plan ("AFSCME") submitted to CA, Inc. ("CA") a proposed bylaw ("Bylaw") for inclusion in the proxy materials for that company's 2008 annual stockholders' meeting. The Bylaw, if adopted by CA's shareholders, would amend the company's bylaws to require the board to reimburse a stockholder or stockholder group for reasonable expenses incurred in soliciting proxies in support of the nomination of one or more candidates to the board, but less than a majority (known as a "short slate" of director nominees).[24] The requirement to reimburse the shareholder's expenses depended on one or more of the candidates nominated by the proposing stockholder being elected.[25]

AFSCME's proposal appeared to be an attempt to "level the playing field" in contested director elections. While '[t]he shareholder franchise is the ideological underpinning upon which the legitimacy of director power rests,"[26] most shareholders do not attend corporate annual meetings where management presents their views on the company's business, shareholders can ask questions and then cast their votes. As one court explained:

> [M]ost shareholders are rationally apathetic, the prevailing wisdom explains. Individual investors have too little "skin in the game" to rationally devote the time and energy necessary to keep themselves aware of the details of the corporation's performance or to campaign for corporate change. Furthermore, with ownership diffused among so many holders, there exists a problem of collective action. Although the rise of institutional investment may have significantly narrowed the "gulf between management and ownership … because there may now be perhaps as few as ten or twelve such holders contributing to a decisive voice to a particular issue," the simple fact remains that most shareholders have better things to do than attend a company's annual meeting. Nevertheless, these shareholders — be they individual or institutional — may vote via proxy. As a result, the real action in corporate elections is in the proxy solicitation process.[27]

Even with access to the proxy mechanism, there remain significant hurdles for insurgent shareholders. The proxy solicitation process is "extraordinarily expensive.[28] Moreover, expenses incurred by a board in soliciting proxies for the election of the company's nominees typically are paid by the corporation, as are expenses for preparing and distributing the corporation's annual report, while insurgent shareholders must spend their own time and money to prepare their own proxy statement and proxy card for

their proposed candidates for election to the board.[29] Thus, absent a bylaw such as that proposed by AFSCME, an incumbent board would appear to enjoy a significant financial advantage in its director elections, as the board's proxy solicitation efforts would be funded by the corporation, whether or not the board's candidates win or lose, while solicitations by stockholders are paid for by those stockholders, generally with no right of reimbursement even if the stockholders' candidate is elected, and definitely no reimbursement if the stockholders' candidate fails to win election.[30] According to AFSCME, the unavailability of reimbursement for short slate campaigns by insurgent shareholders contributes to the scarcity of such contests[31] and thus the Bylaw was necessary to induce shareholders to participate in the election process.

Pursuant to Rule 14a-8, CA requested a no-action letter from the Division and submitted an opinion from its Delaware counsel that the proposed Bylaw was not a proper subject for stockholder action and would violate the DGCL.[32] AFSCME, in turn, submitted its response and opinion from its Delaware counsel that the proposed Bylaw was a proper subject for shareholder action and that, if adopted, would be permitted under Delaware law.[33] Faced with these conflicting legal opinions, the Division sought guidance from the Delaware Supreme Court pursuant to the newly enacted provision in Delaware's Constitution.[34]

In short, the Delaware Supreme Court found the proposed Bylaw to be a proper subject for action by shareholders under Delaware law, but found that, if adopted, it could cause CA to violate Delaware law. The Court based it *en banc* decision on the subtle distinctions between Sections 109 and 141 of the DGCL and their respective grants of power to shareholders and directors.

A Bylaw Requiring Reimbursement Of Shareholders'Proxy Expenses Is A Proper Subject For Action By Shareholders

The Court began by noting that Section 109(a) expressly grants the stockholders and the board the power to adopt, amend or repeal bylaws, and provides that such conferral upon the directors "shall not divest the stockholders" of "nor limit" that power.[35] However, the Court found that such shareholder power is "not coextensive with the board's concurrent power" and is "limited by the board's management prerogatives under Section 141(a)" to manage the business and affairs of the corporation.[36] The Court recognized that stockholders may not exercise their power in a manner that encroaches upon the board's statutory power to manage the corporation, but refused to delineate "the location of the bright line that separates the shareholders' bylaw-making power under Section 109 from the directors' exclusive managerial authority under Section 141(a)," and held that "the proposed Bylaw … does not invade the territory demarcated by Section 141(a)."[37]

The Court based this part of its decision on its view that the proposed Bylaw contemplated merely "procedural" rather than "substantive" restrictions on the CA board's authority. The Court held that "the Bylaw, even through infelicitously couched as a substantive-sounding mandate to expend corporate funds, has both the intent and the effect of regulating the process for electing directors of CA" and is therefore "a proper subject for shareholder action."[38] The Court likened the Bylaw to other "procedural, process-oriented" bylaws found in the DGCL and case law, such as those establishing the number of directors on the board, the number of directors required for a quorum, the vote requirements for board action, and bylaws requiring unanimous board attendance and board approval for any board action and unanimous ratification of any committee action.[39] Although the Bylaw included the command to reimburse ("The board … shall cause the corporation to reimburse a stockholder…") and could have been phrased more benignly (*e.g.*, to provide that the proposing stockholder "shall be entitled to reimbursement…"), the Court did not find the wording "dispositive of whether or not it is process-related."[40]

The Court explained that a bylaw would still be considered process related if, hypothetically, it required "that the directors of a corporation live in different states and at a considerable distance from the corporation's headquarters," or if it "require[d] all meetings of directors to take place in person at the corporation's headquarters."[41] A bylaw that required the corporation to reimburse its directors' travel expenses would also be considered process related.[42]

The Court also emphasized that the Bylaw concerned "the process for electing directors — a subject in which shareholders of Delaware corporations have a legitimate and protected interest."[43] In particular, the Court recognized that the Bylaw would encourage the nomination of non-management board candidates by committing the board to reimburse to shareholders' expenses incurred in soliciting proxies (when those candidates are successfully elected), thereby facilitating the exercise of shareholders' right to participate in selecting the contestants.[44] As the Bylaw concerned the election process, the fact that it required the expenditure of corporate funds, in and of itself, did not render it an improper subject for shareholder action.[45] That conclusion, however, answered only the first question posed by the SEC.

The Bylaw, If Adopted, Could Cause The Corporation To Violate Delaware Law

While the Court found that the mandatory nature of the Bylaw did

not render it an inappropriate subject for shareholder action, it conversely held that the same mandatory language could, in certain circumstances, require CA's board to violate Delaware law.[46] With this part of the decision, the Court effectively held that the Bylaw fell within one of the provisions in Rule 14a-8 permitting a board to exclude the proposal from its proxy materials.

The Court held that the Bylaw "would violate the prohibition, which [the Court's] decisions have derived from Section 141(a), against contractual arrangements that commit the board of directors to a course of action that would preclude them from fully discharging their fiduciary duties to the corporation and its shareholders."[47] The Court noted that it had previously invalidated contracts that would require board action or inaction so as to limit directors' exercise of fiduciary duties. For example, the Court has invalidated "no shop" provisions preventing directors of a target corporation from communicating the terms of a merger or buyout offer to a competing bidder in an effort to obtain the highest available value for shareholders,[48] and "slow hand" poison pill rights provisions that prevented a newly elected board from redeeming a poison pill for several months, thus delaying the board's ability to negotiate a possible sale of the company.[49] In such cases, the provisions, though voluntarily imposed by the board, impermissibly deprived the board of its statutory duty to manage the corporation and discharge its fiduciary duties.

Similarly, the Court held that the AFSCME proposed Bylaw would likewise prevent CA's directors "from exercising their full management power in circumstances where their fiduciary duties would otherwise require them to deny reimbursement of a dissident slate."[50] The Court gave as an example a proxy contest "motivated by personal or petty concerns, or to promote interests that do not further, or are adverse to, those of the corporation," in which cases "the board's fiduciary duty could compel that reimbursement be denied altogether."[51] Thus, while the Bylaw afforded CA's directors with discretion to determine the amount of reimbursement that would be appropriate to pay (*e.g.*, only the "reasonable" expenses), because the Bylaw required some payment rather than allowing the directors to decide whether or not it would be appropriate under the facts to pay any expenses at all, the Bylaw had the potential[52] of causing CA to violate Delaware law.

The *CA, Inc.* Decision Has Been Properly Criticized Throughout The Corporate Bar

The *CA, Inc.* decision has been properly criticized throughout the Chancery Court bar. Those criticisms have centered around both the practical and logical issues that the *CA, Inc.* Court failed to address.

Beginning with the logical, while there is a whole line of cases restricting directors' ability to preclude themselves or their successors from exercising their fiduciary duties (*e.g.*, dead-hand poison pills, slow-hand pills,[53] no-shop clauses,[54] etc.), there is also no question that directors can bind themselves and the corporation to obligations to make payments in the future without a fiduciary out. For example, directors could approve a contract for the building of a factory that would commence a year into the future. That factory could cost a material amount of money. Business circumstances could change prior to the commencement of construction on that factory. No one could rightly argue that the directors could simply say, because their fiduciary duty caused them to believe that the construction of the factory no longer made business sense, that they could walk away from the contract with impunity.

The *CA Inc.* Court never discussed why the proposed By-law was more like a dead-hand pill, or a no-shop provision in a merger agreement, than like a simple contractual obligation to pay money in the future. Either the Court did not consider this or could not distinguish this situation. Particularly where the amount of money was left to the Board's discretion (i.e., only "reasonable" expenses) it is even harder to understand the logic of *CA Inc.*

Moreover, unlike the situation of a dead-hand pill, a slow-hand pill or a no-shop merger provision — in which the board is attempting to keep a decision from reaching the stockholders — the Bylaw in question in *CA Inc.* would only come into effect after: 1) a majority of the stockholders agreed to the Bylaw; and 2) a majority of the stockholders voted for the short-slate of the insurgent.[55] Thus, there would be far more shareholder protection under the Bylaw than in those situations in which restraint on future director judgment has been rejected.

The *CA Inc.* decision sent shockwaves through boardrooms for a practical consideration near and dear to directors' hearts. For if a bylaw cannot force payments to insurgents who are successful in electing a short slate without a fiduciary out, how can a bylaw require mandatory advancement of expenses without a fiduciary out? And, if a fiduciary out is necessary, is there really such a thing as mandatory advancement of expenses after *CA Inc.*? The practice of mandatory advancement of expenses has long been a fixture of Delaware corporations. The *CA Inc.* Court did not discuss why that situation is distinguishable from the proposed Bylaw. Absent such a distinction, many directors now fear that their protection of "mandatory" advancement of expenses is now subject to the Board's fiduciary duty at the time of the request.

Lessons From The *CA, Inc.* Decision On Corporate Governance

Important lessons can be learned from the Delaware Supreme Court's decision in *CA, Inc.* The Court confirmed that shareholders' right to amend bylaws under Section 109 is constrained by the directors' statutory obligation to manage the corporation. Thus, shareholder proposed bylaws may not prevent the directors from fulfilling their fiduciary duties. A bylaw that regulates corporate procedures will not be viewed as unlawfully interfering with the directors' managerial authority or limiting their exercise of fiduciary duty.

Additionally, a bylaw is not illegal under Delaware law simply because it regulates election procedures.

However, the Court appeared to hold that the expenditure of corporate funds necessarily implicates the directors' fiduciary duties. Thus, bylaws requiring an expenditure of corporate funds must provide boards with a "fiduciary out" — an excuse not to spend the company's money if, in the board's view, such expenditure would not be in the best interests of the corporation and its shareholders and would, therefore, be made in breach of the directors' fiduciary duties.

The Court's broad holding on the validity of shareholder proposed bylaws addressing the process for electing directors will likely precipitate the submission of similar proposals by other "activist" institutional investors. The Court's opinion left open certain questions that will no doubt result in future litigation over the propriety of such shareholder proposed bylaws.[56]

For instance, the Court did not define a bright line between bylaws mandating substantive decisions and bylaws relating to the "processes and procedures" by which those decisions are made. Additionally, while the Court found the expenditure of corporate funds to be a subject of the board's fiduciary discretion, it did not identify any other corporate financial obligations that require a "fiduciary out." Nor did it provide parameters for defining the fiduciary out. The AFSCME proposal required the board to pay only the "reasonable" expenses of a successful short slate, apparently providing the board with the discretion to determine the amount of reimbursement that was reasonable (which could possibly be zero if, for example, the proxy contest was motivated by personal concerns or did not further or was adverse to the corporation's interests). Addressing this point, the Court simply found that the Bylaw "does not go far enough."[57] The Court also left open the question of the standard of review that would be applied to a board's decision not to reimburse a shareholder's proxy solicitation expenses pursuant to a fiduciary out exception.The Court did make it clear that the Bylaw (and presumably other provisions constraining a board's exercise of fiduciary duties) would be valid if contained in the corporation's certificate of incorporation rather than in the bylaws. However, as a board resolution is required to amend the certificate of incorporation, the more realistic alternative for shareholders confronted with an uncooperative board is to include in the proposed bylaw a fiduciary out clause. For example, the AFSCME proposal could have been redrafted to require reimbursement unless the board in the exercise of its fiduciary duties concludes that (using the Court's words) the "proxy contest is motivated by personal or petty concerns or to promote interests that do not further, or are adverse to, those of the corporation."

The Corporation Law Section Responds To The *CA Inc.* Decision

As a result of the *CA, Inc.* decision, the Delaware State Bar Association's Corporation Law Section has proposed an amendment to the DGCL by adding a new section that provides that a bylaw may require the corporation to reimburse proxy solicitation expenses incurred by a stockholder. Proposed new Section 113, titled "Proxy Expense Reimbursement," identifies a non-exclusive list of conditions that bylaws may impose on such a right to reimbursement. The text of proposed Section 113 is as follows:

> (a) The bylaws may provide for the reimbursement by the corporation of expenses incurred by a stockholder in soliciting proxies in connection with an election of directors, subject to such procedures or conditions as the bylaws may prescribe, including:
>
> (1) Conditioning eligibility for reimbursement upon the number or proportion of persons nominated by the stockholder seeking reimbursement or whether such stockholder previously sought reimbursement for similar expenses;
>
> (2) Limitations on the amount of reimbursement based upon the proportion of votes cast in favor of one or more of the persons nominated by the stockholder seeking reimbursement, or upon the amount spent by the corporation in soliciting proxies in connection with the election;
>
> (3) Limitations concerning elections of directors by cumulative voting pursuant to § 214 of this title, or
>
> (4) Any other lawful condition.
>
> (b) No bylaw so adopted shall apply to elections for which any record date precedes its adoption.

While the text of the proposed statute does not say so explicitly, the proposed Section 113 appears to overturn *CA, Inc*. The DSBA's Corporation Law Section approved the new Section 113 (and certain other proposed amendments to the DGCL) on February 26, 1009, and those amendments will next be presented to the Delaware legislature this spring for approval.

Thus, it appears that the specific holding of *CA Inc.* will be short lived, but the questions the opinion raises will be around for years to come.

1 Messrs. Grant and Kairis are directors in Grant & Eisenhofer P.A. ("G&E") and counsel to AFSCME in *CA, Inc. v. AFSCME Employee Pension Plan*, 953 A.2d 227 (Del 2008).

2 *See* Charles Nathan & Dennis Craythorn, *The 2009 Proxy Season and the Year of Investor Anger*, 240 N.Y.L.J. 9 (Nov. 17, 2008) (noting a "surge in shareholder proposals related to corporate governance, from 88 in 2000 to 427 in 2003").

3 *Id.* (noting that such "Say on Pay" proposals "shot to prominence in 2007 when 39 proposals went to a shareholder vote, after just four proposals were voted in 2006 … [and] in 2008, … a total of 67 Say on Pay proposals were voted").

4 *See generally* William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 Cardozo L. Rev. 261, 263-65 (1992) (discussing this property or contract theory of the corporation, as well as the alternative minority view that a corporation is a social institution in which managers and directors acquire some degree of duty of loyalty to various "stakeholders" in addition to duties owed to stockholders). The Securities and Exchange Commission ("SEC") has acknowledged that most state corporation codes delegate to the board of directors the responsibility for managing the "business and affairs" of the corporation "absent a specific provision to the contrary in … the corporation's … bylaws." Adoption of Amendments Relating to Proposals by Security Holders, Exchange Act Release Nos. 12999, 19771, 34012999, 35019771, 1976 WL 160347, at *7 (Nov. 22, 1976).

5 The DGCL, which governs Delaware corporations, provides "considerable flexibility in the construction of mechanisms for corporate governance and control." *Centaur Partners, IV v. National Intergroup*, Inc., 582 A.2d 923, 926 (Del. 1990); *see also Shintom Co., Ltd. v. Audiovox Corp.*, 888 A.2d 225, 228 (Del. 2005) ("The Delaware General Corporation Law is an enabling statute that provides great flexibility for creating the capital structure of a Delaware corporation."). That in large measure is why so many corporations are incorporated in Delaware.

6 8 Del.C. § 141(a) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation"). *See also Maldonado v. Flynn*, 413 A.2d 1251, 1255 (Del. Ch. 1980) ("the board of directors of a corporation, as repository of the power of corporate governance, is empowered to make the business decisions of the corporation. The directors, not the stockholders, are the managers of the business affairs of the corporation"), *rev'd on other grds sub nom. Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1481); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986); *Adams v. Clearance Corp.*, 121 A.2d 302 (Del. 1956).

7 *See North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92, 99 (Del. 2007); *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939). Directors may not delegate their decision-making authority on matters as to which they are required to exercise their business judgment, *see Rosenblatt v. Getty Oil Co.*, slip op. at 41 (Del. Ch. Sept. 19, 1983), aff'd, 493 A.2d 929 (Del. 1985); nor can the board delegate or abdicate this responsibility in favor of the stockholders themselves. *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1154 (Del. 1989); *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985).

8 8 Del.C. § 242(b).

9 *See generally* Fletcher, *Cyclopedia of the Law of Private Corporations* at § 4166. As explained in Frantz Mfg. Co. v. EAC Indus., 501 A.2d 401,407 (Del. 1985), "[t]he power to make and amend the bylaws of a corporation has long been recognized as an inherent feature of the corporate structure."

10 *See Oberle v. Kirby*, 592 A.2d 445, 457-58 (Del. 1991); *Prickett v. American Steel & Pump Corp.*, 253 A.3d 86, 88 (Del. Ch. 1969).

11 *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437 (Del. 1971).

12 8 Del.C. § 109(b).

13 8 Del.C. § 109(a) provides that "[t]he fact that such power [to adopt, amend or repeal bylaws] has been so conferred upon the directors … shall not divest the stockholders or members of the power, nor limit their power to adopt, amend or repeal bylaws."

14 17 C.F.R. § 240.14a-8. In order to submit a shareholder proposal, a shareholder must own at least $2,000 in market value or 1% of securities entitled to be voted on the proposal at the annual meeting, must have held the securities for at least one year, must continue to hold those securities through the date of the meeting, and must attend the annual meeting, either directly or through a qualified representative. 17 C.F.R. § 240.14a-8(b)(1), (h)(1).

15 Maya Mueller, *The Shareholder Proposal Rule: Cracker Barrell, Institutional Investors, and the 1998 Amendments*, 28 Stetson L. Rev. 451, 460 (Fall 1998).

16 *See generally* Jay W. Eisenhofer & Michael J. Barry, *Shareholder Activism Handbook*, § 7.01[A] at 7-4 - 7-5 (2006) (describing such inappropriate subjects as matters promoting political, social, racial or religious causes and those relating to the company's ordinary business operations).

17 17 C.F.R. § 240.14a-8(i)(1)-(2).

18 17 C.F.R. § 240.14a-8(f) ("What if I fail to follow one of the eligibility or procedural requirements? … The company *may* exclude your proposal, but only after it has notified you of the problem…") (emphasis added).

19 17 C.F.R. § 240.14a-8(j)(1).

20 17 C.F.R. § 240.14a-8(j)(2).

21 *See* Staff Legal Bulleting No. 14, Shareholder Proposals, available at http://www.sec/gov/interps/legal/cfslb14.htm (July 13, 2001) (explaining that the Division will issue an "informal" no-action letter that "indicate[s] either that there appears to be some basis for the company's view that it may exclude the proposal or that [it is] unable to concur in the company's view that it may exclude the proposal."). The SEC has cautioned, however, that no-action letters are not binding on the company, the proponent or the SEC. *See Statement of Informal Procedures for the Rendering of Staff Advice with Respect to Shareholder Proposals*, Exchange Act Release Nos. 19603, 12599, 34-12599, 35-19603 and 1C-9344, 9 S.E.C. Docket 1040, 1976 WL 160411 (July 7, 1976); *see also MONY Group, Inc. v. Highfields Capital Mgt. L.P.*, 368 F.3d 138, 146 (2d Cir. 2002) ("no-action letters constitute neither agency rule-making nor adjudication and thus are entitled to no deference beyond whatever persuasive value they might have"); *New York City Employees' Retirement Sys. v. S.E.C.*, 45 F.3d 7, 13 (2d Cir. 1995) ("the court need not give [no-action letters] the same high level of deference that is accorded formal policy statements or rule-making orders").

22 Delaware Constitution, Article IV, Section 11(8); 76 Del. Laws 2007, Chapter 37 Section 1, effective May 3, 2001. Section 11(8) originally provided:

> To hear and determine questions of law certified to it by other Delaware courts, the Supreme Court of the United States, a Court of Appeals of the United States, a United States District Court, or the highest court of any other state, where it appears to the Supreme Court that there are important and

> urgent reasons for an immediate determination of such questions by it. The Supreme Court may, by rules, define generally the conditions under which questions may be certified to it and prescribe methods of certification.

The amendment added "the United States Securities and Exchange Commission" following " a United States District Court."

23 *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008).

24 24 The full text of the proposed Bylaw is as follows:

> RESOLVED, that pursuant to section 109 of the Delaware General Corporation Law and Article IX of the bylaws of CA, Inc., stockholders of CA hereby amend the bylaws to add the following Section 14 to Article II:
>
> The board of directors shall cause the corporation to reimburse a stockholder or group of stockholders (together, the "Nominator") for reasonable expenses ("Expenses") incurred in connection with nominating one or more candidates in a contested election of directors to the corporation's board of directors, including, without limitation, printing, mailing, legal, solicitation, travel, advertising and public relations expenses, so long as (a) the election of fewer than 50% of the directors to be elected is contested in the election, (b) one or more candidates nominated by the Nominator are elected to the corporation's board of directors, (c) stockholders are not permitted to cumulate their votes for directors, and (d) the election occurred, and the Expenses were incurred, after this bylaw's adoption. The amount paid to a Nominator under this bylaw in respect of a contested election shall not exceed the amount expended by the corporation in connection with such election.

25 *CA, Inc.*, 953 A.2d at 230.

26 *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988).

27 *Jana Master Fund, Lt. v. CNET Networks, Inc.*, 954 A.2d 335, 340-41 (Del. Ch. 2008) (citations omitted).

28 *Id.* (citing Randall S. Thomas R. Catherine T. Dixon, *Aranow & Eishorn On Proxy Contests For Corporate Control § 21.01 (3d ed. 2001); Mark A. Stach, An Overview of Legal and Tactical Considerations in Proxy Contests: The Primary Means of Effecting Fundamental Corporate Change in the 1990s*, 13 Geo. Mason L. Rev. 745, 776 (1991) (noting that, in a proxy fight for control of Lockheed, "the incumbents spent approximately $8 million and the insurgents spent approximately $6 million")).

29 *See Jana*, 954 A.2d at 341 ("Generally, although management is reimbursed for its proxy expenses from the corporate coffers, insurgent shareholders finance their own bid and can hope for reimbursement only if that bid is successful"); Lucian Arye Bebchuk and Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy* Contests, 78 Cal. L. Rev. 1073, 1106 (1990) ("companies generally pay all the expenses for the selection campaign of incumbents, but reimburse challengers only if they gain control over the board of directors").

30 As the Delaware Supreme Court noted in *CA, Inc.*:

> Generally, and under the current framework for electing directors in contested elections, only board-sponsored nominees for election are reimbursed for their election expenses. Dissident candidates are not, unless they succeed in replacing at least a majority of the entire board.

CA, Inc., 953 A.2d at 237. Even under a bylaw such as that proposed by AFSCME, the incumbent board would still enjoy a significant advantage in contested elections, as dissidents would have to front the cost of their campaigns in advance, and run the risk of receiving no reimbursement if they fail to win any board seats.

31 *See Jana*, 954 A.2d at 341 ("such a rule undoubtedly proves intimidating and likely discourages many shareholders from attempting to wage a proxy contest.").

32 The SEC staff rejected two other grounds advanced by CA that the bylaw was improper: (1) that it conflicted with SEC proxy rules (Rule 14a-7) and (2) improperly related to a procedure for the election of directors.

33 *CA, Inc.*, 953 A.2d at 230.

34 The SEC certified two questions for review by the Delaware Supreme Court: (1) whether the proposal is a proper subject for action by shareholders as a matter of Delaware law, and (2) whether the proposal, if adopted, would cause CA to violate Delaware law. *Id.* at 231.

35 *Id.* at 231 (quoting 8 Del. C. § 109(a)).

36 *Id.* at 232 (citing, *inter alia, Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281, 1291-92 (Del. 1998 ("Section 141(a) … confers upon any newly elected board of directors *full* power to manage and direct the business and affairs of a Delaware corporation.") (emphasis in original)). The CA Court characterized the board's managerial authority under Section 141(a) as a "cardinal precept of the DGCL." *Id.* at 232 n.7.

37 *Id.* at 234 n.14.

38 *Id.* at 235-36.

39 *Id.* at 235 (citing *Frantz Mfg. Co. v. EAC Indus.*, 501 A.2d 401 (Del. 1985); *Hollinger Int'l, Inc. v. Black*, 844 A.2d 1022 (Del. Ch. 2004), *aff'd*, 872 A.2d 559 (Del. 2005) (shareholder-enacted bylaw abolishing a board committee created by a board resolution does not impermissibly interfere with the board's authority under Section 141(a)).

40 *Id.* at 236.

41 *Id.*

42 *Id.*

43 *Id.* at 237 (citing, *inter alia, Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 6060 n.2 (Del. Ch. 1988) ("Delaware courts have long exercised a most sensitive and protective regard for the free and effective exercise of voting rights.")).

44 *Id.*

45 *Id.*

46 Thus, the Bylaw failed Section 109(b)'s requirement that it be "not inconsistent with the law." 8 Del. C. § 109(b).

47 *Id.* at 238 (citing *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1994); *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998)).

48 *Paramount*, 637 A.2d at 51.

49 *Quickturn*, 721 A.2d at 1291.

50 *CA, Inc.*, 953 A.2d at 239. That the limitation on the directors' powers would be imposed through a shareholder vote rather than by the directors themselves did not "legally matter" to the Court. *Id.* Only if AFSCME's proposal were instead enacted as an amendment to CA's certificate of incorporation would that distinction be dispositive to the Court, as limits on board authority may be contained in the certificate pursuant to Section 141(a). *Id.* at 239 n.32 (citing 8 Del. C. § 102(b)(1) and § 242).

51 *Id.* at 240. The Court explained that "[s]uch a circumstance could arise, for example, if a shareholder group affiliated with a

competitor of a company were to cause the election of a minority slate of candidates committed to using their director positions to obtain, and then communicate, valuable proprietary strategic or product information to a competitor." *Id.* at 240 n.34.

52 Because the two questions certified by the SEC required analysis of the Bylaw in the abstract, rather than in the course of litigation involving application of the Bylaw to specific facts, the Court held that it "must necessarily consider any possible circumstance under which a board of directors might be required to act." *Id.* at 238.

53 "Dead hand" provisions are those limiting the ability of directors other than the incumbents and their designated successors to amend or redeem a shareholder rights plan. A variation on this limitation on director power is the "slow hand" or "no hand" provision which provides that the rights plan could not be amended or redeemed for a specified period of time after a change in the majority of the directors or other similar event. The Delaware Courts have invalidated such proposals on both statutory and fiduciary duty grounds. *See, e.g., Quickturn Design Systems, Inc. v. Shapiro*, 721 A.2d 1281, 1292 (Del. 1998) (finding "no hand" provision in violation of Section 141(a) because it prevented newly appointed directors from completely discharging their fiduciary duties to "protect fully the interests of the corporation and its stockholders"); *Carmody v. Toll Brothers, Inc.*, 723 A.2d 1180, 1190-95 (Del. Ch. 1998) (upholding challenges to dead hand provision because (plaintiffs claimed) it violated Section 141(a) by interfering with the directors' statutory power to manage the business and affairs the corporation, it interfered with the shareholder voting franchise without the required compelling justification, and it was adopted for entrenchment purposes in a disproportionate defensive measure).

54 *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 51 (Del. 1994) (invalidating "no shop" provision of merger agreement preventing directors of target from communicating bids to other potential bidders to obtain the highest available value for shareholders); *see also, Ace Limited v. Capital Re Corp.*, 747 A.3d 95, 106 (Del. Ch. 1999) ("no talk" provision preventing board from communicating with other bidders unless it received an opinion from counsel that such action was required to prevent a breach of fiduciary duty would likely be found to be invalid).

55 This is what makes the Court's example of a situation in which it would be a breach of the directors' fiduciary duty to reimburse a successful short-slate even more absurd. The insurgent would have to convince a majority of the shareholders voting to elect his/her slate. Thus, the concept that the insurgent's slate was "motivated by personal or petty concerns, or not to promote interests that do not further, or are adverse to, those of the corporation" would seem at odds with the fact that to get elected the stockholders would have to believe that the insurgent slate is in their best interest. The directors, having lost that debate despite their significant financial advantage, would then have to violate the will of the majority to reach the Court's hypothetical. One wonders if this would be subject to a business judgment analysis or an interested director one.

56 Following the Court's decision in *CA, Inc.*, the SEC rejected at least one, rather unusual, shareholder proposal on similar grounds, finding that it would improperly cause the company to violate Delaware law. *See* SEC No-Action Letter, 2008 WL 5433185 (Nov. 7, 2008) (rejecting request that company require all of its directors to take an oath of allegiance to the U.S. Constitution; apparently accepting company's argument that the proposal could impair the board's ability to manage the company as, for instance, the board may determine that it is in the company's best interest to nominate a foreign national to the board, or appoint one to fill a vacancy, but may be constrained in that selection by the nominee's inability to take the oath).

57 *CA, Inc.*, 953 A.2d at 240.

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