Shifting SANDS

- Shareholder proposals to get new consideration
- Legal changes may relieve SEC of responsibility for interpretation
- Delaware Supreme Court to accept legal challenges to proxy access
- Bylaw challenges must be specific to be successful
- Corporates could see solid benefit in new court system

By Frank Zarb Jr

The SEC's administration of shareholder proposals is about to change fundamentally. However, the impetus for this transformation – the May 2007 amendment to Delaware law that allows the SEC to request legal interpretations from the Delaware Supreme Court – has received scant attention as the SEC only used its authority for the first time this past summer. Everything went smoothly with this initial 'test', but if the SEC decides to take the plunge this coming proxy season, it will commence a drastic transformation of the way it administers the shareholder proposal process.

Regulator as mediator

When the SEC adopted its shareholder proposal rule in the early 1940s, it served as a disclosure device. Once a company became aware that a shareholder planned to make a proposal at an upcoming annual meeting, the SEC believed that the company should disclose that fact in its proxy materials and viewed the failure to make such a disclosure as a possible material omission.

This position on disclosure begged the question of which proposals were proper under state law. Because companies and shareholders lacked the resources or time to obtain answers in the state courts, the SEC became the monkey in the middle. In time, SEC staff developed the no-action letter process that exists today. Rule 14a-8 under the Securities Exchange Act of 1934 requires a company to submit a no-action letter request to the staff if it plans to omit a proposal from its proxy materials. The staff's decisions are non-binding, as either party may obtain a binding resolution in court. Thus, SEC staff became an informal and inexpensive mediator between shareholders and companies.

Companies seeking no-action relief under Rule 14a-8 must explain the basis upon which they plan to omit the proposal. The rule contains several conditions for a company to omit a proposal, but the heart of the rule is a set of provisions that permit the exclusion of proposals that are improper under state law.

Once the SEC staff issues a response to the no-action letter request, either party may go ahead and request reconsideration or 'appeal' the resolution to the SEC's five commissioners.

The staff has had little guidance – and wide discretion – in determining whether proposals conformed to state law. Until now the Commission's decisions under Rule 14a-8(i)(1) were typically informed by the only

available evidence: the submission of legal opinions by the company and, in a few cases, the shareholder. But this approach placed the staff in the difficult position of evaluating often-inconsistent legal opinions based on scant case law.

In administering the controversial 'ordinary business' exclusion under Rule 14-8(i)(7), the staff has not tried to remain consistent with the laws of any state. In 1983 the SEC explained that state law 'is rarely conclusive as to what is or is not ordinary business, and the staff generally has had to make its own determinations as to whether a proposal involves an activity relating to the issuer's ordinary business.'

The staff accordingly has developed its own positions – or 'common law' – through the no-action letter process. As it applies to proposals addressing what it terms 'significant social policy issues', the staff's effort has been subject to external pressure from shareholders and companies alike. As a result there is an increasing distance between the administration of Rule 14a-8 and the state law that had been its original substantive basis. The SEC's still-pending proxy access proposals to allow shareholders to include their own director nominees alongside management's nominees on the proxy card suggest further federalization of the process.

THE RULES

- **14a-8(i)(1)** permits a company to omit a shareholder proposal 'if the proposal is not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization.'
- **14a-8(i)(2)** permits a company to omit a proposal 'if the proposal would, if implemented, cause the company to violate any state, federal, or foreign law to which it is subject.'
- **14a-8(i)(7)** permits a company to omit a proposal 'if the proposal deals with a matter relating to the company's ordinary business operations.' This exclusion derived from state laws making management responsible for supervising day-to-day operations.

Delaware enters the process

The growing detachment between the SEC's shareholder proposal process and state law is about to change. On May 15, 2007, the Delaware Supreme Court amended its court rules to permit the SEC to 'certify to this court for decision a question or questions of law rising in any matter before it ... if there is an important and urgent reason for an immediate determination of such question or questions by this court and the [SEC] has not decided the question or questions in the matter.'

In June 2008 the SEC certified to the Supreme Court questions about the propriety under state law of a shareholder proposal submitted to CA by the AFSCME pension plan. In its certification request, the SEC stated that, absent advice from the court, it would break the tie between competing opinions of Delaware law in favor of the shareholder, citing the company's burden of persuasion under Rule 14a-8.

AFSCME's proposal was to amend the company's bylaws to require the company to reimburse shareholders for the reasonable expenses incurred in soliciting approval of their own candidates for the board of directors.

The company submitted a no-action request claiming the proposal was not proper under Delaware law and, if implemented, would cause the company to violate Delaware law. Because the proposal was written as a requirement, rather than a recommendation to the board of directors, it did not benefit from the presumption of validity that Rule 14a-8 accords advisory proposals.

In support of its no-action request, the company submitted an opinion of Delaware counsel. A well-reasoned legal opinion normally would carry the day. In this case, however, AFSCME submitted its own, competing opinion of Delaware counsel. The state of play at that point in the process highlights the SEC's quandary to date in implementing the rule. Does it read the opinions and try to decide which one is more persuasive, or does it call a draw and decide in favor of the shareholder, since the company bears the burden of persuasion? In this case, the SEC decided to pursue its new channel of communication. After briefing and oral argument, the Delaware Supreme Court rendered its decision. The court first addressed whether the proposal was improper under Delaware law for the purposes of Rule 14a-8(i)(1). It answered that question in the affirmative, having concluded that the proposed bylaw was procedural rather than substantive.

The court next addressed whether the bylaw amendment would cause the company to violate any state laws under Rule 14a-8(i)(2). The court's analysis on this issue erected a high hurdle for the shareholder proponent. Noting that it was forced to decide the issue in the

abstract rather than as applied to known facts, the court considered whether the bylaw could violate state law under any possible scenario. It ruled in the company's favor, concluding that the bylaw under some circumstances could cause directors to breach fiduciary duties.

Transformation of 14a-8

The logical evolution of this new process is clear. There should be more appeals to the commissioners of no-action determinations, seeking reversal by the SEC or certification to the Delaware Supreme Court. For no-action letter requests under Rule 14a-8(i)(1) and (i)(2), some unsuccessful companies and shareholders will undoubtedly request that the SEC either reverse the staff's determination, or seek advice from the Delaware Supreme Court. In cases where the criteria for certification are satisfied, it is unclear on what basis the SEC could resist. The principal criterion is that the proposal involves an unsettled area of Delaware law, and very few issues are settled when it comes to board versus shareholder authority to amend the bylaws. The corporate community should be the major driver behind these requests, since they will tend to lose the 'tie' in cases of battling legal opinions. Companies also appear to have much to gain from the high hurdle that a bylaw amendment must surmount in demonstrating that it would not under any scenario cause the company to violate Delaware law, for the purposes of the Rule 14a-8(i)(2) exclusion.

Preparing for proxy season

The speed at which these developments will evolve is unclear, but they deserve close monitoring through the upcoming proxy season. In the short term, companies that plan to submit no-action letter requests based on Rules 14a-8(i)(1) and/or (i)(2) should be prepared to leave extra time to accommodate a possible appeal to the SEC, along with possible certification procedures.

Companies and shareholders should be aware of the criteria for certification and be prepared to include arguments in favor or against certification in correspondence with the staff or Commission. In most cases, the issue should be considered at the stage where a staff determination is appealed to the Commission.

Although the certification process is efficient and economical compared to full-scale state court litigation, it is not without cost, for example the expense of retaining Delaware counsel to brief and argue the matter before the Delaware Supreme Court.

Finally, all parties should monitor any certifications made in the course of the proxy season for additional authority that may bear on their arguments. Opinions issued by the Delaware Supreme Court may be relevant to other exclusions in addition to those directly implicated by the case.

As Yogi Berra said, 'It's hard to make predictions, especially about the future.' While the timing is unclear, it is almost certain that the new Delaware certification procedures will have a fundamental impact on the administration of the SEC's shareholder proposal rule.

BACK TO BUSINESS

The SEC may ultimately have to relinquish its role in interpreting the controversial 'ordinary business' exclusion under Rule 14a-8(i)(7). With state law advice now available, there is less need for the SEC to develop its own 'common law' interpretation. At least for companies organized in Delaware, it is unclear on what basis the SEC can decline to certify a question as to the applicability of this rule. The court's review may ultimately encompass the SEC's approach to, and resolution of, the controversial 'social policy' shareholder proposals.

The SEC's shareholder proposal rules will likely come under pressure in other areas as well. The line around the SEC's role will have to be clarified. Will the SEC also come under pressure to seek the court's advice under Rule 14a-8(i)(8), the exclusion for proposals relating to the election of directors, which is the center of the controversy over proxy access?

The SEC will be forced to decide what Rule 14a-8 is all about. The SEC's proxy access proposals further the trend toward 'federalization' of the proxy process, suggesting a permanent second seat for state law. The new Delaware certification procedures suggest a contradictory trend, toward reintroducing state law into the process. At some point, the SEC will have to choose which direction to take.

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