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Delaware Supreme Court Answers Questions Certified By SEC; Rejects Stockholder Bylaw Requiring Reimbursement Of Proxy Solicitation Expenses

On July 17, 2008, the Delaware Supreme Court issued its anticipated opinion in *CA, Inc. v. AFSCME Employees Pension Plan*, which addresses the interplay between 8 *Del.C.* § 109 (which vests stockholders with the power to adopt, amend or repeal bylaws) and 8 *Del. C.* § 141(a) (which vests directors with the power to manage the business and affairs of a corporation).

After considering these provisions, as well as several key Delaware Supreme Court decisions addressing director authority under Section 141(a), the court held that a stockholder proposed bylaw that would require reimbursement of proxy solicitation expenses under certain circumstances was invalid under Delaware law because the bylaw could require a board to reimburse election expenses in circumstances where the board's fiduciary duties might warrant otherwise.

The issue was presented to the Delaware Supreme Court under unique circumstances — it is the first case to be decided pursuant to the court's newly created jurisdiction to hear and determine questions of law certified to it by the United States Securities and Exchange Commission.

Background

CA, Inc. and one of its stockholders, AFSCME, took conflicting positions with the SEC over the validity of the bylaw, which was proposed by stockholders for inclusion in CA's proxy materials for its upcoming 2008 annual meeting of stockholders. (CA's current bylaws and certificate of incorporation had no provision that specifically addressed the reimbursement of proxy expenses.) The proposed bylaw provided 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

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> 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.

CA sent a request for a no-action letter to the SEC explaining its intention to exclude the proposed bylaw from its proxy materials on the ground that it was not a proper subject for stockholder action, and that if implemented, it would violate Delaware law. AFSCME sent a letter to the SEC staking out a conflicting position.

As a result, the SEC certified the following two questions to the Delaware Supreme Court:

1. Is the AFSCME Proposal a proper subject for action by shareholders as a matter of Delaware law? (As the court clarified, the issue is "more precisely, whether the bylaw may be proposed and enacted by shareholders without the concurrence of the company's board of directors.")

2. Would the AFSCME Proposal, if adopted, cause CA to violate any Delaware law to which it is subject?

Analysis

On the first issue, CA argued that the bylaw, if implemented, would improperly limit the substantive decision-making authority of CA's board to decide whether or not to expend corporate funds for a particular purpose, here, reimbursing director election expenses. The court disagreed with this argument, remarking that "[i]mplicit in CA's argument is the premise that any bylaw that in *any* respect might be viewed as limiting or restricting the power of the board of directors automatically falls outside the scope of permissible bylaws. That simply cannot be. That reasoning, taken to its logical extreme, would result in eliminating altogether the shareholders' statutory right to adopt, amend or repeal bylaws." Rather, as viewed by the court, the key issue is "what is the scope of shareholder action that Section 109(b) permits yet does not improperly intrude upon the directors' power to manage [a] corporation's business and affairs under Section 141(a)."

Although the court did not provide a complete answer to this question, the court determined that "the shareholders' statutory power to adopt, amend or repeal bylaws is not coextensive with the board's concurrent power and is limited by the board's management prerogatives under Section 141(a)." After noting that the court was not attempting to delineate a "bright line" rule between bylaws that shareholders may unilaterally adopt under Section 109(b) and those that shareholders may not under Section 141(a), the court concluded that the specific bylaw at issue, which was intended to regulate the process for electing directors, is a proper subject matter for shareholder action. Therefore, the court answered the first question certified in the affirmative.

The court next turned to the second question of whether the bylaw violates any common law rule or precept of Delaware law. The court reviewed the seminal decisions of *Paramount Communications, Inc. v. QVC Network, Inc.* and *Quickturn Design Systems, Inc. v. Shapiro* — both of which invalidated, pursuant to Section 141(a), contractual arrangements that directors had

imposed upon themselves — and concluded that "the 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 stockholders." The court rejected AFSCME's argument that *QVC* and *Quickturn* were distinguishable because the bylaw was proposed by stockholders and not the board, calling that a distinction without a difference.

In reaching its conclusion, the court held that the bylaw had the potential to prevent directors from exercising their full managerial power in circumstances where their fiduciary duties would otherwise require them to deny reimbursement to a dissident slate. For example, the court envisioned "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, [and thus] the board's fiduciary duty could compel that reimbursement be denied altogether."

The court concluded by expressing its view that, "[t]hose who believe that CA's shareholders should be permitted to make the proposed bylaw as drafted part of CA's governance scheme have two alternatives. They may seek to amend the Certificate of Incorporation to include the substance of the bylaw; *or* they may seek recourse from the Delaware General Assembly."

Conclusion

The Delaware Supreme Court's opinion reaffirms the long standing principle under Delaware law that directors, not stockholders, are charged with managing the business and affairs of the corporation. The court squarely rejected the argument that Section 109 provides stockholders with broad authorization to adopt bylaws limiting the board's managerial authority. Instead, the court held that "the shareholders' statutory power to adopt, amend or repeal bylaws is not coextensive with the board's concurrent power and is limited by the board's management prerogatives under Section 141(a)."

The court did hold, however, that bylaws that facilitate a stockholder's ability to participate in selecting director candidates, or that encourage candidates other than board-sponsored nominees to stand for election, are proper subject matters for shareholder action. However, the court determined that the bylaw in this case went too far, because it required directors to reimburse a dissident slate in circumstances where their fiduciary duties might require otherwise. (The opinion does leave open the possibility that a revised reimbursement bylaw with an appropriate "fiduciary out" might be valid.)

Though the Delaware Supreme Court resolves important questions of Delaware law in this opinion, it expressly acknowledges that it was making no attempt to delineate a bright line rule to resolve all tension between Sections 109 and 141(a). Rather, the court signaled that it will continue to provide guidance on this area on a case-by-case basis. Moreover, the extent to which the court's reasoning might call into question the validity of other bylaws that purport to limit directors' exercise of fiduciary duty (for instance, with respect to the adoption and maintenance of poison pills or mandatory advancement rights) is uncertain. Resolution of these questions must await future developments in the case law.