

Client Alert

An informational newsletter from Goodwin Procter LLP

Delaware Supreme Court Invalidates Bylaw Mandating Expense Reimbursement in Contested Elections

On July 17, 2008, the Delaware Supreme Court decided *CA, Inc. v. AFSCME Employees Pension Plan* and addressed a proposed bylaw mandating the reimbursement of expenses for contested elections of less than all directors (*i.e.*, a “short slate”). The court held that, although a proper subject for stockholder action, the proposed bylaw, as drafted would violate Delaware law. More importantly, the court articulated some principles to assist corporations in assessing the permissibility, in general, of stockholder proposed bylaws, and, in specific, of mandatory expense reimbursement in the context of contested elections.

Background

AFSCME, a union pension plan and a stockholder of CA, submitted a proposed bylaw for inclusion in CA’s proxy statement. The proposed bylaw mandated that CA reimburse the reasonable expenses of stockholders nominating directors in a contested election “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 [of such] candidates . . . are elected . . . , (c) stockholders are not permitted to cumulate their votes for directors, and (d) the election occurred, and the Expenses were incurred, after th[e] bylaw’s adoption.” The stated intent of the bylaw was to encourage stockholder participation in the director selection and election process by removing one deterrent to contested elections of less than 50% of the directors. A similar bylaw is unnecessary when more than a majority of the board is replaced because, if successful, the new board controls the decision to reimburse their own expenses.

CA requested a “no action” letter from the Securities and Exchange Commission to allow it to omit the proposal from its proxy statement under SEC Rule 14a-8 on the basis (i) that the proposed bylaw was not a proper subject for stockholder action and (ii) that, if implemented, the bylaw would violate Delaware law. AFSCME disagreed and both parties submitted legal opinions supporting their position. Faced with two directly conflicting legal opinions, the SEC used the Delaware Supreme Court’s certification procedures for the first time and sought guidance on the following two questions of Delaware law:

1. Is the proposed bylaw a proper subject for action by stockholders as a matter of Delaware law?
2. Would the proposed bylaw, if adopted, cause CA to violate any Delaware law to which it is subject?

A Proper Subject for Stockholder Action?

The court began by noting that Delaware General Corporation Law (“DGCL”) §109(a) expressly grants both the board and the stockholders the independent power to adopt, amend and repeal corporate bylaws. However, the court found that the stockholders’ power is not coextensive with the board’s power and is limited by DGCL §141(a), which embodies the “cardinal precept” of Delaware law that the board, not the stockholders, manages the business and affairs of the corporation. In general, stockholders may not exercise their power in a manner that encroaches on the board’s authority to manage the corporation.

After acknowledging the difficulty of delineating “with doctrinal exactitude” the scope of stockholder power in all cases, the court drew a distinction between restrictions on board authority that are “procedural” and those that are “substantive,” *i.e.*, that eliminate the board’s discretion and compel a specific result. In the court’s view, the proper function of bylaws is to define the process and procedures by which substantive business decisions are made, not to dictate the decision itself. Making business decisions relating to the management of the corporation is the core function of the board, and, thus, the exclusive province of the board.

Turning to AFSCME’s proposal, the court observed that both the intent and expected effect of the proposed bylaw relate to the process for electing directors. The court further emphasized the legitimate and protected interest that stockholders have in exercising their voting rights in director elections. Procedures that encourage candidates other than board-sponsored nominees to seek director seats support that interest by facilitating the stockholders’ participation in selecting the candidates. On that basis, the court concluded that AFSCME’s proposed bylaw was a proper subject for stockholder action under Delaware law.

Violation of Delaware Law?

Although not in violation of a specific statutory provision of Delaware law, the court determined that, as drafted, the proposed bylaw would violate the common law prohibition against contracts restraining a board from fully discharging its fiduciary duties, citing precedent in the context of “no shop” covenants and “slow hand” poison pills. By removing the decision to reimburse proxy expenses entirely from the board’s discretion, the proposed bylaw compels expense reimbursement even in those situations where the board’s fiduciary duties could preclude it from making that decision. Those situations are real possibilities, as Delaware law allows a board to reimburse proxy expenses “[w]here the controversy is concerned with a question of policy as distinguished from personnel o[r] management.” However, as the court noted, where a 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 fiduciary duties of the directors may compel the board to deny reimbursement. A bylaw provision addressing reimbursement of proxy expenses would need to reserve the board’s full power to exercise its fiduciary duty to decide if reimbursement is appropriate in each specific case.

The fact that the limitation would be imposed by stockholders, as opposed to the board itself as in the cited precedents, did not, in the court's view, change the scope of the board's managerial power and responsibility. The court, however, did indicate that the inclusion of a provision such as AFSCME's proposed bylaw in the certificate of incorporation would not violate Delaware law and legitimately limit the board's authority, as limits on board authority may be contained in the certificate pursuant to DGCL §141(a).

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