SULLIVAN & CROMWELL LLP

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Delaware Corporate Law

Delaware Supreme Court Decides That Shareholder-Adopted Bylaw May Not Restrict Directors' Exercise of Their Fiduciary Duties

SUMMARY

On July 17, 2008, the Delaware Supreme Court issued an important decision concerning shareholder-adopted bylaws under Delaware law. *CA, Inc.* v. *AFSCME Employees Pension Plan*, No. 329, 2008 (Del. July 17, 2008). The Court held that a shareholder bylaw concerning the reimbursement of expenses in a proxy contest was a proper subject for stockholder action, but that in the case of this specific bylaw, the bylaw could not (1) mandate a board of directors to reimburse expenses in all cases, or (2) prevent the directors from fulfilling their fiduciary duties. The Court also confirmed that "a proper function of bylaws is not to mandate how the board should decide specific substantive business decisions."

The Delaware Supreme Court's decision, issued in response to the SEC's first certification of legal questions to that Court, addressed a proposed stockholder bylaw that would have required the Board of Directors of CA, Inc. ("CA") to reimburse the reasonable expenses incurred by stockholders in conducting successful "short-slate" proxy contests (*i.e.*, where a slate of candidates runs for fewer than half the seats on the board). The Court held that, while the proposed bylaw related to director elections and, thus, was a proper subject for stockholder action under Delaware law, the proposed bylaw "mandates reimbursement of election expenses in circumstances that a proper application of fiduciary principles could preclude" and, thus, if adopted, could cause CA to violate Delaware law.

Robert Giuffra of Sullivan & Cromwell argued on behalf of CA in the Delaware Supreme Court.

BACKGROUND

The proposed bylaw (the "Proposed Bylaw") submitted by the AFSCME Employees Pension Plan ("AFSCME"), if adopted, would have amended CA's bylaws to direct CA's Board to cause the corporation to reimburse certain stockholders for their proxy-related expenses:

> 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.

On April 18, 2008, CA's counsel sent a letter to the SEC's Division of Corporation Finance (the "Division") stating that CA proposed to exclude the Proposed Bylaw from CA's 2008 proxy materials pursuant to Rule 14a-8 under the Securities Exchange Act of 1934, on the ground, among others, that the Proposed Bylaw conflicts with Delaware law. CA requested from the Division a "no-action letter" stating that the Division would not recommend any enforcement action to the SEC if CA excluded the Proposed Bylaw from CA's 2008 proxy materials.

Faced with conflicting opinions submitted by CA's Delaware counsel and AFSCME's Delaware counsel, on June 27, 2008, the SEC invoked for the first time a new provision of the Delaware Constitution that permits the Delaware Supreme Court to hear questions certified to it by the SEC. The SEC certified the following two questions of Delaware state law:

- 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 SEC's certification of these questions to the Delaware Supreme Court opened a new chapter in determining whether Rule 14a-8 allows companies to exclude from their proxy statements stockholder proposals that raise questions of Delaware corporate law. In the past, when the Division received conflicting legal opinions on matters of state law raised in Rule 14a-8 requests, the Division had simply concluded that the requesting party—the issuer seeking to exclude the proposal—failed to carry the burden of persuasion, and denied the request for a no-action letter. Certain other attempts to judicially resolve disputes as to the validity of a proposed bylaw in the Delaware Court of Chancery failed on the

ground that the dispute was not ripe. Given the difficulty of challenging the legality of a proposed bylaw, companies often had little choice but to include questionable bylaws in their proxy statements.

On July 1, 2008, the Delaware Supreme Court accepted for review the two questions certified by the SEC, concluding that "there are important and urgent reasons for an immediate determination of the questions certified."

THE COURT'S DECISION

Under Section 109(b) of the Delaware General Corporation Law ("DGCL"), a bylaw 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, officers or employees." Under Section 141(a) of the DGCL, "[t]he 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." In interpreting these two sections of the DGCL, the Delaware Supreme Court stated that "a proper function of bylaws is not to mandate how the board should decide specific substantive business decisions, but rather, to define the process and procedures by which those decisions are made." Thus, "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)," because the board's authority to manage the corporation is a "cardinal precept" of Delaware corporate law.

The Delaware Supreme Court answered the first certified question—whether the Proposed Bylaw is a proper subject for action by shareholders as a matter of Delaware Law—in the affirmative, because the Proposed Bylaw relates to the "process for electing directors." According to the Court, "purely procedural bylaws do not improperly encroach upon the board's managerial authority under Section 141(a)." Therefore, a bylaw may "establish[] or regulate[] a process for substantive director decision-making," but may not "mandate[] the decision itself." The Court determined that the Proposed Bylaw was "procedural" in nature, because the Proposed Bylaw had "both the intent and the effect of regulating the process for electing directors of CA." The Court emphasized that its holding on this issue was "case specific," and that the Court was not attempting 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)."

At the same time, the Court found that the Proposed Bylaw, if adopted, could cause CA to violate Delaware law, because it required the reimbursement of proxy expenses under circumstances that could be contrary to the CA Board's fiduciary duties. Thus, the Court answered the second certified question—

whether the Proposed Bylaw, if adopted, would cause CA to violate any Delaware law to which it is subject—in the affirmative.[1]

Citing its *QVC* and *Quickturn* precedents, the Court held that a bylaw cannot require a board to breach its fiduciary duties. The Court held that the Proposed Bylaw, if adopted, "would violate the prohibition, which our 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." The Court stated that the Proposed Bylaw could "prevent the directors from exercising their full managerial power in circumstances where their fiduciary duties would otherwise require them to deny reimbursement to a dissident slate." The Court reaffirmed that a board may expend corporate funds to reimburse proxy expenses only where the controversy is concerned with "a question of policy as distinguished from personnel o[r] management." 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 that reimbursement be denied altogether." Such a circumstance could arise, for example, "if a shareholder group affiliated with a competitor of the 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 the competitor."

The Proposed Bylaw would have afforded CA's Board discretion to determine "what *amount* of reimbursement is appropriate, because the directors would be obligated to grant only the 'reasonable' expenses of a successful short slate," but, according to the Court, "that does not go far enough, because the Bylaw contains no language or provision that would reserve to CA's 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." In other words, because there could be situations in which the Proposed Bylaw would require the Board to breach its fiduciary duties, the Proposed Bylaw was facially invalid. The Court concluded that, if shareholders wish to make the Proposed Bylaw part of CA's corporate governance scheme, they may seek recourse from the Delaware General Assembly or seek to amend CA's certificate of incorporation (which, under the DGCL, requires both shareholder and board approval and, thus, as a practical matter, would have to occur through a precatory proposal requesting that the board pursue the charter amendment).

[1] Because the question arose in the context of a certification from the SEC, the Court stated that "we must necessarily consider any possible circumstance under which a board of directors might be required to act." If the question arose in the context of the application of the Proposed Bylaw to specific facts, however, the Court "would start with the presumption that the Bylaw is valid and, if possible, construe it in a manner consistent with the law."

IMPLICATIONS

- The Delaware Supreme Court's decision reaffirms the bedrock principle of Delaware corporate law that the directors of a corporation, not the shareholders, manage the business and affairs of the corporation.
- The Court's decision confirms that shareholder bylaws may not prevent the directors from fulfilling their fiduciary duties. To attempt to address the concerns articulated by the Court with the Proposed Bylaw, stockholders may attempt to modify their proposed bylaws in ways that leave boards with discretion to discharge their fiduciary duties.
- The Court's decision makes clear that bylaws may not "mandate how the board should decide specific substantive business decisions," but may "define the process and procedures by which those decisions are made." Where the line will be drawn between those bylaws that mandate substantive decisions and bylaws that are procedural likely will be decided by the Delaware courts on a case-by-case basis in the future.
- Under the Court's reasoning, a binding shareholder bylaw proposal to prohibit a board of directors from adopting or implementing a "poison pill" likely would be deemed improper under Delaware law.

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CONTACTS

New York		
H. Rodgin Cohen	+1-212-558-3534	cohenhr@sullcrom.com
Robert J. Giuffra Jr.	+1-212-558-3121	giuffrar@sullcrom.com
David B. Harms	+1-212-558-3882	harmsd@sullcrom.com
James C. Morphy	+1-212-558-3988	morphyj@sullcrom.com
William J. Williams Jr.	+1-212-558-3722	williamsw@sullcrom.com
Washington, D.C.		
Janet A. Geldzahler	+1-202-956-7515	geldzahlerj@sullcrom.com
London		
John L. Hardiman	+44-20-7959-8545	hardimanj@sullcrom.com