Weil Briefing: Corporate Governance

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Delaware Supreme Court Addresses Validity of Shareholder Bylaws: Answering Some Questions and Raising Others

The Delaware Supreme Court late last week issued an important opinion addressing the validity of shareholder-adopted bylaws, *CA, Inc. v. AFSCME Employees Pension Plan.*[1] At issue was a shareholder-proposed bylaw that would require the board of directors, subject to certain conditions, to reimburse a shareholder for reasonable expenses incurred in connection with nominating candidates in a contested election. AFSCME submitted the proposed bylaw for inclusion in the proxy statement of CA, Inc. for its upcoming annual meeting. Answering two questions certified to it by the Securities and Exchange Commission, under Delaware's new certification procedure, the court determined that the proposed bylaw, as drafted: (1) was a proper subject for shareholder action but (2) was inconsistent with Delaware law in that it would impinge on the statutory province of the board of directors to exercise its business judgment in managing corporate affairs.

The opinion is significant not only jurisprudentially as a matter of Delaware corporation law, but also in the broader context of corporate governance and the relative powers of directors and shareholders. It shines an analytical light important in this era of shareholder activism on the role of both shareholders and boards in corporate decision-making. Although the opinion was carefully crafted to address only the proposed bylaw before the court, it provides a framework for addressing issues, such as shareholder access to company proxy materials, that recently have been the subject of widespread debate.

Highlights

Important aspects of the decision include the following:

- The court addressed for the first time the long-debated interplay between the board's statutory authority to manage the business and affairs of the corporation and the shareholders' statutory authority to adopt bylaws relating to the management of the corporation's business and the conduct of its affairs or regulating the powers of shareholders and directors. The decision holds that the shareholders' power to adopt bylaws is limited by the board's management prerogatives and responsibilities, but does not attempt to delineate the exact contours of this limitation.
- The decision addresses only the proposed bylaw, finding that it could under some circumstances preclude the board from discharging its fiduciary duty and thus would be inconsistent with the management role of the board contemplated by the statute. Changes in the board's management role could be provided in the certificate of incorporation but not in the bylaws.
- The court tempered its emphasis on the board's management prerogatives, however, with its holding that the subject matter of the proposed bylaw was a proper one for shareholder action,

even though the bylaw would have required an expenditure of corporate funds. The court explained that, in providing reimbursement of election expenses of successful rival candidates, the bylaw would facilitate the shareholders' right to participate in selecting the candidates for election to the board, a "a subject in which the shareholders … have a legitimate and protected interest."[2] Because the bylaw would facilitate that purpose, the fact that it would require the expenditure of corporate funds would not, by itself, make the bylaw an improper subject of shareholder action.

- Rather, the deficiency of the proposed bylaw arose from violating the prohibition developed in the court's case law against "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."[3] The court's discussion raises the possibility that a similar bylaw might be considered valid if it contained a "fiduciary out" provision—under which the board could deny reimbursement if it determined that in light of particular circumstances application of the corporation's funds to reimbursement would be contrary to the best interests of the corporation and its shareholders.
- In reaching its conclusions on the two questions, the court drew a distinction between bylaws that "define the process and procedures by which" business decisions are made—the "proper function" of bylaws—and bylaws that purport to "mandate how the board should decide specific substantive business decisions"—an improper function of bylaws.[4] The court eschewed articulating "with doctrinal exactitude a bright line that divides those bylaws that shareholders may unilaterally adopt . . . from those which they may not,"[5] noting that such a determination is highly contextual.[6] It pointed out that the proposed bylaw "would encourage candidates other than board-sponsored nominees to stand for election" and even suggested how the bylaw could have been written to be on its face validly process-oriented.[7]

The Future of Shareholder-Proposed Bylaws Relating to Director Elections

The *CA* decision is likely to be much discussed in the ongoing debate over the role shareholders should play in corporate governance and the relative roles which federal and state law should play in establishing and regulating shareholder rights.

- The court's discussion leaves open whether a shareholder-adopted bylaw providing for reasonable shareholder access to company proxy materials for shareholder nominees would be valid, given the expenditure of corporate funds that would be involved and the other considerations that may affect the directors' ability to satisfy their fiduciary duties with regard to providing access.
- The decision is almost certain to increase the attention—already significant—of activist shareholders on attaining access. Commenting on the decision, an AFSCME representative stated, "the focus for shareholders has to be on the [SEC] and the creation of an appropriate right of shareholder access at the federal level."[8]
- At the same time, the decision's affirmation of shareholder power to regulate election procedures and its focus on the board's fiduciary role in acting on behalf of the company in specific situations (actions themselves subject to judicial review) provide a framework for developing access procedures under state law, without any action at the federal level.

- The decision will likely affect the SEC's further consideration of the issue of the permissibility of access proposals under Rule 14a-8, as it revisits, as proposed by Chairman Cox, a change in the rule it considered but rejected last year that would have permitted access proposals in the form of bylaw amendments where such bylaws were permitted by state law.[9]
- The opinion's dual emphasis on the role of the board in making specific decisions and the role of the shareholders in establishing corporate procedures through bylaws may also provide fertile ground for dealing with some of the complex problems that are associated with access proposals, such as which, and how many, shareholders may have access to a company's proxy materials, and for how many nominees, in any one election.

Background and Analysis of the Opinion

Earlier this year, AFSCME Employees Pension Plan submitted under SEC Rule 14a-8 a proposed "mandatory reimbursement bylaw" for inclusion in CA's 2008 proxy materials. The proposed bylaw, if adopted by the stockholders, would *require* the board of directors to cause CA to reimburse a stockholder or group of stockholders (the "Nominator") for "reasonable expenses . . . incurred in connection with nominating one or more candidates in a contested election of directors" if, among other conditions, "(a) the election of fewer than 50% of the directors to be elected is contested in the election, [and] (b) one or more candidates nominated by the Nominator are elected to the corporation's board of directors." AFSCME explained that it was limiting the reimbursement right provided by the proposed bylaw to a slate of nominees who would not constitute a majority of the board, because a majority slate, if elected, could as a practical matter apply the corporation's funds to reimburse their expenses.[10]

CA proposed to exclude the bylaw from inclusion in its proxy materials, and it requested a no-action letter from the SEC. CA and its Delaware counsel argued that the bylaw should be excluded because it would conflict with Delaware law and was not a proper subject for stockholder action.[11] AFSCME and its Delaware counsel countered that the proposed bylaw would be valid under Delaware law. The SEC was thus presented with conflicting opinions concerning the governing corporation law. Invoking for the first time a procedure authorized last year by an amendment to the Delaware constitution, the SEC certified to the Delaware Supreme Court the following questions:

- Is the AFSCME proposal a proper subject for action by shareholders as a matter of Delaware law?
- Would the AFSCME proposal, if adopted, cause CA to violate any Delaware law to which it is subject?

The Delaware Supreme Court accepted briefs on an expedited schedule and then heard argument from AFSCME and CA on July 9, 2008, rendering its opinion equally expeditiously, just over a week after argument.

Following the decision, the SEC Staff issued a no-action letter to CA permitting it to exclude the proposal from its proxy statement as being contrary to applicable Delaware law.

Certified Question 1: The Bylaw Is a Proper Subject for Shareholder Action Because It Regulates the Process of Director Selection

The first certified question required the court to address a tension between sections 109(a) and 141(a) of the Delaware General Corporation Law (DGCL). Section 109(a) gives stockholders "the power to adopt, amend or repeal bylaws." It also allows a corporation to confer, in its certificate of incorporation, such power on its directors, provided that the conferral of power on the directors does not limit the stockholders' power. Section 141(a) provides that "[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors, except as may be otherwise provided in [the DGCL] or in its certificate of incorporation."

According to the court, section 109(a) might be understood, when read in isolation, as providing shareholders and directors with "identical, coextensive power" to adopt bylaws.[12] But when read in light of section 141(a), "the shareholders' statutory power to adopt . . . bylaws is not coextensive with the board's concurrent power and is limited by the board's management prerogatives under section 141(a)."[13] Read in that context, the proposed bylaw presented a tension between the right of stockholders to participate in the director election process by nominating an opposing slate and the board's substantive decision-making authority to decide whether or not to reimburse director election expenses.

In analyzing what the limits on the shareholders' right to adopt bylaws might be, the court also considered DGCL sections 109(b) and 102(b)(1). Section 109(b) provides that the bylaws may contain "any provisions, not inconsistent with law or 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 [or] directors." Section 102(b)(1) provides that the certificate of incorporation may contain provisions "for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, limiting and regulating the powers of the corporation, the directors and the stockholders." Notably, section 102(b)(1) does not mention limiting the powers of directors by bylaw provisions, which CA argued made the proposed bylaw inconsistent with Delaware law.

Rejecting the idea that any bylaw that might be viewed as limiting or restricting in any respect the power of the directors would be impermissible, the court distinguished a bylaw that "establishes or regulates a process for substantive decision-making" from one that "mandates the decision itself."[14] Emphasizing the legitimate shareholder interest in the director election process (as detailed above), the court observed that the bylaw was intended to "promote the integrity of that electoral process by facilitating" shareholder nomination of director candidates. The court therefore held that the bylaw "is a proper subject for shareholder action," rejecting the idea that the fact that the bylaw would require an expenditure of corporate funds altered the bylaw's process-oriented character.[15]

Certified Question 2: The Bylaw Is Invalid Because It Would Bind the Board to Take Actions That Might Breach Its Fiduciary Duties

Pointing out that the second question certified to it "requested a determination of the validity of the Bylaw in the abstract" and "therefore, in response … we must necessarily consider any possible circumstance under which a board of directors might be required to act" under the proposed bylaw, the court held that the proposed bylaw, as drafted, "would violate the prohibition

. . . 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."[16] The court cited *Paramount Communications, Inc. v. QVC Network, Inc.*, in which the Delaware Supreme Court invalidated a "no-shop" provision in a merger agreement because it would preclude the board from taking actions that might be required by its fiduciary duties, and *Quickturn Design Systems, Inc. v. Shapiro*, in which the Delaware Supreme Court invalidated a poison pill with a delayed redemption provision because that provision might deprive any newly elected board of its managerial authority under section 141(a) and prevent the board from exercising its fiduciary duties.

The court rejected AFSCME's arguments that, because the proposed bylaw was to be adopted by the shareholders (rather than the board, as in the case of the provisions involved in *QVC* and *Quickturn*) and would remove entirely from CA's board any discretion with respect to reimbursement of election expenses in the circumstances specified in the bylaw, there could be no conflict with the board's discharge of its fiduciary duty regarding reimbursement. This argument, the court concluded, "concedes the very proposition that renders the Bylaw, as written, invalid: the Bylaw mandates reimbursement of election expenses in circumstances that a proper application of fiduciary principles could preclude."[17] Referencing the (sparse) Delaware case law on the subject, the court pointed out that a board may permissibly expend corporate funds to reimburse proxy contest expenses where the contest "is concerned with a question of policy as distinguished from personnel o[r] management."[18] "But," it elaborated, "in a situation where 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 board's fiduciary duty could compel the reimbursement be denied altogether."[19] Accordingly, the bylaw's provision limiting reimbursement to "reasonable" expenses did not remedy its deficiency. Seemingly contemplating a bylaw that, in contrast to the proposed bylaw before it, would "reserve to … directors their full power to exercise their fiduciary duty to decide whether or not it would be appropriate, in a specific case, to award reimbursement at all,"[20] the court noted that "a decision by directors to deny reimbursement on fiduciary grounds would be judicially reviewable."[21]

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If you have any questions about this development, please do not hesitate to speak with your regular contact at Weil, Gotshal & Manges LLP. Questions may also be addressed to any of the following: E. Norman Veasey, 302-656-1410, Robert Todd Lang, 212-310-8200, Stephen A. Radin, 212-310-8770 or members of the Firm's Public Company Advisory Group: Howard B. Dicker, 212-310-8858; Cathy Dixon, 202-682-7147; Gil Friedlander, 214-746-8178; Holly J. Gregory, 212-310-8038; P.J. Himelfarb, 202-682-7197; Robert L. Messineo, 212-310-8835; and Ellen J. Odoner, 212-310-8438. Our e-mail protocol is firstname.lastname@weil.com.

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[1] No. 329, 2008 (Del. July 17, 2008).

[2] *Id.*, slip op. at 16.

[3] *Id.* at 19.

[4] *Id.* at 12.

[5] *Id.*

[6] *Id.* at 16.

[7] *Id.* at 15 & n.20.

[8] K. Scannel & J. Burns, *Delaware Court Rules For CA in Suit*, WALL ST. J., July 18, 2008, at C6 (quoting Richard Ferlauto, AFSCME's Director of Pension Investment).

[9] Concerning the SEC's consideration last year of the treatment of access proposals under Rule 14a-8, see our July 27 and November 29, 2007, *Weil Briefings* at http://www.weil.com/wgm/cwgmhomep.nsf/Files/Briefings019_2007/$file/Briefings019_2007.pdf and <http://www.weil.com/wgm/cwgmhomep.nsf/Files/Briefings022_2007/$file/Briefings022_2007.pdf>.

[10] *See* CA, Inc., SEC No Action Letter, *available* June 27, 2008 (attachment to incoming letter).

[11] Rule 14a-8(i)(1) provides that a corporation may exclude from its proxy materials a shareholder proposal that "is not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization." 17 C.F.R. § 240.14a-8(i)(1). Rule 14a-8(i)(2) provides that a corporation may exclude from its proxy materials a shareholder proposal that would "cause the company to violate any state . . . law to which it is subject." 17 C.F.R. § 240.14a-8(i)(2).

[12] *CA, Inc. v. AFSCME Employees Pension Fund*, slip op. at 6.

[13] *Id.* at 7.

[14] *Id.* at 10-11, 14.

[15] *Id.* at 14, 16-18. The court also explicated the interaction of (i) the exception in section 141(a) to the board's managerial authority provided by the reference therein to provisions otherwise specified in the DGCL with (ii) section 109's grant of authority to shareholders to adopt, amend and repeal bylaws, holding that section 109 does not create an exception to section 141(a); rather section 109 provides that bylaws cannot be "inconsistent with law," including section 141(a). *Id.* at 7, n. 7.

[16] *Id.* at 19.

[17] *Id.* at 22.

[18] *Id.* at 22 (citing *Hall v. Trans-Lux Daylight Picture Screen Corp.*, 171 A. 226, 227 (Del. Ch. 1934); *Hibbert v. Hollywood Park, Inc.*, 457 A.2d 339, 345 (Del. 1983)).

[19] *Id.* at 22-23.

[20] *Id.* at 23.

[21] *Id.* at 23 n. 35. The court did not address the standard of review that would apply to such a decision, but cited the Chancery Court decision in *Blasius Indus. Inc. v. Atlas Corp.* 541 A.2d 651 (Del. Ch. 1988), which provides for an enhanced review of actions that might frustrate the exercise of the shareholder franchise, in discussing the legitimate shareholder interest in the subject of the proposed bylaw. *Id.* at 16 n. 21.
