

Mandatory Shareholder Proposals – CA, Inc. v. AFSCME Employees Pension Plan

On July 17, 2008, the Supreme Court of Delaware ruled on two questions of law regarding a shareholder proposal to amend a company's bylaws to require its board to reimburse expenses incurred in connection with nominating candidates in contested director elections.¹ The court held that though such a proposal was a proper subject for shareholder action, the proposed bylaw, if adopted, would violate Delaware law.² The case was brought before the court on certification of questions of law from the Securities and Exchange Commission ("SEC").³ Following the Court's decision, the SEC's Division of Corporation Finance advised the corporation that it could omit the shareholder proposal from its proxy materials.⁴

I. Facts and Procedural History

AFSCME Employees Pension Plan ("AFSCME"), a shareholder of CA, Inc., a Delaware corporation ("CA"), proposed a bylaw for inclusion in CA's 2008 proxy materials that would require the board of directors to reimburse the reasonable fees of any stockholder or group of stockholders that sought to elect less than 50% of the board and succeeded in electing at least one director.⁵ CA's bylaws had no provision specifically addressing reimbursement of proxy expenses, so the decision whether to reimburse was left to the discretion of the board pursuant to the article of CA's Certificate of Incorporation which states that "[t]he management of the business and the conduct of the affairs of the corporation shall be vested in [CA's] Board of Directors."⁶

CA sought a no-action letter from the SEC's Division of Corporation Finance (the "Division") and requested that the SEC not recommend any enforcement action if CA excluded the AFSCME proposal. CA argued that the proposal could be excluded as permitted by SEC Rule 14a-8(i)(1) because the proposal was not a proper subject for action by the shareholders, and by Rule 14a-8(i)(2) because the bylaw, if implemented, would cause the company to violate the Delaware General Corporation Law. AFSCME responded to CA's no-action request with a letter arguing the opposite legal position.⁷ Because the Division was confronted with two conflicting legal opinions, the SEC certified the questions of Delaware law to the Delaware Supreme Court. The Court concluded that "there are important and urgent reasons for an immediate determination of the questions certified," and accepted the questions for review on July 1, 2008.⁸

¹ *CA, Inc. v. AFSCME Employees Pension Plan*, No. 329, 2008 (Del. July 17, 2008), available at, [http://courts.delaware.gov/opinions/\(relpyda4hyqbyonmmpawvp45\)/download.aspx?ID=109110](http://courts.delaware.gov/opinions/(relpyda4hyqbyonmmpawvp45)/download.aspx?ID=109110).

² *Id.* at 14, 23.

³ *Id.* at 1, 4. In 2007, the Delaware Constitution was amended to authorize the Court to hear questions of law certified by the SEC. This certification request was the first ever to be submitted pursuant to the amendment.

⁴ CA, Inc., SEC No-Action Letter (July 17, 2008), available at, <http://www.sec.gov/divisions/corpfin/cf-noaction/2008/ca071708-14a8.htm>.

⁵ *CA, Inc. v. AFSCME Employees Pension Plan*, No. 329, 2008, at 2.

⁶ *Id.* at 2, 3.

⁷ *Id.* at 3.

⁸ *Id.* at 4.

II. The Court's Framework

The Court first proceeded to “delineate a framework” within which to proceed with its analysis. It noted that Delaware General Corporation Law empowers both the board and the shareholders to adopt, amend, or repeal the corporation’s bylaws.⁹ However, the Court recognized that the shareholders’ statutory power to adopt, amend, or repeal bylaws under Section 109 is not coextensive with the board’s concurrent power to do so since the scope of the shareholders’ powers does not include the power of a board to manage the affairs of a corporation as provided in Section 141(a).¹⁰ Therefore, to determine whether the proposal was a proper subject for shareholder action, the Court had to first determine: (1) the scope of the shareholders’ power to adopt, alter, or repeal bylaws, and then (2) whether the proposed bylaw fell within that permissible scope.¹¹

III. The Proposal is a Proper Subject for Shareholder Action

In addressing the question of whether the bylaw was a proper subject for stockholder action, the Court first had to decide “whether the Bylaw is one that establishes or regulates a process for substantive director decision-making, or one that mandates the decision itself.” Procedural, process-oriented bylaws are properly within the scope of shareholders’ authority under the Delaware General Corporation Law.¹² The Court recognized that “a bylaw that requires the expenditure of corporate funds does not, for that reason alone, become automatically deprived of its process-related character.”¹³ For example, a bylaw that requires attendance at board meetings would still be process oriented even though it would require the corporation to expend its funds to reimburse directors for travel expenses. Whether a bylaw is process-oriented “must necessarily be determined in light of its context and purpose.”¹⁴

The context of the bylaw at issue was the process for electing directors. Thus, for the proposal to be within the scope of the shareholders’ power, the primary function of the proposed reimbursement bylaw had to be to regulate that process. The Court explained that the election of directors is a subject in which shareholders have a legitimate interest and that shareholders have the right to participate in selecting the contestants. Shareholders are entitled to facilitate that right by proposing bylaws that would encourage candidates other than board-sponsored nominees. The proposed bylaw would encourage the nomination of non-management board candidates by promising reimbursement of the nominating shareholders’ expenses if at least one of the candidates was elected. It therefore had both the intent and the effect of regulating the process for electing directors, a subject in which shareholders have a legitimate interest, and so was a proper subject for shareholder action.¹⁵

The Court was clear that its holding was case specific. It did not attempt to delineate a bright line rule in its opinion. It only held that “wherever may be 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), the proposed Bylaw at issue here does not invade the territory demarcated by Section 141(a).”¹⁶

⁹ *Id.* at 5 (citing 8 Del. C. § 109(a)).

¹⁰ *Id.* at 6, 7 (citing 8 Del. C. § 141(a)).

¹¹ *Id.* at 7, 8.

¹² *Id.* at 12-14.

¹³ *Id.* at 16.

¹⁴ *Id.* at 16.

¹⁵ *Id.* at 16-18.

¹⁶ *Id.* at 12 n.14.

IV. The Proposed Bylaw, If Implemented, Would Cause CA to Violate Delaware Law

In analyzing whether the bylaw would violate Delaware law, the Court first discussed how the procedural posture of the case affected its analysis. In a more typical case involving the application of a bylaw to a specific set of facts, the Court would start with the presumption that the bylaw was valid and construe it in a manner consistent with the law, if possible.¹⁷ However, certified questions “request a determination of the validity of the bylaw in the abstract.” As a result, the Court was required to consider any possible circumstance under which the board might be required to act.¹⁸

The Court concluded that the bylaw would violate the prohibition against contractual arrangements that commit board members to a course of action in a manner which would preclude them from fully discharging their fiduciary duties¹⁹ because there was at least one hypothetical under which the board would breach their fiduciary duties if they complied with the proposed bylaw.²⁰ Under Delaware law, a board may expend corporate funds to reimburse proxy expenses where a proxy contest controversy concerns a question of policy.²¹ However, in a situation where a proxy contest is motivated by personal or petty concerns or to promote interests that do not further those of the corporation, the board’s fiduciary duty could compel that reimbursement be denied altogether.²²

The proposed bylaw afforded CA’s directors full discretion to determine what *amount* of reimbursement would be appropriate but did not contain any language that would reserve for the board the ability to decide not to award any reimbursement. Thus, the bylaw’s mandated reimbursement of election expenses in circumstances that a proper application of fiduciary principles would preclude was found by the Court to be an illegal encroachment by shareholders on the powers of a board to manage a corporation.²³

The Court went on to explain that it was not expressing a view as to whether such a bylaw would create a better governance scheme, but was only deciding what is legally permitted under Delaware law. The Court concluded that if shareholders want to make the bylaw as drafted part of CA’s governance scheme, they could either seek to amend CA’s certificate of incorporation or seek recourse from the Delaware General Assembly.²⁴

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; or John Schuster at 212.701.3323 or jschuster@cahill.com.

¹⁷ *Id.* at 18.

¹⁸ *Id.* at 19.

¹⁹ The Court previously derived this prohibition from Section 141(a) in *Paramount Comm., Inc. v. QVC Network, Inc.*, 63 A.2d 34 (Del. 1994) and *Quickturn Design Sys., Inc. v Shapiro*, 721 A.2d 1281 (Del. 1998).

²⁰ *CA, Inc. v. AFSCME Employees Pension Plan*, No. 329, 2008, at 19.

²¹ *Id.* at 22.

²² *Id.* at 23.

²³ *Id.* at 23.

²⁴ *Id.* at 23-24.