KEEPING "FIDUCIARY OUTS" OUT OF SHAREHOLDER-PROPOSED BYLAWS: AN ANALYSIS OF *CA, INC. V. AFSCME*

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The question of whether shareholders can amend bylaws to give themselves increased access to the ballot or greater opportunities to nominate board members falls in the middle of an ongoing debate over how control of the corporation should be allocated between shareholders and directors. The issue also highlights the potential for conflict between two seemingly clear statutory rights: the shareholders' right to amend bylaws under DGCL § 109, and the board's right to manage the corporation under DGCL § 141(a). This Note examines the CA, Inc. v. AFSCME *opinion of the Delaware Supreme Court in order to (1) look at the extent to which § 141(a) limits § 109 in this context, and (2) discuss why fiduciary outs should not be required in shareholder-proposed bylaws, particularly in light of the 2009 amendments to the DGCL explicitly authorizing Delaware corporations to adopt proxy access and proxy expense reimbursement bylaws.*

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INTRODUCTION

The power struggle between shareholders and directors is nothing new in corporate law, and academics have weighed in heavily on both sides of the debate.[1] Leading the pack in support of shareholder empowerment is Lucian Bebchuk, who argues that shareholders should have greater access to the ballot and an increased ability to control the balance of power be-

1. *See generally*, J.W. Verret, *Pandora's Ballot Box, Or a Proxy with Moxie? Majority Voting, Corporate Ballot Access, and the Legend of Martin Lipton Re-Examined*, 62 BUS. LAW. 1007, 1021-29 (2007) (providing a brief history of the "tug of war between managers and shareholders").

tween themselves and management.[2] On the directors' side, Martin Lipton has long advocated a pro-management stance,[3] Stephen Bainbridge has advanced his "director primacy" theory,[4] and several academics and practitioners alike have pushed back against Bebchuk's recent proposals.[5] The present focus of the debate is on shareholder efforts to gain more control over the election process, and this power struggle is currently being played out in the bylaw context.

So which side is right? Who *should* be making important corporate decisions that will affect how a company is run? Should shareholders, as owners of the corporation, have the power to adopt bylaws that could potentially impinge upon managerial power, or should directors have unfettered discretion to run the corporation as they see fit so long as they comply with their fiduciary duties and act in what they believe to be the best interests of the company?

In *CA, Inc. v. AFSCME Employees Pension Plan*,[6] the Delaware Supreme Court recently made its view known on an important battleground in the debate over corporate control—shareholder adopted bylaws regulating the process for electing directors. The Delaware Supreme Court held that bylaws mandating reimbursement of expenses in contested election contests are a proper subject for shareholder action, but not without a "fiduciary out."[7] The Delaware legislature has since re-

2. *See, e.g.*, Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005); Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675 (2007).

3. *See, e.g.*, Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979).

4. Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 STAN. L. REV. 791 (2002) ("In contrast [to the principle of shareholder primacy, . . .] corporate law is better understood as a system of director primacy in which the board of directors is not a mere agent of the shareholders, but rather is a sort of Platonic guardian serving as the nexus of the various contracts making up the corporation.").

5. *See, e.g.*, Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733 (2007); Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561 (2006); Stephen M. Bainbridge, *Director Primacy & Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006).

6. 953 A.2d 227 (Del. 2008).

7. A fiduciary out is an "anomalous contract provision[ ] that generally provide[s] an escape hatch to a target corporation from performing some contractual undertaking meant to advance the closing of an acquisition

sponded by amending the Delaware General Corporation Law ("DGCL"), essentially codifying the first part of the *AFSCME* opinion and explicitly authorizing bylaws relating to proxy access and reimbursement of election expenses. The new DGCL amendments, however, make no mention of fiduciary outs. This leaves open two questions. The first is what *AFSCME* suggests about the permissible scope of future shareholder adopted bylaws. The second is how courts should handle fiduciary outs in the bylaw context in the future.

This paper attempts to answer both of those questions. First, it examines the fine line between what has historically been considered a proper subject for corporate bylaws and what has not. It then attempts to determine where the limits on the scope of shareholder-proposed bylaws may lie in the future. Moreover, this paper addresses how such bylaws should be written where there is the possibility of future conflict between the board's right to manage under Section 141(a) of the DGCL and the mandate of a proposed bylaw. Specifically, in light of the Delaware Supreme Court's decision in *CA, Inc. v. AFSCME*, which seems to suggest that a "fiduciary out" clause can cure the defects that might otherwise plague a shareholder-proposed bylaw with the potential to interfere with a board's right to manage the company, I argue that a fiduciary out is not the answer. In fact, I take the position that it would be dangerous to introduce the concept of fiduciary outs into the bylaw context. This Note discusses the implications of expanding the use of fiduciary outs in such a manner.

The remainder of this Note is organized as follows. Part I provides an overview of the *AFSCME* opinion and the events leading up to the decision. Part II analyzes the Delaware Supreme Court's reasoning in coming to its decision that reimbursement of expenses is a proper subject for shareholder-proposed bylaws. This Part also discusses the amendments to the 2009 DGCL, looking at how these amendments potentially af-

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agreement." William T. Allen, *Understanding Fiduciary Outs: The What and the Why of an Anomalous Concept*, 55 BUS. LAW. 653, 653 (2000). More specifically, a fiduciary out allows the board of directors to terminate an agreement—typically a merger agreement—if completing the deal would cause the directors to violate their fiduciary duties (which would result, for example, if a more favorable bidder later emerged and proposed a superior transaction). For a more in depth discussion of fiduciary outs and their history and purpose, see *infra* at Part III.B.

fect the interpretation and impact of the court's decision on future shareholder proposals. Part III analyzes the court's reasoning as to whether the particular bylaw in question in *AFSCME* would be legal under Delaware law and challenges the validity of the court's conclusions—specifically, the court's suggestion of including a fiduciary out in the bylaw in order for it to be deemed valid. This Part briefly traces the history and purpose of fiduciary outs, focusing on the situations where they have been used and required in the past. Part III then goes on to suggest that using fiduciary outs in the shareholder bylaw context is inconsistent with the history and purpose of fiduciary out exceptions. Instead, this Note suggests that fiduciary outs were designed to protect shareholders in situations where a board could take action that would usurp the shareholders' choice—a danger that is not present in the shareholder-adopted bylaw context. Finally, Part IV considers the implications of the *AFSCME* decision and suggests where courts (and shareholders in drafting their bylaw proposals) should go from here.

I.
CA, Inc. v. AFSCME Employees Pension Plan

A. *Timeline and Factual Background*

On July 17, 2008, the Delaware Supreme Court issued its highly anticipated decision in *CA, Inc. v. AFSCME Employees Pension Plan.*[8] The case involved a shareholder-proposed bylaw that would require the board of CA, Inc. ("CA") to reimburse reasonable expenses for a dissident short slate[9] of directors in a proxy contest, provided that at least one of the nominees actually won the election. The text of the proposed bylaw read as follows:

> 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, in-

8. 953 A.2d 227 (Del. 2008).

9. That is, an election contest for less than half of the seats on the board.

> cluding, 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.[10]

AFSCME Employees Pension Plan ("AFSCME"), a shareholder of CA, submitted the proposed bylaw on March 13, 2008, to be included in CA's proxy materials for its 2008 annual meeting of stockholders. On April 18, 2008, CA's counsel sent a letter to the SEC's Division of Corporation Finance in an attempt to exclude the proposed bylaw from its proxy materials on various grounds under Rule 14a-8 of the Securities Exchange Act of 1934[11] and requesting a no-action letter.[12] CA attached an opinion from its local Delaware counsel, Richards, Layton, & Finger P.A., to the letter, stating that the

10. 953 A.2d at 230.

11. Exchange Act Rule 14a-8 allows companies to exclude certain shareholder proposals from their proxy materials if the proposal falls under one of the thirteen categories listed in the Rule. CA asserted that AFSCME's bylaw proposal could be excluded from CA's proxy materials under sections (i)(1), (i)(2), (i)(3), and (i)(8) of the Rule.

Rule 14a-8(i)(1) allows a proposal to be excluded if it is an improper subject for shareholder action;

Rule 14a-8(i)(2) allows for exclusion if the proposal, if adopted, would cause the company to violate any law to which it is subject;

Rule 14a-8(i)(3) allows for exclusion if the proposal conflicts with another Exchange Act Rule; and

Rule 14a-8(i)(8) allows for exclusion if the proposal relates to a procedure for the election of directors.

The SEC ultimately rejected CA's arguments to exclude under sections (i)(3) and (i)(8) of the Rule. For a discussion of Rule 14a-8(i)(8) and how it could apply to AFSCME's proposal, *see infra* at Part II.A.3. 17 C.F.R. § 240.14a-8 (2010).

12. No-action Request from CA's Counsel to the Division (Apr. 18, 2008), *available at* http://www.sec.gov/rules/other/2008/ca14a8cert_att-a.pdf [hereinafter "April 18 No-Action Request"].

proposal "is not a proper subject for stockholder action and, if implemented. . ., would violate the [DGCL]."[13] On May 21, 2008, AFSCME submitted a response to CA's no-action request, accompanied by an opinion from Grant & Eisenhofer P.A., counsel to AFSCME, stating that the bylaw "is valid under Delaware law" and that "Delaware law recognizes stockholders' ability to enact bylaws such as the one contained in [AFSCME's proposal]."[14]

On June 27, 2008, faced with conflicting interpretations of Delaware law from two respected Delaware law firms, the SEC certified two questions to the Delaware Supreme Court: (1) whether reimbursement of expenses is a proper subject for shareholder-adopted bylaws, and (2) whether the specific bylaw in question, if adopted, would violate Delaware law.[15] The court accepted the certified questions for review on July 1, 2008, and heard oral arguments in Dover, Delaware on July 9, 2008. A mere eight days later, the court issued its decision.[16]

B. *The Court's Decision*

The court answered both certified questions in the affirmative, determining that reimbursement of expenses is a proper subject for shareholder action, but that the specific proposal at issue would have violated Delaware law if adopted. As to the second question, the court reasoned that because there could be a hypothetical situation where reimbursement would cause the directors of CA to violate their fiduciary duties, the bylaw as written must be invalid under Delaware law. The court suggested, however, that if the bylaw contained a fiduciary out, it might be permissible. In other words, the court held that ex-

13. *Id.* at 13.

14. Response by AFSCME to the Division (including opinion from Grant & Eisenhofer P.A.), at 10-11 (May 21, 2008), *available at* http://www.sec.gov/rules/other/2008/ca14a8cert_att-b.pdf.

15. The SEC certified these questions pursuant to Article IV, Section 11(8) of the Delaware Constitution, which was amended in 2007 to authorize the Delaware Supreme Court to hear and determine questions of law certified to it by the SEC. This case represented the SEC's first certified questions to the court. 953 A.2d at 229 & n.1.

16. The case was tried on such an expedited basis because CA's annual meeting of shareholders was scheduled to be held on September 9, 2008, and CA intended to file its definitive proxy materials in connection with that meeting on or about July 24, 2008. 953 A.2d at 229.

pense reimbursement is a proper subject for bylaws in theory, but a bylaw mandating reimbursement is not permissible without a fiduciary out.

II.
ANALYZING THE COURT'S REASONING: IS PROXY EXPENSE REIMBURSEMENT A PROPER SUBJECT FOR SHAREHOLDER-PROPOSED BYLAWS?

The first question the court looked at is whether reimbursement of expenses is a proper subject for a shareholder-adopted bylaw, or "more precisely, whether the Bylaw may be proposed and enacted by shareholders without the concurrence of [CA's] board of directors."[17]

Under DGCL § 109(a) and CA's Certificate of Incorporation, both the shareholders and the board of CA have the power to adopt, amend, or repeal the company's bylaws.[18] The *AFSCME* court concluded, however, that § 109 does not permit *all* bylaw amendments. It is constrained by DGCL § 141(a), which provides that the business and affairs of the company shall be managed by or under the direction of the board of directors.[19] The court held that "the shareholders' statutory power to adopt, amend or repeal bylaws is not coex-

17. *Id.* at 231. The court makes this more precise distinction because if both the shareholders *and* CA's board wanted to adopt this proposal, they could amend the Certificate of Incorporation to do so. Both parties, including CA's counsel, agreed to this point at oral argument.

> **Justice**: Suppose. . . the exact same bylaw were made part of the Certificate of Incorporation. Would your position be the same?
> **Mr. Guiffra**: Then it would be absolutely permissible.
> **Justice**: So if the shareholders acting alone—that is, without concurrent director approval—adopt this bylaw, your position is that that contravenes Delaware law. Similarly, if the directors were to do the same thing, that would contravene Delaware law. But if the directors and the shareholders acting together voted to adopt this bylaw as part of the Certificate of Incorporation, that would be alright?
> **Mr. Guiffra**: Yes.

Transcript of Oral Argument (on file with author), audio *available at* http://courts.delaware.gov/courts/Supreme%20Court/oral%20arguments/2008-07-09_329,_2008_CA_v_AFSCME.MP3. The difference, according to Mr. Guiffra, is that in the Certificate of Incorporation, it is permissible to limit the board's power under DGCL § 102. Such limitation, however, is not permissible in the bylaws.

18. *See* DEL. CODE ANN. tit. 8, § 109(a).

19. DEL. CODE ANN. tit. 8, § 141(a).

tensive with the board's concurrent power and is limited by the board's management prerogatives under Section 141(a)."[20] Thus, there are certain situations in which the board's managerial authority necessarily trumps shareholder power with respect to bylaws.

In order to decide whether the subject of the bylaw at issue was proper under Delaware law, the court first had to determine: (1) the scope of the shareholders' power to adopt, change, or repeal bylaws permitted under DGCL § 109 without impermissibly intruding upon the directors' power to manage under § 141(a), and (2) whether the proposed bylaw at issue fell within that permissible scope, based on Delaware precedent and the DGCL.[21]

A. *The Scope of Permissible Shareholder-Adopted Bylaws*

1. *DGCL § 109 vs. DGCL § 141(a): Process vs. Substance*

In determining the scope of permissible shareholder bylaws under DGCL §§ 109 and 141(a), the court drew on Delaware's well-established distinction between process-oriented and substance-oriented bylaws: "[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."[22] To support this assertion, the court points to Court of Chancery language stating that "there is a general consensus that bylaws that regulate the process by which the board acts are statutorily authorized."[23] Such statutorily authorized, process-oriented permissible bylaws include, for example, bylaws that "fix the number of directors on the board,. . . preclude board action without a meeting,. . . regulate notice requirements,. . . and [even require] the presence of all directors and unanimous board consent to take action."[24]

Bylaws that are typically not permissible because they go to substantive business decisions of the board include those

20. 953 A.2d at 232.
21. *Id.* at 232-33.
22. *Id.* at 234-35.
23. *Id.* at 235 (citing Hollinger Int'l, Inc. v. Black, 844 A.2d 1022, 1078-79 (Del. Ch. 2004), *aff'd* 872 A.2d 559 (Del. 2005)).
24. *Id.* at nn.17-18 & accompanying text.

limiting a board's power to adopt poison pills[25] and shareholder bylaws mandating the expenditure of corporate funds.[26] However, the fact that implementation of a proposed bylaw "would require the expenditure of corporate funds will not, in and of itself, make such a bylaw an improper subject matter for shareholder action."[27] The court in *AFSCME* pointed to examples of other permissible situations where a process-oriented bylaw may require expenditure of corporate funds, such as a bylaw requiring that all board meetings take place in person at the corporation's headquarters, which could inevitably require the corporation to expend funds to reimburse the directors for their travel expenses.[28]

Accordingly, some bylaws can involve both process-oriented *and* substantive decisions of the board. Reimbursement of election expenses appears to be such a situation—it is substantive in that it involves the expenditure of corporate funds, which is typically a management decision, but it is also process-oriented in that it affects the process of director elections. The court in *AFSCME* held that in situations where a bylaw's subject matter may be both substantive and process-oriented (such as reimbursement), the fact that a bylaw requires the expenditure of corporate funds does not automatically make it substantive and deprive it of its process-related nature.[29] Rather, in such circumstances, "[w]hether or not a bylaw is process-related must necessarily be determined in light of its context and purpose."[30] If the context and purpose of the bylaw is found to be mostly process-oriented, it will likely be permissible,[31] while if the main purpose of the bylaw is to influence a substantive decision of the board, it may be excludable.

Additionally, a company can generally seek to exclude a proposal from its proxy materials if it falls within one of the

25. *See, e.g.*, Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281 (Del. 1998).

26. The expenditure of corporate funds is generally considered substantive because it is "traditionally a managerial judgment" and thus a decision that should be left to the board. *See AFSCME* Oral Argument (transcript on file with author).

27. 953 A.2d at 237.

28. *Id.* at 236.

29. *Id.*

30. *Id.* at 236-37.

31. *See id.* at 237.

categories specified in Exchange Act Rule 14a-8.[32] SEC no-action letters are merely advisory though, and if a shareholder pursues litigation, courts are not bound by the Division's no-action recommendation.[33]

2. *The AFSCME Bylaw—Process or Substance?*

In *AFSCME*, the court concluded that the bylaw at issue, "even though infelicitously couched as a substantive-sounding mandate to expend corporate funds, has both the intent and the effect of regulating the process for electing directors,"[34] and therefore is a proper subject for shareholder action. This is because the court believed that the context of the bylaw was the process for electing directors, and its main purpose was to "promote the integrity of that electoral process by facilitating the nomination of director candidates."[35] Thus, despite the fact that the bylaw would require the expenditure of corporate funds, it was a proper subject for shareholder action because it was primarily related to regulating the election process.

The court, however, appeared to muddy the distinction between process and substance in two respects. First, the key issue with AFSCME's bylaw as written is its mandatory nature: the board "*shall cause* the corporation to reimburse."[36] But although the bylaw is mandatory, it only calls for the reimbursement of *reasonable* expenses. This appears to leave the determination of what level of reimbursement is reasonable up to the board to make. At oral argument, Robert Guiffra, the attorney for CA, seemed to suggest that the mandatory nature of the bylaw ("shall cause") could not be reconciled with the reasonableness requirement of expenses to reimburse. When asked about his position, however, he conceded the following:

> **Justice**: So is it your position that reimbursement that's otherwise impermissible under Delaware law could still be a reasonable expense?

32. *See supra* at note 11.

33. *See, e.g.*, N Y. City Employees' Ret. Sys. v. Dole Food Co., 969 F.2d 1430, 1432 (2d Cir. 1992) (requiring inclusion of a shareholder-proposed precatory bylaw "request[ing]" that the board establish a committee to evaluate health care reform proposals, despite the fact that the Dole board had obtained a no-action letter from the SEC).

34. 953 A.2d at 235-36.

35. *Id.* at 237.

36. *Id.* at 230 (emphasis added).

Mr. Guiffra: I don't think it can be your honor.

Justice: Well then that answers the problem under the language of this bylaw.

Indeed. In other words, Mr. Guiffra takes the position that reimbursement that is otherwise impermissible under Delaware law could never be a reasonable expense, yet the board would still be required to expend money because the bylaw doesn't permit any sort of judgment. But, following that logic, since reimbursement for election expenses in a situation that was purely personal is not permissible under Delaware law, it would never be considered a reasonable expense. And if the reimbursement that would otherwise be impermissible under Delaware law is *not* reasonable (i.e. purely personal expenses), then the board should *not* have to pay it under the bylaw, regardless of its mandatory nature, since the language of the bylaw only requires the board to cause reimbursement of *reasonable* expenses. This clearly seems to be a substantive decision left to the board to determine, in which case the bylaw might be an excludable proposal. The court does not sufficiently clarify this issue.

Second, as noted above, the opinion tries to distinguish the decision to expend money from a substantive decision by establishing that what this bylaw actually regulates is the process for electing directors, because its purpose is to encourage the nomination of non-incumbent board candidates by promising them reimbursement of proxy expenses provided that one or more of the insurgent candidates is elected. The bylaw, however, necessarily regulates the substantive decision of whether to expend corporate money (and how much) because the mandatory language of the bylaw takes that decision out of the board's business judgment and makes it a requirement. The idea that the main purpose of the bylaw regulates the process of director elections does not change the substantive nature of it. Thus, the court seems to be suggesting that in cases where a bylaw is both process-oriented and regulates substantive board decisions, the one that is greater (process or substance) in terms of the context and purpose of the bylaw is ultimately more important, and will determine whether the bylaw can be excluded. In effect, this makes careful drafting of bylaws critically important to their ultimate validity, because bylaws that deal with substance but are *more* process-oriented will be allowed, despite the fact that they may regulate substan-

tive decisions of the board as well, and vice versa (bylaws that regulate process but are *more* substantive may be excluded, even though they deal with process).

3. *Exchange Act Rule 14a-8(i)(8)*

Alternatively, if AFSCME's bylaw does in fact regulate a process decision relating to the election of directors (that is, the bylaw is related to the *process of elections*), it seems that the bylaw could have been excludable from CA's proxy materials under Exchange Act Rule 14a-8(i)(8). In 2007, the SEC amended the language of the rule to read that a proposal could be excluded:

> If the proposal relates to a nomination or an election for membership on the company's board of directors or analogous governing body or a procedure for such nomination or election.[37]

The final iteration of the rule went on to clarify the term "procedure" as used in the election exclusion to mean: "relat[ing] to procedures that would result in a contested election either in the year in which the proposal is submitted or in any subsequent year."[38] This amendment goes against, and was in fact proposed in response to, a 2006 decision suggesting that the Rule only allowed companies to exclude proposals that would result in immediate election contests.[39]

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37. Shareholder Proposals Relating to the Election of Directors, Final Rule, 72 Fed. Reg. 70,450, 70,453-54 (Dec. 11, 2007).

38. *Id.*

39. *Id.* (citing AFSCME v. AIG, 462 F.3d 121, 128 (2d Cir. 2006)). In that case, the bylaw at issue would have required the company, AIG, to include certain shareholder-nominated candidates in its proxy statement. AIG obtained a no-action letter from the SEC, but the Second Circuit held that a proposal could not be excluded under Rule 14a-8(i)(8) if it established "a process for shareholders to wage a future election contest," as opposed to an immediate election contest. *AFSCME v. AIG*, 462 F.3d at 128. By adopting this Final Rule, the SEC was in effect reaffirming its long-standing interpretation of Rule 14a-8(i)(8) to be that it allows a company to exclude a shareholder proposal if it would either result in an immediate election contest, or if it would establish a process for a future election contest—that is, a company may exclude any proposal that could result in an election contest from its proxy materials under Rule 14a-8(i)(8). Thus, if AFSCME's proposal relates to CA's "process for electing directors," as the Delaware Supreme Court suggests, and it has the effect of encouraging more people to challenge the incumbent board (i.e. "result[ing] in a contested election. . . in any subse-

In fact, CA did attempt to exclude the bylaw from the company's proxy materials on this ground. Providing no explanation, the SEC's Division of Corporation Finance rejected CA's request, simply stating that "[t]he Division does not concur in CA's view that CA may exclude the proposal from its proxy materials in reliance on Rule 14a-8(i)(3) or Rule 14a-8(i)(8)."[40]

The SEC may have denied the no-action request as to Rule 14a-8(i)(8) because of a footnote in the Final Rule noting that "the [SEC] staff has taken the position that a proposal may not be excluded under Rule 14a-8(i)(8) if it relates to. . . [r]eimbursement of shareholder expenses in contested elections,"[41] among other things. The AFSCME bylaw, however, arguably falls under the Rule because it would "facilitate stockholder efforts to contest director elections . . . by creating a procedure for funding those contests when the proposed criteria are met[, and] its principal effect would be [ ] to make election contests more likely."[42] Essentially, by including that footnote making clear that 14a-8(i)(8) explicitly did *not* exclude proposals relating to reimbursement of expenses in contested elections, the SEC was allowing states to decide whether such proposals would be excludable or not excludable under state law. That is, the SEC was allowing Delaware to decide the issue via the certification process and under Rule 14a-8(i)(1) and (2), and not interfering with that decision. Still, it would have been helpful if the SEC had provided a reason for rejecting CA's argument under 14a(8)(i)(8).

B. *The 2009 Amendments to the DGCL*

In any event, the answer to the first *AFSCME* question—whether reimbursement of proxy expenses is a proper subject for shareholder bylaws—is essentially moot as a result of the recently adopted amendments to the DGCL that created two

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quent year"), it seems that it would fall under this Rule and should be excludable under Rule 14a-8(i)(8). *CA, Inc. v. AFSCME*, 953 A.2d at 233, 236, 237.

40. SEC Certification of Questions of Law Arising from Rule 14a-8 Proposal by Shareholder of CA, Inc. at 2 (June 27, 2008), *available at* www.sec.gov/rules/other/2008/ca14a8cert.pdf.

41. Shareholder Proposals Relating to the Election of Directors, 72 Fed. Reg. at 70,454 n.56.

42. April 18 No-Action Request at 4-5.

new Sections explicitly allowing corporations to adopt bylaws regarding proxy access and expense reimbursement.

Sections 112 and 113, along with several other proposed amendments to the DGCL, were introduced to the Judiciary Committee of the Delaware General Assembly on March 10, 2009.[43] House Bill #19 was passed by the Delaware House of Representatives on March 18, and by the Senate on April 8, 2009. It was signed by the Governor on April 10, 2009, and went into effect on August 1, 2009.[44]

The first of the amendments added a new section to the DGCL, Section 112, regarding shareholder access to proxy solicitation materials. Specifically, Section 112 addresses shareholders' ability to get their nominees on the corporation's proxy by allowing corporations to adopt a bylaw that would require inclusion of one or more shareholder nominees in its proxy, subject to certain conditions (including "[a]ny other lawful condition").[45] This seems to narrow the exclusions allowed under Exchange Act Rule 14a-8(i)(8).[46]

Moreover, a second new section, Section 113, addresses the reimbursement of proxy solicitation expenses. Specifically, it allows corporations to adopt a bylaw "provid[ing] for the reimbursement by the corporation of expenses incurred by a stockholder in soliciting proxies in connection with an election of directors, subject to such procedures or conditions as the bylaws may prescribe."[47] Such conditions may include:

> (1) Conditioning eligibility for reimbursement upon the number or proportion of persons nominated by the stockholder seeking reimbursement or whether such stockholder previously sought reimbursement for similar expenses;
>
> (2) Limitations on the amount of reimbursement based upon the proportion of votes cast in favor of one or more of the persons nominated by the stock-

43. H.B. 19, An Act to Amend Title 8 of the Delaware Code Relating to the General Corporation Law, 145th Gen. Assem. (Del. 2009).

44. *See* http://www.legis.delaware.gov/LIS/LIS145.nsf/vwLegislation/HB+19?Opendocument.

45. DEL. CODE ANN. tit. 8, § 112 (effective Aug. 1, 2009).

46. That is, certain proposals that may have seemed excludable under Rule 14a-8(i)(8) will now be explicitly allowed to be included in Delaware under Section 112 of the DGCL.

47. DEL. CODE ANN. tit. 8, § 113(a) (effective Aug. 1, 2009).

holder seeking reimbursement, or upon the amount spent by the corporation in soliciting proxies in connection with the election;
(3) Limitations concerning elections of directors by cumulative voting pursuant to § 214 of this title; or
(4) Any other lawful condition.[48]

This Section most certainly allows bylaws simply dealing with the subject of expense reimbursement (regardless of the second *AFSCME* question—whether the bylaw would violate any common law rule or precept). Moreover, it would seem to explicitly allow bylaws such as the one proposed by AFSCME. AFSCME's bylaw (1) conditioned eligibility for reimbursement upon the number of persons nominated, as it would only reimburse a short slate; (2) it limited the amount of reimbursement based on a proportion of votes in favor of one or more of the nominees, since at least one of the nominees was required to win, and it also limited reimbursement to the amount spent by CA itself, and (3) it did not allow for cumulative voting.

There is no mention of a "fiduciary out" requirement in Section 113. Accordingly, "[i]t remains to be seen whether, notwithstanding the express statutory authority for a proxy reimbursement bylaw provided by Section 113, Delaware courts will read a fiduciary out requirement into such a bylaw."[49] This Note suggests that they should not.

As an initial matter, the adoption of Section 113 raises an issue with respect to the fiduciary out requirement in *AFSCME*. That is, whether, now that bylaws relating to reimbursement of expenses are explicitly allowed by Delaware statute, it is reasonable to think that courts *need to* read a fiduciary out re-

48. *Id.*

49. Posting of Mark A. Morton to The Harvard Law School Forum on Corporate Governance & Financial Regulation, http://blogs.law.harvard.edu/corpgov/2009/02/28/proposed-amendments-to-the-delaware-general-corporation-law-2/ (Feb. 28, 2009, 4:24 pm EST). *See also, e.g.*, Duane Morris LLP, Client Alert, *2009 Amendments to the Delaware General Corporation Law Address Corporate Governance, Focus on Stockholder Rights* (Apr. 22, 2009), *available at* http://www.duanemorris.com/alerts/alert3234.html ("Notably, the amendments do not expressly require that a bylaw adopted under Section 113 contain a fiduciary out. It is unclear whether the Delaware courts would read a fiduciary-out standard into such a bylaw or invalidate bylaws adopted pursuant to Section 113 if they do not contain a fiduciary out.").

quirement into Section 113, given that the General Assembly did not include one in the statute. The answer seems to be a simple one: if a case has decided something (namely, the court here held that reimbursement of expenses is a proper subject for shareholder bylaws, but only if the bylaw includes a fiduciary out), and the legislature adopts a statute that is broader than that holding (i.e. reimbursement of expenses is a proper subject, with no mention of a fiduciary out requirement), statutory interpretation does not require reading a fiduciary out into the statute.[50] Moreover, fiduciary out requirements are not read into other sections of the DGCL,[51] so it is particularly unlikely that requiring a fiduciary out is necessary in this situation. Thus, the absence of a fiduciary out requirement in the statute speaks for itself. In any event, this Note suggests that the court should not have required a fiduciary out in the first place.

III.
THE SCOPE OF THE RIGHT: FIDUCIARY OUTS

A. *Would the AFSCME Proposal, If Adopted, Cause CA to Violate Delaware Law?*

In answering the second question (whether the AFSCME proposal, if adopted, would cause CA to violate Delaware law), the Delaware Supreme Court held that because hypothetical circumstances exist where the board could be in breach of its fiduciary duties by complying with the bylaw, the bylaw was not valid under Delaware law. Specifically, the bylaw, "as drafted, 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."[52] More explic-

50. *See, e.g.*, 2A Sutherland Statutory Construction § 46:6 (7th ed. 2007) ("While every word of a statute must be presumed to have been used for a purpose, it is also the case that every word excluded from a statute must be presumed to have been excluded for a purpose.").

51. For example, fiduciary outs are not currently required to be used in conjunction with mandatory indemnification provisions statutorily allowed for under Section 145.

52. CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227, 238 (Del. 2008).

itly, the court spelled out that, "in order for the Bylaw not to be 'not inconsistent with law'. . . it would also need to contain a provision that reserves the directors' full power to discharge their fiduciary duties."[53] In other words, a fiduciary out.

The hypothetical set of facts that forced the court to find that the bylaw in question violated Delaware law was a situation in which the bylaw was adopted, an insurgent ran for purely personal reasons and won, and the board was required to reimburse him. This would be problematic because in the absence of a mandatory bylaw, the board would not reimburse for purely personal reasons; instead, reimbursement would only be proper if policy reasons were implicated. That is because, "[u]nder Delaware law, a board may expend corporate funds to reimburse proxy expenses '[w]here the controversy is concerned with a question of policy as distinguished from personnel o[r] management.' But 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."[54] Stated differently, reimbursement for proxy expenses involving a contest over matters of corporate policy is permissible, but absent that (i.e. if the contest is motivated by purely personal reasons), reimbursement may be impermissible under Delaware law.

Notwithstanding the fact that Michael Barry, the attorney for AFSCME, stated in oral argument that he "personally cannot fathom a situation where a director nominated by shareholders is elected for other than policy reasons,"[55] in which case a fiduciary out would arguably be unnecessary, the court focused on this set of hypothetical facts. Thus, the second question was decided essentially in the abstract, with the Justices recognizing that in the real world (as opposed to this theoretical case in which no particularized facts were involved) there will be litigation involving concrete sets of facts, and future cases will be decided based on specific sets of facts.[56]

53. *Id.* at 236 n.20.

54. *Id.* at 240 (footnotes omitted).

55. *See AFSCME* Oral Argument (July 9, 2008) (transcript on file with author).

56. Justice Jack B. Jacobs, Del. Sup. Ct., Comments at Harvard Law School (Dec. 1, 2008) (transcript on file with author).

In coming to its conclusion that a fiduciary out might be the answer, the court analogized the case at bar to other cases where it had "previously invalidated contracts that would require a board to act or not act in such a fashion that would limit the exercise of their fiduciary duties."[57] Namely, the court discussed its reasoning used in *Paramount Communications, Inc. v. QVC Network, Inc.*[58] and *Quickturn Design Systems, Inc. v. Shapiro.*[59] In Chancellor Chandler's words, "[g]enerally speaking, these cases[, along with *Omnicare v. NCS Healthcare, Inc.*,[60]] stand for the proposition that a contract is unenforceable if it would require the board to refrain from acting when the board's fiduciary duties require action."[61]

In *QVC*, the Delaware Supreme Court invalidated deal protection measures including a no-shop provision in a merger agreement with a favored bidder because they precluded the target board from negotiating with a competing bidder who was offering the shareholders more money for their shares. This implicated the directors' fiduciary duties because the case involved a change of control (specifically, a sale of the control premium), which invoked the board's *Revlon* duties to get the best price reasonably available for shareholders.[62] The court reasoned, "[t]o the extent that a contract. . . purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable."[63] Similarly, in *Quickturn*, the court invalidated a poison pill that had a delayed redemption provision which would prevent a newly-elected board from redeeming the pill for six months because it would "impermissibly deprive any newly elected board of both its statutory authority to manage the corporation under [DGCL § 141(a)] and its concomitant fiduciary duty pursuant to that statutory mandate."[64]

57. *AFSCME*, 953 A.2d at 238.

58. 637 A.2d 34 (Del. 1994).

59. 721 A.2d 1281 (Del. 1998).

60. 818 A.2d 914 (Del. 2003).

61. Unisuper Ltd. v. News Corp., No. 1699-N, 2005 WL 3529317, at *7 (Del. Ch. Dec. 20, 2005).

62. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings Inc., 506 A.2d 173 (Del. 1986).

63. *QVC*, 637 A.2d at 51.

64. *Quickturn*, 721 A.2d at 1291.

Applying the reasoning used in *QVC* and *Quickturn* to AFSCME's proposed bylaw, the court held:

> Both *QVC* and *Quickturn* involved binding contractual arrangements that the board of directors had voluntarily imposed upon themselves. This case involves a binding bylaw that the shareholders seek to impose involuntarily on the directors in the specific area of election expense reimbursement. Although this case is distinguishable in that respect, the distinction is one without a difference. . .
>
> [The proposed bylaw in this case] would also 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. That this limitation would be imposed by a majority vote of the shareholders rather than by the directors themselves, does not, in our view, legally matter.[65]

The problem with that reasoning, however, is that the distinction may in fact be one *with* a difference. The key difference is that in the merger context, the shareholders are potentially facing the most important thing that can happen to them as shareholders of a publicly held firm—being cashed out of the company. A fiduciary out in that situation guarantees that the board cannot absolutely lock up a deal without allowing the shareholders to vote on it and have the opportunity to reject it. Moreover, the fiduciary out there prevents the board from tying the shareholders' hands; here, the shareholders are tying their own hands. To understand why this distinction matters, it is instructive to look at how the concept of fiduciary outs developed in corporate contracts, and where fiduciary outs have been used in the past.[66]

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65. CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227, 239 (Del. 2008).

66. *See also* Sample v. Morgan, 914 A.2d 647, 672 n.79 (Del. Ch. 2007) (explaining that the *Quickturn* and *Omnicare* "decisions were rendered in cases involving board conduct in the mergers and acquisitions context, in which the concern arises that directors may seek to restrict their own authority (or that of their successors) in order to retain control or favor a particular bidder. The Delaware General Corporation Law does not contain provisions that prevent directors from entering into contracts with third-parties for legitimate reasons simply because those contracts necessarily impinge on the

B. *Tracing the History and Purpose of Fiduciary Outs*

Are fiduciary outs the answer? Do they provide a simple way to fix bylaws that cross the line into directors' managerial authority? Looking to the history of fiduciary outs, including the context of and justifications for why they have been used in the past, this paper suggests not. Former Chancellor William Allen defined fiduciary outs as "anomalous contract provisions that generally provide an escape hatch to a target corporation from performing some contractual undertaking meant to advance the closing of an acquisition agreement."[67] In particular, they "allow[ ] the directors of one party to terminate a merger agreement if their fiduciary duties require them to do so, usually where a subsequent bidder proposes what the directors believe to be a superior transaction. The purpose of a fiduciary out is to ensure that the directors are able to obtain the best transaction for the company's shareholders."[68] In light of this, fiduciary outs have been used in the past solely in the merger context or circumstances that involve extinguishing shareholder ownership interest in a company—situations where the board, although perhaps acting in what it believes to be the best interest of the shareholders, could ultimately usurp the shareholders' choice.[69]

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directors' future freedom to act. If the judiciary invented such a per se rule, directors would be rendered unable to manage, because they would not have the requisite authority to cause the corporation to enter into credible commitments with other actors in commerce").

67. William T. Allen, *Understanding Fiduciary Outs: The What and the Why of an Anomalous Concept*, 55 BUS. LAW. 653, 653 (2000).

68. Dennis J. Block & Jonathan M. Hoff, *Protective Provisions, Fiduciary Outs in Merger Agreements*, N.Y.L.J., Aug. 24, 2000.

69. *Id.* ("Although there is no statutory requirement for a merger agreement to contain a fiduciary out, such provisions have been routinely included in merger agreements since the landmark decision in *Smith v. Van Gorkom*.") For some examples of Delaware cases since 1985 where fiduciary outs have been used or required, see, e.g., Barsky v. Flaherty, 1987 WL 33981 (Del. Ch. Dec. 30, 1987); In re Holly Farms Corp. S'holders Litig., 564 A.2d 342, (Del. Ch. 1989); In re MCA, Inc., 598 A.2d 687 (Del. Ch. 1991); Ace Ltd. v. Capital Re Corp., 747 A.2d 95 (Del. Ch. 1999); In re IXC Commc'ns, Inc. v. Cincinnati Bell, Inc., 1999 WL 1009174 (Del. Ch. Oct. 27, 1999); In re Lukens Inc. S'holders Litig., 757 A.2d 720 (Del. Ch. 1999); McMillan v. Intercargo Corp., 768 A.2d 492 (Del. Ch. 2000). All of these cases took place in the merger context.

Probably the most well-known case (and one of the most hotly contested) on fiduciary outs in Delaware is *Omnicare v. NCS Healthcare, Inc.*[70] In that case, the Delaware Supreme Court reversed a decision of the Delaware Court of Chancery and held that the board of NCS Healthcare "was required to contract for an effective fiduciary out clause to exercise its continuing fiduciary responsibilities to the minority stockholders."[71]

As a result of the *Omnicare* decision, directors of Delaware corporations cannot enter into a binding merger agreement without including an effective fiduciary out clause allowing the corporation to terminate the deal if a better one emerges, or to make sure that the shareholders retain their ability to vote down the original agreement.[72] To clarify when a fiduciary out might be necessary, the Delaware Supreme Court in *Omnicare* explained, "[m]erger agreements involve an ownership decision and, therefore, cannot become final without stockholder approval. *Other contracts do not require a fiduciary out clause* because they involve business judgments that are within the *exclusive* province of the board of directors' power to manage the affairs of the corporation."[73]

The *Omnicare* decision was met with considerable backlash and criticism for requiring a fiduciary out, even in the merger

70. 818 A.2d 914 (Del. 2003).

71. *Id.* at 939. The case involved a merger agreement between NCS and Genesis containing a "force the vote" provision requiring the NCS board to submit the merger to shareholder vote even if it no longer recommended the merger itself. The agreement also contained "lock up provisions" guaranteeing that more than a majority of the NCS shares would vote in favor of the merger. The dual effect of these mechanisms was that even if another bidder (Omnicare) appeared with a better offer, the Genesis deal would have to go to a shareholder vote, and the deal was guaranteed to get approval of a majority of the shareholders. Stated differently, the combination of requiring the board to submit the vote to shareholders, plus the voting agreements, meant that the NCS-Genesis deal was a "fait accompli." *Id.* at 936. From the minute the board signed the agreement, they knew that the Genesis deal would go through—any other proposal, no matter how superior, was "mathematically impossible." *Id.* Thus, the court held that this type of absolute lock-up of a deal was preclusive and coercive without a fiduciary out.

72. *See* Dennis J. Block, *Uncertainties Concerning the Validity of Lock-Up Agreements Without an Effective "Fiduciary Out" Clause*—Omnicare, PLI Contests for Corporate Control (2006).

73. 818 A.2d at 939 n.88 (emphasis added in part).

context.[74] Perhaps because of this backlash and the controversial place *Omnicare* holds in Delaware law, the Supreme Court did not once rely on or cite it in its *AFSCME* decision, notwithstanding its centrality in the decisional law on fiduciary outs.[75]

C. *Applying That History to* AFSCME*: Why Fiduciary Outs Should Not Be Introduced Into the Shareholder Bylaw Context*

As noted in Part III.B, fiduciary outs have until now been used solely in the merger context—circumstances where the

74. *See, e.g.*, Stephen Bainbridge, *Dead Hand and No Hand Pills: Precommitment Strategies in Corporate Law*, http://papers.ssrn.com/abstract=347089 (2003) (discussing the benefits of using precommitment strategies). While some people support the fiduciary out requirement, many corporate practitioners worried about the effect that invalidating absolute lock-ups *per se* would have on a board's ability to precommit. That is, precommitment itself can be valuable, and the *Omnicare* decision limits a board's ability to do so, which could have the result of taking some deals off the table entirely. In fact, *Omnicare* itself was such a situation—NCS was in dire financial straits and Genesis was its only option; it needed to lock up the deal or it would go bankrupt, and no other viable bid had emerged. As the dissent notes, had NCS not agreed to Genesis's demand for certainty in closing the deal, "there would have been no Genesis deal!" 818 A.2d at 941. Thus, the dissent continued, "the only value-enhancing transaction available would have disappeared." *Id.* Indeed, the majority adopted the Chancery Court's findings that the NCS directors had acted in good faith and fulfilled their duties of care and loyalty by entering into the Genesis agreement. *Id.* at 940.

75. As Vice Chancellor Lamb hinted at in *Optima International of Miami v. WCI Steel, Inc.*, the *Omnicare* decision is itself "of questionable continued vitality." Transcript of Oral Argument on Plaintiff's Motion for Preliminary Inunction & Ruling of the Court at 127, Optima Int'l of Miami v. WCI Steel, Inc., C.A. No. 3833-VCL (Del. Ch. June 27, 2008). *See, e.g.*, Steven M. Davidoff, The Long, Slow Death of Omnicare, DealBook Blog, N.Y. TIMES, Aug. 28, 2008, http://dealbook.blogs.nytimes.com/2008/08/28/the-long-slow-death-of-omnicare/. Moreover, Chief Justice Steele, the current Chief Justice of the Delaware Supreme Court, was one of the two dissenters in the *Omnicare* opinion (the other was then-Chief Justice Veasey). It is likely that should a similar set of facts present themselves today, the results may be quite different. At the 2008 Annual Tulane University Corporate Law Institute, Vice Chancellor Lamb "issued an open call to the lawyers and investment bankers gathered [there] to find a way to challenge that precedent-setting decision. . .[proclaiming] 'If some of you in this room don't get some guts, we'll never get rid of *Omnicare*.'" Heidi N. Moore, *Judge to Deal Makers: Start Some Trouble. I Dare You. . .Please.*, Deal Journal, WALL ST. J., Apr. 3, 2009, http://blogs.wsj.com/deals/2009/04/03/judge-to-deal-makers-start-some-trouble-i-dare-youplease/ (quoting Lamb).

board was making a binding corporate decision that could affect the shareholders' ownership interest in the company. Accordingly, using fiduciary outs in the shareholder bylaw context is not the purpose for which fiduciary out exceptions were originally designed. As such, the *AFSCME* decision is troublesome because it introduces fiduciary outs into an area in which they have never been used before—namely, outside the context of a merger agreement or situation where shareholder interest in the company is being extinguished. In *AFSCME*, the shareholders were the ones voting to adopt this bylaw. Contrary to the court's analogy, this is not a situation like *Quickturn* or *QVC*. There are two key differences. First, previous cases suggesting the need for a fiduciary out involved situations where the board was binding itself, as opposed to a majority of shareholders binding the board to effectuate a shareholder desire. Here, the bylaw was being imposed on the board by the shareholders; the board was not binding itself to do something and taking that choice away from shareholders. Second, previous cases were exclusively in the merger context—where the shareholders could actually be cashed out of the company and lose their ownership interest. The *AFSCME* case, on the other hand, concerned a bylaw involving reimbursement of expenses, which, although admittedly could reach large sums of money and arguably could affect the election process, is quite different from divesting a shareholder's ownership interest entirely.

To understand why the first distinction—the fact that shareholders are binding the board as opposed to the board binding itself—matters in terms of a fiduciary out requirement, it is helpful to think about why fiduciary duties even exist:

> Fiduciary duties exist in order to fill the gaps in the contractual relationship between the shareholders and directors of the corporation. Fiduciary duties cannot be used to silence shareholders and prevent them from specifying what the corporate contract is to say. Shareholders should be permitted to fill a particular gap in the corporate contract if they wish to fill it. This point can be made by reference to principles of agency law. . . Where the principal wishes to make known to the agent exactly which actions the principal wishes to be taken, the agent cannot refuse

to listen on the grounds that this is not in the best interests of the principal.[76]

In *Unisuper v. News Corporation*, Chancellor Chandler went on to say that "[o]nce the corporate contract is made explicit on a particular issue, the directors must act in accordance with the amended corporate contract. There is no more need for the gap-filling role performed by fiduciary duty analysis."[77] Notably, that case involved the question of whether a contract between the board and shareholders that was *not* in the bylaws or the certificate could be upheld, but the reasoning is telling, and can be applicable to the bylaw context as well.[78] The language of the decision generated some controversy—three partners from Wachtell, Lipton, Rosen & Katz suggested that "[i]f the chancellor's words are taken broadly and literally, News Corp. fundamentally redefines what a director is by changing the allocation of power between shareholders and boards. . . any such 'directors are agents' theory is contrary to statute, contrary to controlling Delaware precedent, bad for shareholders and completely impractical as a corporate governance regime."[79] But Chancellor Chandler did not mean to significantly change Delaware law. Rather, he explained that "[h]e was referring to agency principles as a way of trying to rebut an argument by the defendant [in *News Corp.*] that the board was free at any point to enter into a contract with shareholders, and then reject it."[80] He continued, "[it] would be a strange thing to invoke your fiduciary duties as a sword to break a contract that you had made with shareholders."[81] Applying that reasoning to *AFSCME*, the idea of requiring fiduciary outs in shareholder-proposed bylaws does not seem to fit: the bylaw is something that the shareholders want, ex ante,

76. Unisuper Ltd. v. News Corp., No. 1699-N, 2005 WL 3529317, at *8 (Del. Ch. Dec. 20, 2005).

77. *Id.*

78. *See, e.g.*, JANA Master Fund, Ltd. v. CNET Networks, Inc., 954 A.2d 335, 338 (Del. Ch. 2008) ("[A] corporation's bylaws and charter are contracts among its shareholders.").

79. Theodore N. Mirvis, Paul K. Rowe, & William Savitt, *What is a Director?*, The Deal, Mar. 21, 2006.

80. Roy Harris, *Delaware Rules: Heated debates over governance, director independence, and executive pay will likely be resolved in Delaware's Chancery Court*, CFO MAGAZINE, Aug. 1, 2006, at 55, 58 (internal quotation marks omitted).

81. *Id.*

and that they are voting to bind the board to do. They do not need to be protected from their own decision in that situation.

As to the second distinction—that is, why the fiduciary out analysis changes when the context changes from situations where the shareholders are being cashed out of the company to the director election context—this distinction matters because the context of mergers is precisely why courts apply heightened scrutiny in those circumstances. Namely, in the context of mergers, defensive measures raise the "omnipresent specter" of entrenchment.[82] In the takeover context, directors face the fear of losing their jobs, so they may be directly interested in the transaction. Moreover, boards in those situations are taking actions that affect shareholders' ability to dispose of their property, so courts are less likely to allow boards to precommit to something that may not ultimately be in the best interest of the shareholders. Additionally, mergers are not 100% certain—it is nearly impossible to know exactly what will happen in the market or which other bidders may emerge after a deal is signed. Fiduciary outs allow boards a way out if they bind the company to an agreement that turns out not to be in the best interests of the shareholders. Shareholder-adopted bylaws on the other hand, including the bylaw at issue in *AFSCME*, do not pose the same threats of entrenchment, uncertainty, and limitation on the ability of shareholders to dispose of their property.

1. *Problems With Requiring a Fiduciary Out in* AFSCME

The problem with requiring a fiduciary out in *AFSCME*'s bylaw proposal is that a fiduciary out actually gives the board broader discretion to deny reimbursement than the bylaw otherwise permits. In other words, the difference between requiring a fiduciary out and requiring the board, ex ante, to reimburse insurgents for expenses incurred in contested elections relating to any matter of corporate policy[83] is that the fiduciary out appears to provide the board with more situations in which it would be able (perhaps even in which it would be required) to deny reimbursement. This is because if the bylaw itself mandates reimbursement except in purely personal situa-

82. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985).

83. *See infra* at IV.B for a suggestion of how to cure the defect in the bylaw directly rather than requiring a fiduciary out.

tions, justification for reimbursement is still ex ante. With a fiduciary out, however, the justification would be considered ex post. The board would essentially have to meet after the fact to consider every reimbursement. This would be problematic as there is almost always an ex post reason to deny reimbursement—namely, waste.[84]

Perhaps from the board's perspective, it would be better to have a fiduciary out because then it can come up with an ex post reason not to reimburse, but the presence of the fiduciary out could have a real effect on what the bylaw actually is intended to do, which is to reimburse in every situation where it is legal to reimburse.

Additionally, in almost every situation, whether the board does *or* does not reimburse, the board will be at increased risk of shareholder suit. For example, if the board does reimburse, the directors may be sued by a shareholder claiming that the reimbursement was in violation of the board's fiduciary duties. On the flip side, if the board does not reimburse because they believe (perhaps wrongly) that reimbursement would be in violation of their fiduciary duties, some shareholders may sue claiming that the board breached their duties under the bylaw.

2. *Problems With Requiring Fiduciary Outs in Bylaws Generally*

More broadly, it is important to examine how such a fiduciary out would be implemented, and where the limits of extending the context of fiduciary outs would be. For example, would this determination affect the board's ability to pre-commit in other contexts (i.e. with respect to *any* mandatory bylaw, or other binding contracts not involving a merger)? Consider the following hypotheticals:

a. Standard Corporate Contracts

Companies regularly enter into binding long-term contracts in order to lock in prices or guarantee certain goods and services. Suppose Company A entered into a contract with Company B to buy a certain number of widgets at a price of $10 per widget for five years, but then the market price of widgets dropped after the first year to $5 per widget. Could the board say that honoring the contract would cause them to

84. *See infra* at IV.D.

breach their fiduciary duties because they know that they can get less expensive widgets? Similarly, suppose Company A entered into a contract with Company B to buy widgets at $10 each for five years, but one year into the contract Company C offered to sell the same amount of widgets to Company A for $1 each for the remaining four years. Could Company A then breach its contract with the Company B if they had a fiduciary out in the contract? This would surely be impermissible, but it is difficult to determine just how far the limits of fiduciary out exceptions would go.

b. Mandatory Indemnification and Advancement Bylaws

More troublesome perhaps, is how this extension of the concept of fiduciary outs could potentially affect other mandatory bylaws, even those already in place. Consider mandatory indemnification and advancement bylaws, which are bylaws requiring indemnification (i.e. "*shall* indemnify"), typically of directors and officers. Corporations are consistently held to be bound by broad mandatory indemnification and advancement provisions.[85] Essentially, once a broad mandatory indemnification bylaw is in place, directors "will be deemed to have waived the opportunity to examine whether the extension of credit to a particular individual is in the corporation's best interests at the time of the request."[86] Delaware courts have enforced mandatory indemnification and advancement bylaws, "even if the board of directors believes the recipient of the advancements is a bad actor and that it would be a breach of the board's duties to provide the advancements."[87] Under the *AFSCME* analysis, however, this would be

85. See, e.g., N. Adele Hogan, Indemnification of Directors and Officers: New Developments in Advancement of Legal Fees to Directors and Officers With Practical Recommendations, Dec. 2008, available at http://www.whitecase.com/files/Publication/c46a9760-19e6-402b-9d48-cc8a3105ca65/Presentation/PublicationAttachment/382b3f12-8777-4603-b9c6-d58e46a865d2/alert_Indemnification_of_Directors_and_Officers.pdf ("[C]ourts tend to treat mandatory advancement provisions in bylaws or charters as contracts that should be interpreted according to their terms and, therefore, a corporation is likely to be held to its promises.") (discussing recent cases).

86. Joseph M. McLaughlin, *Indemnification Update for Directors' and Officers' Liability*, N.Y.L.J., June 17, 2008, *available at* http://www.law.com/jsp/ihc/PubArticleIHC.jsp?id=1202422291471.

87. Travis Laster, CA v. AFSCME: *The Delaware Supreme Court Giveth and the Supreme Court Taketh Away*, DealLawyers.com Blog (July 18, 2008), http://

impermissible because the bylaw would require the board to take action in breach of its fiduciary duties. Thus, "a board that advances funds pursuant to a mandatory advancement bylaw is now open to a claim that their fiduciary duties required them not to advance. . . [Similarly,] a board can argue that a mandatory advancement bylaw cannot trump its fiduciary duties, and therefore it has the discretion not to pay."[88]

In sum, a fiduciary out is the wrong approach both in the *AFSCME* case and in the bylaw context generally because it gives broader discretion to the board any time their fiduciary obligations are implicated—most problematically in situations such as with mandatory indemnification and advancement bylaws that are already in place, where the board otherwise would not have had to make a potential business decision every time it acts in the face of a mandatory bylaw. This exposes directors to enhanced scrutiny and possible shareholder claims that they otherwise would not be subject to.

IV.
RECOMMENDING AN ALTERNATIVE: WHAT THE COURT COULD HAVE DONE

In a talk at Harvard Law School that took place shortly after the court issued the *AFSCME* decision, Justice Jacobs, who authored the opinion, discussed some of the issues driving the court to decide the case the way it did:

> The opinion . . . was basically our best effort to reach a decision unanimously given a set of facts that was basically hypothetical . . . . If we had more than two weeks and were not under the pressure of time because there was a shareholder vote coming up . . . we might have been able to write it better . . . . I'm not

www.deallawyers.com/blog/archives/000924.html. *See, e.g.*, Sun-Times Media Group, Inc. v. Black, 954 A.2d 380, 405 (Del. Ch. 2008) (*Bergonzi* requir[ing] the continued advancement of funds to a corporate official who had plead guilty); Orloff v. Shulman, No. 852-N, 2005 WL 5750635, at *13 (Del. Ch. Nov. 23, 2005) ("Bylaw amendments mandating litigation advances are a fundamental part of Delaware's policy to encourage qualified people to serve as corporate directors. . .[and] are presumed to be valid unless they are unreasonable.").

88. Travis Laster, CA v. AFSCME: *The Delaware Supreme Court Giveth and the Supreme Court Taketh Away*, DealLawyers.com Blog (July 18, 2008), http://www.deallawyers.com/blog/archives/000924.html.

suggesting that it was the best way it could have been handled.[89]

The court recognized that this was a decision that would have lasting implications and in fact might act as a sort of blueprint for shareholders in drafting their proposals for the 2009 proxy season. In fact, the SEC issued over 400 no-action letters under Rule 14a-8 in 2009, according to the SEC website.[90] At this time, it is important to cabin the holding of the *AFSCME* decision and clarify that shareholder bylaws are not the proper place for fiduciary exceptions, and instead to provide an alternative roadmap for shareholders to follow in drafting their bylaw proposals. Some suggestions are outlined below.

A. *Suggest Using Precatory Proposals*

One way that shareholders can get around the issue of whether their proposed bylaw is a proper subject for shareholder action is by casting their proposed bylaws as precatory proposals—that is, requesting or recommending that the corporation take a certain action but not requiring the board to do so. As opposed to allowing a mandatory bylaw that might be inconsistent with Delaware law only if it contained a fiduciary out, precatory proposals would not risk violating state law and thus could more easily be adopted. In fact, both the court and the parties conceded that this would be permissible with respect to AFSCME's bylaw proposal:

> **Justice:** So if this bylaw said *shall consider* reimbursement of expenses [instead of "shall cause the corporation to reimburse"], you have no problem with it?
> **Mr. Guiffra:** Absolutely, that would be a permissible bylaw.
>
> Of course, one problem with precatory proposals is that boards often fail to follow the course of action recommended by shareholders, but that is a separate concern. At the very least, it solves the fiduciary out issue and allows shareholders to get their proposals

89. Justice Jack B. Jacobs, Del. Sup. Ct., Comments at Harvard Law School (Dec. 1, 2008) (transcript on file with author).

90. *See* Division of Corporation Finance, 2009 No-Action Letters Issued Under Exchange Act Rule 14a-8, http://www.sec.gov/divisions/corpfin/cf-noaction/2009_14a-8.shtml#chrono.

included in the proxy as recommendations to the board.

B. *Allow the Mandatory Bylaw But Cure the Hypothetical Fiduciary Defect Directly in the Bylaw Itself*

Assuming the court was right on the first question in the *AFSCME* case, and reimbursement of proxy expenses is in fact a proper subject for shareholder bylaws (especially now given the 2009 amendments to the DGCL), then rather than a fiduciary out, what the court should have suggested is changing the language of the bylaw to directly address the hypothetical situation they were worried about: that is, to require reimbursement of reasonable expenses *if the election involved a question of any matter of policy.* Both the court and the parties seem to suggest that such a bylaw would be acceptable, since the only real problem the court has with it as written is the hypothetical situation requiring reimbursement even for purely personal reasons, and anything else would arguably be consistent with Delaware law. This would solve the problem bothering the court, as the board would no longer be faced with a situation where it would have to reimburse an insurgent, in breach of its fiduciary duties, who ran for purely personal reasons.

I believe that from a policy perspective this is the best way to handle future bylaws that the shareholders have a right to propose under DGCL § 109, but that have the possibility of conflicting with the board's managerial power under DGCL § 141(a). This solution cures the hypothetical problem with the bylaw, but it also allows the board to reimburse in all circumstances where it is legal to do so, which is exactly what the shareholders wanted in proposing this bylaw. The difference between this proposal and the fiduciary out suggested by the court in *AFSCME* is that, as discussed *infra* at [[29-30]], the fiduciary out does not in fact mandate what the shareholders want the bylaw to do. Instead, a fiduciary out requirement would introduce uncertainty into the reimbursement process, require the board to consider every election reimbursement, and ultimately give the board broader discretion to deny reimbursement. This proposal, in contrast, directly addresses the hypothetical problem of purely personal reimbursement and otherwise allows for reimbursement, without implicating the

directors' fiduciary duties and opening the board up to potential litigation.

C. *Declare the Bylaw Valid*

The court could have also declined to issue an advisory opinion and simply answered yes to the second certified question, holding the bylaw valid as written. It could have done this in two ways. First, it could have declared the bylaw valid (as other mandatory bylaws are, such as mandatory indemnification bylaws), and waited for a real situation to occur where either the board or a minority shareholder felt it would be a breach of the board's fiduciary duty to follow the mandate of the bylaw, allowing the shareholders to bring suit then. One difference with mandatory indemnification bylaws as opposed to the bylaw at issue in *AFSCME* is that indemnification bylaws are statutorily provided for in the DGCL under section 145 whereas reimbursement bylaws (at least before the addition of DGCL § 113) are not, but they provide a comparable example here.

Alternatively, the court could have declared the bylaw valid and allowed a fiduciary exemption—that is, a sort of immunity for directors from their fiduciary duties in exercising the bylaw, somewhat analogously to how mandatory indemnification bylaws are currently treated. In fact, Mr. Barry addressed this suggestion at oral argument in the context of discussing mandatory reimbursement bylaws where the board would be released from its fiduciary duties in following the bylaw, but in the absence of such a mandatory bylaw, the board would have to make a decision as to whether or not it was consistent with its fiduciary duties to reimburse. He compared the situation at bar to mandatory indemnification provisions:

> **Justice:** [A] mandatory bylaw eliminates the directors' obligation to discharge their fiduciary duties in this context.
>
> **Mr. Barry:** It does, and it's perfectly permissible. First, show me any mandatory indemnification provision requiring the board to [have to consider whether] indemnification is ok in this particular context. [There isn't one.] If you have a mandatory indemnification provision, you gotta pay. And. . . this court has already ordered the reimbursement of

> proxy expenses where the. . . sitting directors didn't think it was within their discretion and fiduciary responsibility to do that.

With respect to mandatory indemnification provisions, the board would still make a decision to determine whether the director was entitled to indemnification based upon whether he was sued arising under his work for the corporation or sued for entirely personal reasons, but once the determination is made, indemnification is mandatory regardless of fiduciary duties. Similarly, the board here would still have to determine whether the person *qualifies* for mandatory reimbursement,[91] but once that determination is made, reimbursement of expenses would be mandatory.

D. *Waste*

Finally, one way to think of this mandatory reimbursement requirement is as a pure gift (or waste), which would require ratification by 100% of the shareholders. Thus, the court could treat the decision to automatically expend corporate funds as waste and allow unanimous shareholder approval to essentially ratify the decision, so long as the board expressly conveys to the shareholders that their vote will operate as ratification of the board's actions.[92] Accordingly, although virtually impossible in practice, if the bylaw received unanimous consent of the shareholders, then it could cure the fiduciary problems of the bylaw and allow the board to reimburse in all circumstances. While waste would not be a problem in most circumstances, it might be a problem in the hypothetical situation of reimbursement for purely personal reasons, so the vote would cure even that hypothetical problem.

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91. *See supra* at 489-90 for a discussion of the "reasonableness" requirement of the reimbursement and whether purely personal expenses could qualify for reimbursement at all.

92. *See* Gantler v. Stephens, 965 A.2d 695, 713 (Del. 2009) (limiting shareholder ratification to situations where director action does not require shareholder approval to become effective—i.e. amendments to the Certificate of Incorporation—and where the director conduct at issue is expressly submitted to the shareholders for ratification).

CONCLUSION

AFSCME represents an important decision in Delaware that was actually a long time coming. In 2006, Chancellor Chandler was "[s]truck by the heightening of tension in the relationship between shareholders and management, and shareholders and the board of directors, [and he was] gearing up to preside over a period of legal history-making he expect[ed] to rival the court's last landmark era" of the corporate takeover craze in the 1980s.[93] He noted that questions were "already being asked about whether shareholders can adopt bylaws that trump board decisions. And then when they do, if they have that power, can the board of directors then turn around and negate or change the bylaw. . . . That issue has never been directly faced or answered in Delaware, but I think it's inevitable that it will be decided."[94]

A year later, Vice Chancellor Leo E. Strine, Jr. similarly predicted the inevitability of these questions arising in Delaware. In an SEC Roundtable Discussion regarding the interaction between federal proxy rules and state corporation law, he commented:

> [T]here was a time where there were some people who got things excluded on the grounds that state law made them clearly improper when there was no decision of the Delaware Supreme Court or even the Delaware Court of Chancery. I think those of us from Delaware would say one of the things the Commission could do to facilitate this is to make clear that if it's uncertain under state law and it's a by-law proposal, then it shouldn't be excluded and they should be able to put it on absent some showing, and then leave it to us, hold us accountable, and if we make the wrong decisions, you can bet we are going to hear about it from the institutional investor community and from the management community.[95]

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93. Roy Harris, *Delaware Rules: Heated debates over governance, director independence, and executive pay will likely be resolved in Delaware's Chancery Court*, CFO MAGAZINE, Aug. 1, 2006, at 55, 56 (internal quotation marks omitted).

94. *Id.* (internal quotation marks omitted).

95. SEC Roundtable Discussions Regarding the Federal Proxy Rules and State Corporation Law, May 7, 2007, at 34, *available at* http://www.sec.gov/spotlight/proxyprocess/proxy-transcript050707.pdf.

At the time, he said, "[n]o one has proposed a by-law to my knowledge dealing with reimbursement of expenses[, so] I won't speak to that."[96]

Two years have passed since that Roundtable Discussion, and both Chancellor Chandler and Vice Chancellor Strine's predictions have come to a head. Now that AFSCME has proposed such a bylaw and the SEC certified its questions of law to the Delaware Supreme Court, the court has weighed in, and so has the Delaware Legislature.

Since the time of the *AFSCME* decision, there has been a slight shift in Delaware towards giving shareholders more power, particularly in the director nomination context. In light of the recently passed DGCL amendments, it has become unambiguously clear that Delaware will allow companies to adopt shareholder bylaws relating to proxy access and reimbursement of expenses. But to the extent that a shareholder proposed bylaw potentially conflicts with a board's ability to fully exercise its fiduciary duties, a fiduciary out is not the correct response to cure the defect in the bylaw. Fiduciary outs have historically been used only in the merger context and in situations where shareholders may need to be protected from a board that is binding itself. In other words, fiduciary outs are meant for situations where a board may take action that could usurp the shareholders' choice (specifically when they are being cashed out of a company); not for situations where the shareholders are binding the board to do something that they want, and their interest in the company is not being extinguished. As such, despite the holding in *CA, Inc. v. AFSCME*, Delaware courts should not read a fiduciary out requirement into the bylaw context.

96. *Id.* at 33.