

Client Alert

Corporate Department

July 30, 2008

Delaware Supreme Court Determines Stockholder-Proposed Bylaw Relating to Proxy Expense Reimbursement to be Invalid

On July 17, 2008, the Delaware Supreme Court issued an important ruling addressing the legality of a stockholder-proposed bylaw. The stockholder-proposed bylaw would have required the board of directors, subject to certain conditions, to cause the subject company to reimburse a dissident stockholder for its reasonable expenses incurred in connection with a successful “short-slate” proxy solicitation (i.e., an election contest waged by a dissident stockholder seeking minority representation on the board resulting in at least one dissident nominee being elected). The Court determined that the proposed bylaw was a proper subject for action by the stockholder since it was an extension of the right of stockholders to participate in the election process. The Court also determined, however, that the bylaw in question would violate Delaware law because it did not permit directors to choose not to reimburse at all, even in circumstances where the directors, in the exercise of their fiduciary duties, might consider reimbursement to be inappropriate.

The decision in *CA, Inc. v. AFSCME Employees Pension Plan, No. 329, 2008* (Del. July 17, 2008), considered a dispute between CA, Inc. (“CA”), a Delaware corporation that develops IT management software, and a stockholder, AFSCME Employees Pension Plan (“AFSCME”).

In March 2008, AFSCME submitted a proposed bylaw amendment (the “Proposal”) for inclusion in CA’s proxy materials for its 2008 Annual Meeting of Stockholders. The Proposal, if adopted, would have amended CA’s bylaws to require CA’s board of directors to cause CA to reimburse a stockholder or group of stockholders for reasonable expenses incurred in connection with nominating one or more candidates in a contested election of the board of directors, if (1) the election of fewer than 50% of the directors to be elected is contested in the election, (2) one or more of the stockholder nominated directors is actually elected to the board, (3) stockholders are not permitted to cumulate their votes and (4) the election occurs and expenses are incurred after the Proposal is adopted. In addition, the Proposal would limit reimbursement to the amount expended by CA on the same election.

Significantly, the Proposal did not contain a “fiduciary-out” clause that would have allowed the board to decide not to reimburse the dissident if doing so would violate the directors’ fiduciary duties.

CA sought to exclude the Proposal from its proxy materials, and requested from the SEC’s Division of Corporation Finance (the “Division”) a “no-action letter” stating that the Division would not recommend an enforcement action to the SEC if CA excluded the Proposal. CA took the position that the Proposal was excludable under SEC Rule 14a-8 as it was not a proper subject for action by stockholders and that, if implemented, it would violate Delaware law. CA submitted to the Division an opinion of its Delaware counsel supporting its position. AFSCME took the opposite position and submitted an opinion of its Delaware counsel supporting its position.

To resolve the conflicting arguments, the SEC certified to the Delaware Supreme Court the following questions:

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

With respect to the first question, without delineating a bright-line dividing bylaws that stockholders can unilaterally adopt from those they may not, the Court found the Proposal was a proper subject for stockholder action because it “has both the intent and effect of regulating the process for electing directors of CA.” In its analysis, the Court recognized the need to balance the “legally sacrosanct” statutory right of stockholders to adopt, amend or repeal bylaws with the board’s statutorily conferred “management prerogatives” to manage the business and affairs of the corporation. The Court reasoned that a bylaw that is “purely procedural” will not “improperly encroach upon the board’s management authority.” Such a bylaw “establishes or regulates a

process for substantive director decision-making,” and does not “[mandate] the decision itself.”

The Court found that even though implementation of the Proposal would mandate expenditure of corporate funds, which is primarily a statutory privilege exclusive to the board, it was nevertheless permissible “in light of its context and purpose,” which was to facilitate “the nomination of director candidates by stockholders or groups of stockholders.” In this process, the Court determined, stockholders have a “legitimate and protected interest.” Furthermore, the Court found the Proposal would “promote the integrity of the electoral process” by allowing stockholders to participate. The Court also stated that under the current framework, board candidates are only reimbursed if they are board-sponsored or if a dissident slate succeeds in replacing the entire board. The Court acknowledged that the Proposal would encourage the nomination of a “short-slate” of non-management board candidates by providing reimbursement to all successful board candidates.

With respect to the second question, the Court determined the Proposal would violate the prohibition, arising out of Section 141(a) of the Delaware General Corporation Law, “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.” Not limiting itself to the facts at hand but considering any possible circumstance under which a board might be required to act, the Court found the Proposal 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.” This could happen, the Court noted, in the case of a proxy contest motivated by “personal or petty con-

cerns, or to promote interests that do not further or are adverse to, those of the corporation.” In such a case, while the board’s fiduciary duty could compel that reimbursement be denied altogether, the Proposal did not permit the board any ability to deny payment of the reimbursement because of its fiduciary obligations. Specifically, the Court stated that 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.”

The Court suggests that it would have no objection to a proposed identical bylaw amendment drafted to include a fiduciary-out for directors. Practically speaking, a fiduciary-out requirement would likely only result in limited circumstances under which a board of directors would feel justified in denying reimbursement based on fiduciary grounds in a qualifying contested election. It is also interesting to note that in its closing remarks the Court suggests to any proponents of the Proposal that seeking to amend the certificate of incorporation of a corporation to include the substance of the Proposal would be permissible. Of course, any charter amendment must also be approved by the board of directors.

An open question remains whether other binding bylaw amendments may be properly proposed on the basis that they are “process-oriented” (e.g., a stockholder-proposed bylaw amendment requiring stockholder approval prior to the board adopting various anti-takeover measures).

Please feel free to contact any of the partners listed below or any corporate partner with whom you work if you would like to discuss this opinion or its potential ramifications.

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