3rd Circ. Expands Exception To Shareholder Proposal Rule


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Law360, New York (August 4, 2015, 10:44 AM ET) -- In April, when the U.S. Court of Appeals for the Third Circuit ruled in Wal-Mart's favor in the case of Trinity Wall Street v. Wal-Mart Stores Inc.,[1] the court's decision was expected to adhere to the U.S. Securities and Exchange Commission's and its staff's long-standing interpretation of the "ordinary business exclusion" to the shareholder proposal rule, Exchange Act Rule 14a-8(i)(7). The circuit court's published opinion in the case, released in July, however, reveals that the court took a slightly different approach to applying the exclusion. This development may provide companies with a broader basis for excluding certain shareholder proposals.

Background

In 2014, Trinity introduced a proposal for inclusion in Wal-Mart's proxy statement to be voted on at the company's annual shareholders meeting. The proposal requested that Wal-Mart's board of directors amend the charter of its compensation, nominating and governance committee to provide for oversight concerning the formulation and implementation of policies and standards that determine whether or not the company should sell a product that:

- especially endangers public safety and well-being;
- has the substantial potential to impair the reputation of the company; and/or
- would reasonably be considered by many offensive to the family and community values integral to the company's promotion of its brand.

Wal-Mart sought to exclude Trinity's proposal from its proxy statement and received the SEC staff's concurrence, in the form of a no-action letter, that the ordinary business exclusion applied.[2] Trinity then brought an action in the U.S. District Court of Delaware seeking to preliminarily and permanently enjoin Wal-Mart from excluding Trinity's proposal from its proxy materials. Under pressure to render a decision on the preliminary injunction before Wal-Mart was scheduled to print its proxy materials, the district court initially decided in favor of Wal-Mart, concluding that at the end of trial the court was unlikely to disagree with the SEC staff's views. When Wal-Mart subsequently moved to dismiss the action, however, the district court changed its position.

In the district court's view, the proposal could not be excluded as dealing with ordinary business matters because the proposal focused on board oversight of merchandising decisions as opposed to giving a directive to management in regards to which products Wal-Mart should sell. Although the district court acknowledged that the proposal "could (and almost certainly would) shape what products are sold by Wal-Mart," the court emphasized that the direct impact of the proposal would be felt at the board level and that it would be up to the board to determine what, if any, policies should be formulated and implemented.

The district court also concluded that the proposal implicated a significant policy issue and that the proposal therefore transcended Wal-Mart's ordinary business operations and for that reason could not be excluded under the ordinary business exclusion. In the district court's opinion, the significant policy issue raised by the proposal was "the social and community effects of sales of high capacity firearms at the world's largest retailer and the impact this could have on Wal-Mart's reputation, particularly if such a product sold at Wal-Mart is misused and people are injured or killed as a result."

Following the district court's decision, many people in the corporate governance community were concerned that other shareholders would follow Trinity's lead and frame shareholder proposals concentrating on ordinary business matters as requests for corporate governance reform by the board or in terms of social or corporate policy issues that might be viewed as significant, all to withstand a challenge under the ordinary business exclusion.

Third Circuit Opinion

The circuit court did not permit the district court's decision to stand. In applying the ordinary business exclusion, the circuit court overruled the district court's decision based on an analysis that attempted to show deference to the views of the SEC and its staff by focusing on the proposal's substance — the proposal's attempt to influence the products that Wal-Mart sells — rather than its form, a request for corporate governance reform. In doing so, the circuit court stated that it applied the SEC's traditional approach to analyzing whether a proposal can be excluded under the ordinary business exclusion. That approach is described in a 1998 SEC rule release[3] as follows:

> The policy underlying the ordinary business exclusion rests on two central considerations. The first relates to the subject matter of the proposal. Certain tasks are so fundamental to management's ability to run a company on a day-to-day basis that they could not, as a practical matter, be subject to direct shareholder oversight. Examples include the management of the workforce, such as the hiring, promotion, and termination of employees, decisions on production quality and quantity, and the retention of suppliers. However, proposals relating to such matters but focusing on sufficiently significant social policy issues (e.g., significant discrimination matters) generally would not be considered to be excludable, because the proposals would transcend the day-to-day business matters and raise policy issues so significant that it would be appropriate for a shareholder vote.
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> The second consideration relates to the degree to which the proposal seeks to "micro-manage" the company by probing too deeply into matters of a complex nature upon which shareholders, as a group, would not be in a position to make an informed judgment. This consideration may come into play in a number of circumstances, such as where the proposal involves intricate detail, or seeks to impose specific time-frames or methods for implementing complex policies.

Step 1: Identify the subject matter. Applying this analysis, the circuit court first identified the subject matter of the proposal. Noting the SEC's "consistent nod to substance over form and its distaste for clever drafting," the circuit court concluded that the subject matter of the proposal is "its ultimate consequence — here a potential change in the way Wal-Mart decides which products to sell" and, more specifically, how Wal-Mart approaches merchandising decisions involving products that fall into the three categories outlined in the proposal. The circuit court stated that "[a] contrary holding — that the proposal's subject matter is 'improved corporate governance' — would allow drafters to evade [the ordinary business exclusion's] reach by styling their proposals as requesting board oversight or review."[4]

Underscoring the point, the circuit court indicated that a proposal does not need to dictate or suggest any changes to the products that a company sells to be excludable as relating to ordinary business operations. Rather, in the circuit court's view, a proposal's request for a board committee to address policies that could shape what products a company sells is the near equivalent of a request for a shareholder referendum on how a company selects its inventory. Describing a retailer's approach to merchandising decisions as the "bread and butter" of its business, the circuit court concluded that "the particulars of that approach involve operational judgments that are ordinary-course matters."

Step 2: Assess whether a significant social policy is implicated and the matter transcends ordinary business. Having determined that the proposal dealt with ordinary business matters, the circuit court then assessed whether the significant policy exception to the ordinary business exclusion applied. At this point, the circuit court's analytic approach deviated from the one that the SEC and its staff has historically used. Under the SEC's approach, a proposal that focuses on sufficiently significant social policy issues is considered to have transcended day-to-day business matters. Thus, assuming that the subject matter of the proposal is related to the company's operations and the proposal does not involve unreasonably intricate details, the proposal would not be excludable as relating to ordinary business matters.[5]

Further, the SEC staff has consistently found that broadly written proposals that touch on a significant policy issue but also encompass ordinary business matters are excludable as dealing with ordinary business matters. Indeed, it likely was the breadth of Trinity's proposal, which covered not only the sale of firearms products but also any product that would impair the company's reputation or would be offensive to the company's values, that led the SEC staff to conclude that the proposal was excludable under the ordinary business exclusion.

The circuit court, however, adopted a different analytical approach, one that does not readily assume that a significant policy issue necessarily transcends a company's ordinary business operations. In contrast to the SEC's approach, the circuit court took the position that "a shareholder must do more than focus its proposal on a significant policy issue; the subject matter of its proposal must [also] 'transcend' the company's ordinary business."

Interpreting the SEC's use of the word "transcend" as referring "to a policy issue that is divorced from how a company approaches the nitty-gritty of its core business," the circuit court made it clear that a proposal dealing with a matter central to a company's business, even if at the heart of a significant policy issue, does not qualify for the significant policy issue exception.

Therefore, according to the circuit court, transcendence is a separate test that must be satisfied even if the proposal focuses on a significant policy issue. The circuit court explained, "[f]or major retailers of myriad products, a policy issue is rarely transcendent if it treads on the meat of management's responsibility: crafting a product mix that satisfies consumer demand."

Finding that the significant policy issue focused on by the proposal did not transcend Wal-Mart's ordinary business operations, the circuit court ruled that the ordinary business exclusion applied and, therefore, Wal-Mart could exclude the proposal from its proxy statement.

Impact of the Opinion

The circuit court's interpretation of the significant policy exception to the ordinary business exclusion differs from the way the SEC appears to have intended it to be and the SEC staff has consistently interpreted it. The court's decision sets a higher bar for shareholders wishing to include certain proposals in company proxy materials in that, even if the proposal focuses on a significant policy issue, the issue must still "transcend" the company's ordinary business functions.

One member of the panel of three judges that considered Wal-mart's appeal, Judge Vanaskie Shwartz, filed a separate opinion concurring with the reversal of the district court decision, but also highlighting her disagreement with the rationale of the majority opinion. Judge Shwartz noted in her opinion that the test outlined by the majority opinion "gives companies carte blanche to exclude any proposal raising social policy issues that are directly related to core business operations."

For companies subject to the Third Circuit's jurisdiction, which includes Delaware corporations, the court's decision could present new options for excluding a proposal. For instance, a company subject to the court's jurisdiction may wish to forgo seeking the SEC staff's concurrence to exclude a shareholder proposal as dealing with ordinary business operations when that proposal, even though potentially focusing on a significant policy issue, would not satisfy the Third Circuit's additional "transcendence requirement." A company choosing that approach still would be required by the SEC's shareholder proposal rule to notify the SEC staff and the proponent of its intention to exclude the proposal but would not have to seek the SEC staff's concurrence.

Then the onus would be on the shareholder proponent or the SEC to challenge the company's decision in a federal district court, which could be bound to apply the Third Circuit's approach for the ordinary business exclusion, including the "transcendence" requirement. The SEC could also seek to challenge the company's decision, but based on past experience in this area, that outcome is unlikely. Companies that take this approach may also want to consider preempting shareholder or SEC litigation by seeking a declaratory judgment, which would, among other things, allow the company to choose a court in the Third Circuit to handle the matter.

For the SEC and its staff, the circuit court's decision poses a number of important questions that merit careful consideration. The most immediate question is whether the circuit court's decision requires a change in the SEC's and its staff's approach toward the ordinary business exclusion. Although it is unclear whether the SEC or its staff will change the long-standing interpretation of the ordinary business exclusion or take some other action in response to the Third Circuit's decision in the Wal-Mart case, the SEC's response to the 2006 decision by the U.S. Court of Appeals for Second Circuit in American Federation of State, County & Municipal Employees, Employees Pension Plan v. American International Group Inc.[6] may be instructive.

In the American International Group, or AIG, matter, the Second Circuit held that AIG could not rely on Rule 14a-8(i)(8) to exclude a shareholder proposal seeking to amend a company's bylaws to establish a procedure under which a company would be required, in specified circumstances, to include shareholder nominees for director in the company's proxy materials. In doing so, the court disagreed with the SEC staff's historical interpretation of the Rule 14a-8(i)(8) exclusion. The SEC staff responded to the Second Circuit's decision by declining to provide its view on the substantive question because of the jurisdictional issue and, thereafter, the SEC amended Rule 14a-8 to address the issue. [7] While it recognized that the court's decision was binding only within the Second Circuit, the SEC expressed concern that “the decision created uncertainty in the rest of the nation about the continuing validity of the longstanding interpretation of Rule 14a-8(i)(8).”[8]

It is unclear if the SEC staff will take the same approach if a similar jurisdictional assertion is made with respect to the Third Circuit’s Wal-Mart decision. Further, the recent trend of litigation over shareholder proposals only increases the likelihood that federal courts, faced with unclear SEC guidance, will render opinions that provide differing and even conflicting interpretations of the shareholder proposal rule. Absent SEC action, it is possible that this trend could lead to increasing fragmentation of the rule’s application, leading to uncertainty for both companies and shareholder proponents who would have to consider jurisdictional issues when dealing with shareholder proposals.

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[1] Trinity Wall Street v. Wal-Mart Stores Inc., No. 14-4764 (3rd Cir. July 6, 2015). On July 10, 2015, the U.S. Supreme Court granted Trinity's application for an extension of time to petition for writ of certiorari. Trinity now has until Sept. 11, 2015, to seek the U.S. Supreme Court's review.

[2] In its no-action letter to Wal-Mart, the SEC staff stated that “[p]roposals concerning the sale of particular products and services are generally excludable under the [ordinary business exclusion.]” SEC No-Action Letter to Wal-Mart Stores Inc. (Mar. 20, 2014).

[3] Securities Exchange Act Release No. 40018 (“Amendments to Rules on Shareholder Proposals”), May 21, 1998.

[4] Trinity argued in its brief to the circuit court that the subject matter of its proposal was the improvement of “corporate governance over strategic matters of community responsibility, reputation for good corporate citizenship, and brand reputation, none of which can be considered ordinary business.”

[5] In determining whether a proposal raises a significant policy issue, the SEC staff assesses whether the issue has been the subject of a consistent or sustained level of public debate over a period of time — a high threshold that insignificant policy issues fail to surpass. In addition, although there are exceptions, most significant policy issues are narrowly defined to prevent ordinary business matters from falling within their scope.

[6] 462 F.3d 121 (2d Cir. 2006).

[7] SEC No-Action Letter to Hewlett-Packard Co. (Jan. 22, 2007).

[8] Securities Exchange Act Release No. 56914 ("Shareholder Proposals Relating to the Election of Directors"), Dec. 6, 2007.