Note

PROTECTING SHAREHOLDER ACCESS TO DIRECTOR ELECTIONS: A RESPONSE TO *CA, INC. V. AFSCME* URGING THE ADOPTION OF A *BLASIUS* STANDARD OF REVIEW FOR THE EXERCISE OF A FIDUCIARY-OUT CLAUSE

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ABSTRACT

The shareholder's role in corporate management is evolving. In CA, Inc. v. AFSCME, *the Delaware Supreme Court likely expanded that role in a ruling that signals the potential for greater shareholder access to the corporate boardroom and enhanced director accountability. The court determined that a shareholder proposal to mandate reimbursement of certain board of director candidates was a proper subject for shareholder bylaws. But the court also held that the particular bylaw in question did not preserve the board's ability to exercise its fiduciary duties and, therefore, violated Delaware law. Future bylaws governing director nominations and elections are likely to include fiduciary-out clauses to preserve directors' fiduciary duties. Boards of directors can use those fiduciary outs to refuse reimbursement to successful candidates, discouraging future shareholder nominees.*

This Note urges Delaware courts to review the exercise of such fiduciary-out clauses under the strict standard of scrutiny articulated in Blasius Industries, Inc. v. Atlas Corp. *The* Blasius *standard*

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requires a compelling justification for a board's decision to interfere in shareholders' election of directors. A board's decision to invoke a fiduciary-out clause to prevent the reimbursement of a successful candidate would signal to all future candidates that the substantial costs of the election process still must be borne by the nominating party. The Delaware Supreme Court reiterated in CA, Inc. *the importance of shareholder participation in the nomination and election of directors. To protect shareholders' fundamental role, the* Blasius *standard should be implemented to ensure shareholders' attempts to nominate candidates are not thwarted by entrenched boards of directors.*

INTRODUCTION

In September 2004, the shareholders of Computer Associates learned that the Department of Justice had indicted their company's former CEO for securities fraud and obstruction of justice.[1] The company itself had been charged with the same offenses, but it had accepted responsibility and agreed to pay $225 million to the victims of the fraud to avoid any further prosecution.[2] Of course, Computer Associates' shareholders had been suspicious of accounting and backdating fraud well before the actual indictment; many executives had stepped down, and, by 2004, Computer Associates had become "a symbol of weak corporate governance."[3] With the Enron and Worldcom accounting scandals still fresh in the minds of both the public and federal authorities, the Securities and Exchange Commission (SEC) had promised to keep a "watchful eye" over Computer Associates' corporate governance in the years to follow.[4]

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1. Press Release, Dep't of Justice, Former Computer Associates Executives Indicted on Securities Fraud, Obstruction Charges (Sept. 22, 2004), *available at* http://www.justice.gov/opa/pr/2004/September/04_crm_642.htm.

2. *Id.* Two years later, the two men charged by the Department of Justice—Sanjay Kumar, the company's former CEO, and Stephen Richard—the former head of sales, pled guilty. *Ex-CA Chief Kumar Pleads Guilty*, CNNMONEY.COM, Apr. 25, 2006, http://money.cnn.com/2006/04/24/technology/kumar/index.htm.

3. Richard Waters, *Former CA Executives Charged with Fraud*, FIN. TIMES, Sept. 22, 2004, http://www.ft.com/cms/s/0/d63c16c8-0cb8-11d9-b543-00000e2511c8.html ("The settlement ends a saga in which CA become [*sic*] a symbol of weak corporate governance and suspect accounting in the technology industry.").

4. *See* Cynthia L. Webb, *Hammer Time for Computer Associates*, WASH. POST, Sept. 23, 2004, http://www.washingtonpost.com/wp-dyn/articles/A44284-2004Sep23.html ("CA will be under the watchful eye of the Securities and Exchange Commission for a year and a half under a deal with the Justice Department and will have to shell out $225 million to pay back shareholders.").

But that same company, operating under the new name CA, Inc. (CA), would be fighting its shareholders again only four years later.[5] And thus, in 2008, CA found itself, once again, in the crosshairs of its shareholders and at the crossroads of corporate governance.

The financial crisis that snowballed throughout the United States in 2008 only accentuated problems with corporate governance that had been in existence for some time.[6] The crisis, at times compared to the Great Depression,[7] left many searching for a readily identifiable culprit for the country's economic malaise. They found easy targets in the corporate boardroom.[8] The public outcry has brought even greater scrutiny of the behavior of corporate America.[9] Many argued that problems stemmed from a failure to oversee executive compensation; indeed, the Obama administration has made efforts to create executive compensation oversight.[10] But in many ways,

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5. *See infra* Part II.A.

6. For further discussion of the protracted debate over proper corporate governance, see *infra* Part I.A.

7. *See, e.g.*, Paul B. Farrell, *30 Reasons for Great Depression 2 by 2011*, MARKETWATCH, Nov. 19, 2008, http://www.marketwatch.com/news/story/well-great-depression-2-2011/story.aspx?guid=%7BB28B49B5-EFD1-4941-B57E-A2BA1545BA09%7D (noting that the 2008 financial downturn might eventually become a second Great Depression).

8. *See, e.g.*, Susanne Craig, *Cuomo, Frank Seek to Link Executive Pay, Performance*, WALL ST. J., Mar. 13, 2009, at C1 (discussing lawmakers' attempts to control executive compensation and noting that "[c]ompensation became a big issue in late 2008 when the government was forced to step in to cover mounting losses on Wall Street").

9. The SEC recognized the need to react to the economic crisis with potential rule changes that indicate greater scrutiny of the current state of corporate governance and shareholder participation in the election of directors. The SEC began one such proposed rule change with the following strong language:

> The nation and the markets have recently experienced, and remain in the midst of, one of the most serious economic crises of the past century. This crisis has led many to raise serious concerns about the accountability and responsiveness of some companies and boards of directors to the interests of shareholders, and has resulted in a loss of investor confidence. These concerns have included questions about whether boards are exercising appropriate oversight of management, whether boards are appropriately focused on shareholder interests, and whether boards need to be more accountable for their decisions regarding such issues as compensation structures and risk management. In light of the current economic crisis and these continuing concerns, the Commission has determined to revisit whether and how the federal proxy rules may be impeding the ability of shareholders to hold boards accountable through the exercise of their fundamental right to nominate and elect members to company boards of directors.

Facilitating Shareholder Director Nominations, Exchange Act Release Nos. 33–9049 & 34-60089, 74 Fed. Reg. 29,024, 29,025 (proposed June 18, 2009) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249, 274).

10. *See, e.g.*, Craig, *supra* note 8 (arguing for limitations on director compensation to tie performance and compensation); David Stout, *Paulson Gives Way on C.E.O. Pay*, N.Y. TIMES, Sept. 24, 2008, http://www.nytimes.com/2008/09/25/business/economy/25cong.html (discussing

executive compensation is merely a red herring and a symptom of larger problems.[11] Indeed, congressional reaction to the crisis has indicated the widespread belief that "among the central causes of the financial and economic crises that the United States faces today has been a widespread failure of corporate governance."[12] This Note suggests that, rather than legislate caps on executive pay and bonuses,[13] lawmakers could use shareholder oversight of directors as a mechanism to help create accountability for those directors' decisions. Because the call for limits on executive compensation is actually symbolic of a host of problems with current corporate governance, the best solutions may be found through an enhanced role for shareholders. The flurry of activity surrounding executive compensation likely reflects a political and public sentiment that supports greater shareholder activity.[14] By protecting shareholders' rights to meaningfully participate in the nomination and election of directors, corporate law can ensure that those who own the company[15] ultimately have the ability to ensure the accountability of management.

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the pressure on Henry Paulson to include limits and regulations on executive compensation prior to providing any bailout).

11. It is also particularly difficult to quantify the value of executives when relatively small distinctions in an executive's skills or performance can have major impacts on a company's financial success and the return to its investors. *See, e.g.*, Ben W. Heineman, Jr., *Principles for Reforming Executive Pay*, BUSINESSWEEK, Jan. 6, 2009, http://www.businessweek.com/managing/content/jan2009/ca2009016_165415.htm (listing some of the challenges facing the 111th Congress with regard to executive pay and the difficulties of balancing appropriate risk-taking and the public desire for less exorbitant compensation); *see also* John F. Olson, *Professor Bebchuk's Brave New World: A Reply to "The Myth of the Shareholder Franchise*,*"* 93 VA. L. REV. 773, 782 (2007) ("[E]ven tiny differences in managerial talent can translate into significant disparities in the market value of today's giant corporations, providing a legitimate rationale for offering what may at first glance appear to be excessive compensation.").

12. Shareholder Bill of Rights Act of 2009, S. 1074, 111th Cong. § 2(1) (2009).

13. *See* Heineman, *supra* note 11 (recommending a perspective on executive pay that balances risk-taking, which promotes innovation, with responsible management of risk).

14. This sentiment is evidenced by the relative success of the "say on pay" legislation as well as the importance attributed to shareholders in Senator Charles E. Schumer's Shareholder Bill of Rights proposed legislation. *See* Joshua Brockman & John Ydstie, *Washington Puts the Squeeze on Executive Pay*, NPR, Oct. 22, 2009, http://www.npr.org/templates/story/story.php?storyId=114048511 (noting that Congress is considering legislation that would give shareholders more power over executive compensation); *see also* S. 1074 § 2 (discussing in its findings the failure of "executive management and boards of directors . . . to enact compensation policies that are linked to the long-term profitability of their institutions").

15. *See* MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS: CASES AND MATERIALS 109 (9th ed. 2005) ("Traditionally, shares of common stock are conceived as ownership or equity interests in the corporation, so that the body of common shareholders are the corporation's owners." (emphasis omitted)).

Although the management of a company traditionally controls day-to-day operations, the board of directors, strapped with fiduciary duties to the shareholders, oversees management and ensures that the choices management makes and the company's general business plan are in the best interests of all shareholders. One way to enhance shareholder access to board of director elections would be to allow shareholders proxy access to the nomination of new directors for a company. Proxy access allows shareholders to influence corporate policies by presenting their proposals alongside those of the management in the proxy voting materials[16] distributed by management. SEC rules allow shareholders to then vote on the entirety of the proposals put forth by both management and other shareholders.[17] Theoretically, then, shareholders already have the capability of nominating and voting new directors onto the board. Shareholders can make directors accountable for decisions they make that are not in the best interests of the shareholders, including, for example, giving excessive compensation to management.[18] But shareholders' practical ability to nominate and elect new directors has been largely nonexistent due to prohibitive costs and a lack of organization.[19] Thus, shareholders of some companies have been trying to change their company's bylaws to allow shareholders greater participation.

In *CA, Inc. v. AFSCME Employees Pension Plan*,[20] the Delaware Supreme Court may have signaled a movement toward greater

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16. These materials include both the material necessary for shareholders to designate their votes and certain information that the board has determined that shareholders need to make such decisions, including, in some cases, shareholder-initiated proposals. *See id.* at 274–81 (discussing the disclosures made by registered corporations and the terminology and materials used in proxy voting).

17. *See* SEC Staff Legal Bulletin No. 14A (2002), *available at* http://www.sec.gov/interps/legal/cfslb14a.htm (discussing the provisions of Rule 14a-8 and its functions within the shareholder proxy context).

18. In corporate law, shareholders select the board of directors, which in turn is responsible for the hiring and compensation of management. *See* EISENBERG, *supra* note 15, at 154–55 (explaining the basic structure and interactions of corporations in the United States).

19. *See* J. Robert Brown, Jr., *The SEC, Corporate Governance and Shareholder Access to the Board Room*, 2008 UTAH L. REV. 1339, 1341–42 (discussing the original absence of director nominations by shareholders and the cost of proxy elections). Professor Brown also notes that the "costs of complying with the rules in many cases render a solicitation [of votes for a director nominee] prohibitively expensive." *Id.* at 1341 (citing Kenneth J. Bialkin, *Why, When and How to Conduct a Proxy Context for Corporate Control*, *in* 5 SECURITIES LAW TECHNIQUES ch. 66 (2006)).

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

director accountability to shareholders and greater shareholder proxy access to director elections.[21] The court determined that a proposal to amend CA's bylaws to require that stockholders be reimbursed for reasonable expenses incurred in nominating candidates in a contested director election was a permissible subject for a shareholder action under Delaware law.[22] The court held, however, that the particular proposal in question was not allowed under Delaware law because it would have required directors to reimburse a candidate, even if doing so would require them to violate their fiduciary duty to the shareholders.[23] But the court indicated that the inclusion of something like a fiduciary-out clause would remedy that concern.[24] A fiduciary-out clause requirement, however, could be a major limitation on shareholders' ability to nominate and elect their own candidates because directors may exercise broad discretion in claiming the protection of these clauses to deny shareholders reimbursement and support their own entrenchment on the board. Ordinarily, such board decisions would receive deferential treatment from courts under a standard known as business judgment deference.[25]

This Note argues that Delaware courts should use a stricter standard of review when directors attempt to promote entrenchment by rejecting reimbursement through reliance on fiduciary-out clauses. Because determining the proper standard of review "to judge director

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21. Indeed, in response to *CA, Inc.* and the financial crisis in general, the SEC has proposed rule changes that seek to inject greater shareholder participation into the nomination and election of directors. Facilitating Shareholder Director Nominations, Exchange Act Release Nos. 33-9046 & 34-60089, 74 Fed. Reg. 29,024, 29,025 (proposed June 18, 2009) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249, 274).

22. *CA, Inc.*, 953 A.2d at 237.

23. *Id.* at 238.

24. *See id.*, 953 A.2d at 240 (holding that the Bylaw mandating reimbursement for the costs of shareholder-nominated candidates was a violation of Delaware law solely because it might, in some situations, require the board to violate its fiduciary duty to the company); *see also infra* notes 124–27 and accompanying text. Fiduciary-out clauses usually limit the board of directors. *See infra* Part III.A. Here, they would function to prevent any proxy that passes from requiring the directors to reimburse candidates when the directors' fiduciary duties to shareholders would otherwise prevent them from doing so. *See infra* Part III.B.

25. *See* Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 927–28 (Del. 2003) ("[T]he business judgment rule is a 'presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.'" (quoting Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1373 (Del. 1995))); Kamin v. Am. Express Co., 383 N.Y.S.2d 807, 815 (Sup. Ct. 1976) (holding that, absent bad faith, stockholders may not question a board of directors' exercise of its discretion when the board is carrying out ordinary business decisions, such as declaring dividends). For further explanation of business judgment deference, see *infra* Part IV.B.1.

action often determines the outcome of the case,"[26] preserving the meaning of the *CA, Inc.* decision requires that courts scrutinize boards' attempts to use fiduciary-out clauses under the stricter standard introduced in *Blasius Industries, Inc. v. Atlas Corp*.[27] Part I of this Note discusses the corporate governance background leading up to the Delaware Supreme Court's decision in *CA, Inc.* Part II illustrates the specific shareholder rights the court recognized in the *CA, Inc.* opinion. Part III then addresses the lingering questions left by the court's opinion and argues that the inclusion of a fiduciary-out clause would place the proposed bylaw in accord with Delaware law, thus quieting the court's concern. Part IV concludes that, given the necessity of these fiduciary-out clauses in future bylaws, the Delaware Supreme Court must take care to prevent the abuse of such clauses. The court should use a *Blasius* standard of review when any board uses a fiduciary-out clause to obstruct shareholder nominees for contested director elections. Only the *Blasius* standard requires the appropriate compelling justification for the board's decision in instances in which directors would be likely to try to protect their seats on the board.[28]

I. FRAMING THE DEBATE AND STATING THE RULES OF ENGAGEMENT

The debate over the proper methods of corporate governance and the appropriate balance between shareholder influence and director control is longstanding. In *CA, Inc.*, however, the Delaware Supreme Court reiterated the importance of shareholder participation in director elections, seemingly taking the pro-shareholder side of the debate. Within that corporate governance context, both the Delaware General Corporation Law (DGCL) and

26. Stroud v. Grace, 606 A.2d 75, 90 (Del. 1992) (citing AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986)).

27. Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988).

28. This Note does not engage the discussion of whether greater shareholder access is beneficial. For a brief discussion of the ongoing debate involving shareholders' rights to proxy access and corporate governance, see *infra* Part I.A. The assumption herein is that the Delaware Supreme Court's language and conclusions in *CA, Inc.* indicate that greater access to elections via reimbursement is a worthwhile goal for a proxy vote. Thus, to protect what the court asserts, and this Note agrees, is a worthwhile end, lower courts must refrain from using deferential standards of review for director decisions. Otherwise, the access to director elections enhanced by reimbursement will be undercut by director discretion over when to provide those reimbursements.

SEC rules have a place. And though the SEC has occasionally disagreed with the courts when promulgating its rules of corporate governance, *CA, Inc.* marked the first time the SEC allowed the Delaware Supreme Court to decide a question addressed to the SEC. The result was an implication of deference by the SEC to the interpretations of the Delaware Supreme Court. This Part explains the background rules and concepts that make clear the importance of the *CA, Inc.* decision.

A. The Debate Over Shareholder Access and Bylaw Proposals

One of the key issues in corporate governance is the need for oversight to ensure that corporate management does not engage in purely self-serving activity.[29] The current means of monitoring corporate management provide that those who oversee management—members of the board of directors—must be truly independent from the company.[30] But there have been a number of problems with the definition of director independence.[31] In response to the financial crisis of 2008, Congress undertook an effort to help shareholders have a greater voice in the face of corporate mismanagement.[32] One key means of shareholder participation and oversight, as previously discussed, is via the proxy contest.[33]

Proxy contests were once considered inefficient and were rare well into the late 1980s and early 1990s.[34] Their importance grew in

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29. *See, e.g.*, Brown, *supra* note 19, at 1339–40 ("With management having an incentive to engage in self-serving activities, shareholders need a mechanism designed to minimize this type of behavior."); Brett H. McDonnell, *Professor Bainbridge and the Arrowian Moment*, 34 DEL. J. CORP. L. 139, 140 (2009) (book review) (noting that a central concern in the hierarchy of a corporation is the temptation that exists when the large amount of wealth created by the corporation is placed under the control of the few members that comprise the board). Professor Brown utilizes the term "agency cost" to describe the problem of finding an efficient means of monitoring corporate managers. Brown, *supra* note 19, at 1339–40.

30. *See* Brown, *supra* note 19, at 1340 ("The latest [monitoring system for management] is reliance on independent directors to watch out for the interests of shareholders.").

31. *Id.* at 1340–41 (noting the slew of problems with the current definition of independence and concluding that "[a]llowing shareholders to nominate and elect their own candidates sidesteps these problems").

32. *See supra* note 8.

33. *See supra* notes 16–19 and accompanying text.

34. *See* Irwin H. Warren & Kevin G. Abrams, *Evolving Standards of Judicial Review of Procedural Defenses in Proxy Contests*, 47 BUS. LAW. 647, 648 (1992) (noting that the "proxy contest for the election of directors continues to be a relatively rare occurrence").

the 1990s, however, due to the increase in institutional investors[35] along with the increase in the ability of boards of directors to thwart changes in control launched via tender offers.[36] With new, higher-profile shareholders and institutional investors came new questions; conflicts between activist investors and boards of directors created a debate about whether shareholders ought to be given oversight of director decisionmaking.[37] But deference to case-by-case development of the law instead of legislation, a tenet of Delaware corporate law,[38] likely led to the slow development of a consistent body of corporate governance law.[39] In the last decade, however, high-profile board crises like that of Hewlett-Packard have stoked the public debate over the appropriate level of shareholder participation in corporate governance.[40]

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35. "Institutional investors" in this Note refers to large companies, like pension funds or insurance companies, or wealthy individuals that buy and sell large enough quantities of a security that they may receive preferential treatment and avoid some regulation because they are presumed to be sophisticated. BusinessDictionary.com, Institutional Investors Definition, http://www.businessdictionary.com/definition/institutional-investors.html (last visited Feb. 28, 2010).

36. *See* Damon A. Silvers & Michael I. Garland, The Origins and Goals of the Fight for Proxy Access 1–3 (2004) (unpublished manuscript), *available at* http://www.sec.gov/spotlight/dir-nominations/silversgarland022004.pdf (stating that "[t]he current vigorous debate on the place of shareholder nominated directors in the public company proxy solicitation process" is a product of scandals in 2001 as well as the growth of institutional investors and the conclusion that "shareholders could not directly hold managers accountable").

37. *See generally* Lucian A. Bebchuk, Essay, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675 (2007) [hereinafter Bebchuk, *Myth*] (discussing the problems with democratic oversight by shareholders); Olson, *supra* note 11 (arguing that Bebchuk "offers scant empirical support for either the proposition that shareholders have little power to effect director changes or the argument that boosting shareholders' ability to force such changes will improve performance"); E. Norman Veasey, Essay, *The Stockholder Franchise Is Not a Myth: A Response to Professor Bebchuk*, 93 VA. L. REV. 811 (2007) (contending that shareholder power to affect change has actually grown in recent decades); Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43 (2003) [hereinafter Bebchuk, *Shareholder Access*] (arguing for the adoption of measures which would increase shareholder access); Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67 (2003) (contending that "[a]llowing shareholders to run an election contest through the company's proxy statement . . . would be a serious mistake").

38. Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749, 1752 (2006) (referring to the "inherent conservatism" of Delaware corporate law as a product of this case-by-case development of the law).

39. *See* Silvers & Garland, *supra* note 36, at 3 (discussing the rise of causes that expedited the discussion and development of a corporate governance body of law over director elections).

40. *See, e.g.*, Don Clark & Joann S. Lublin, *H-P Is Urged to Overhaul Board in Wake of Probe*, WALL ST. J., Sept. 26, 2006, at A2 (describing corporate governance experts' calls for a board overhaul as pension funds seek greater participation in the shareholder nomination process); *see also The Financial Crisis and the Role of Federal Regulators: Hearing Before the H.*

Scholars on one end of the debate, led by Professor Lucian Bebchuk of Harvard University, argue for greater shareholder access in order to provide a more accountable corporate governance system.[41] These scholars argue that shareholders currently have no meaningful ability to respond to unsatisfactory board actions. Because corporate law is built upon an assumption that shareholders are the true owners of a corporation,[42] the absence of meaningful participation reflects a fundamental flaw in the legal justification for placing control with and affording deference to the board.[43] Bebchuk, for example, focuses on enhancing shareholder value in corporations as the primary function of management.[44] He underscores the importance of the board of directors' fiduciary duties to the shareholders, noting that the board is legally the agent of the shareholders.[45] And these fiduciary duties presuppose an ability on the part of shareholders to elect new directors if and when they are dissatisfied.[46]

Comm. on Oversight and Government Reform, 110th Cong. 33 (2008) (statement of Alan Greenspan, former Chairman, Federal Reserve) ("I made a mistake in presuming that the self-interest of organizations, specifically banks and others, were such is [*sic*] that they were best capable of protecting their own shareholders and their equity in the firms."); J. Robert Brown, Jr., *Returning Fairness to Executive Compensation*, 84 N.D. L. REV. 1141, 1142 (2008) ("Board authority is often better described as exercised in the best interests of management rather than shareholders." (citing *The Financial Crisis and the Role of Federal Regulators*, *supra*)).

41. *See, e.g.*, Bebchuk, *Myth*, *supra* note 37, at 676–78 (discussing his general arguments for the need for an enhanced shareholder franchise); Bebchuk, *Shareholder Access*, *supra* note 37, at 44–46 (arguing for the need for "[i]nvigorating [c]orporate [e]lections"); *see also* Silvers & Garland, *supra* note 36, at 16–19 (listing recommendations for the SEC to enhance shareholder access to director elections).

42. *See, e.g.*, EISENBERG, *supra* note 15, at 109 (noting that shareholders are the true owners of corporations).

43. *See* Robert B. Thompson, *Defining the Shareholder's Role, Defining a Role for State Law: Folk at 40*, 33 DEL. J. CORP. L. 771, 778 (2008) ("[T]he corporate franchise is the ideological underpinning on which the core premise of Delaware law rests as the justification for permitting directors such broad control over other people's money."). *See generally* Bebchuk, *Myth*, *supra* note 37 (contending that shareholders do not have the power to hold corporate directors accountable); Bebchuk, *Shareholder Access*, *supra* note 37 (arguing for the adoption of measures that would increase shareholder access); Silvers & Garland, *supra* note 36 (discussing the history and current issues associated with proxy access).

44. *See* Bebchuk, *Myth*, *supra* note 37, at 678 ("I should stress that my analysis of election reform in public companies [focuses] on the sole objective of enhancing shareholder value.").

45. *Id.* at 679–80 (highlighting the role of the shareholder franchise in the philosophical underpinnings of current corporate law).

46. *Id.* at 680.

But opponents of enhanced shareholder access argue that the board of directors should have primary authority,[47] and scholars have debated the extent to which shareholder bylaw proposals should ever be allowed to limit a board of directors' discretion.[48] Those who oppose shareholder access do so in part because they believe institutional investors and shareholder activists will force a company to become focused on short-term gains.[49] Some believe that "Delaware's existing statutory and common law suggest that the corporate form's underlying structure is inconsistent with the use of mandatory bylaws to control corporate activity and curtail board authority."[50] Others, like Professor Lynn Stout, argue that the current amount of board control is appropriate because limiting board turnover has numerous efficiency advantages.[51] These scholars assert

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47. *See, e.g.*, Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 605 (2003) (concluding that the "power and right to exercise decisionmaking fiat" are vested in members of the board of directors, who are not "mere agent[s] of the shareholders" but the actual central authority figures); Veasey, *supra* note 37, at 816–18 (arguing that the current balance of corporate law is working through a movement toward greater corporate governance and shareholder participation without Bebchuk's proposed amendments to legislation); Silvers & Garland, *supra* note 36, at 8 ("In order to protect shareholders, therefore, the [Business Roundtable] believes the nominating committee is best positioned to assess the skills and qualities desirable in new directors." (internal quotation marks omitted)); *cf.* Lipton & Rosenblum, *supra* note 37, at 82–84 ("There is no question that giving shareholders access to the corporate proxy machinery to run an election contest would facilitate the nomination and election of dissident and special interest directors."). *But see* Veasey, *supra* note 37, at 824 ("If effected by private ordering—whether through stockholder-proposed bylaws, changes in the certificate of incorporation, or director-proposed bylaws—Bebchuk's proposals, such as confidential voting or reimbursement of expenses, are not objectionable."). Chief Justice Veasey's criticisms are in line with the point of this Note. The very development of law apparent in *CA, Inc.* indicates the case-by-case trend toward greater corporate governance. For this reason, Chief Justice Veasey would likely support the development of greater shareholder access to director elections when it occurs organically within the Delaware court system.

48. *See, e.g.*, Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?*, 73 TUL. L. REV. 409, 425–33, 479 (1998) (discussing arguments regarding the propriety of shareholder oversight of director decisionmaking).

49. *See, e.g.*, Lipton & Rosenblum, *supra* note 37, at 78 ("[M]any institutional and other activist investors have competing interests that may conflict with the best interests of the public corporation . . . . Different investors have different time horizons. Some may seek to push the corporation into steps designed to create a short-term pop in the company's share price so that they can turn a quick profit." (footnote omitted)).

50. Fredrick H. Alexander & James D. Honaker, *Power to the Franchise or the Fiduciaries?: An Analysis of the Limits on Stockholder Activist Bylaws*, 33 DEL. J. CORP. L. 749, 749–50 (2008).

51. *See, e.g.*, Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 VA. L. REV. 789, 790–91 (2007) (arguing that "shareholders enjoy net benefits from board governance"

that shareholder access to the boardroom does not actually result in a benefit for most shareholders.[52] A further complication in this debate involves competing interpretations of the DGCL rules that most specifically address whether shareholders have a place in the management of a corporation.[53]

The Delaware Supreme Court's opinion in *CA, Inc.* did not attempt to resolve this debate;[54] but, as discussed below, its holding supported the court's previous assertion that "[a] stockholder's ability to participate in corporate governance through the election of directors is a fundamental part of our corporate law."[55] Likewise, the court has previously stated that "[m]aintaining a proper balance" between shareholder participation in the election and the board's actual management depends on "the stockholders' unimpeded right to vote effectively in an election of directors."[56] Given these sentiments, the Delaware Supreme Court made a strong statement on behalf of shareholders' rights of access, at least when it comes to the election process.[57] If the Delaware Supreme Court deems shareholders' access to director elections worth protecting, then other courts should strive to avoid undercutting that determination in the future.

B. Resolving the Tension Between the SEC's Rules and Delaware Corporate Law

The *CA, Inc.* case exemplified the increasingly murky interrelation of Delaware's traditional authority in corporate law, the

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because it "promotes efficient and informed decisionmaking, discourages intershareholder opportunism, and encourages valuable specific investments in corporate team production").

52. *See, e.g.*, *id.* at 791–92 (noting "the myth that shareholder control in public companies actually benefits shareholders").

53. For further discussion of the possible tension between DGCL Section 141(a) and Section 109(b), see *infra* Part I.B.

54. Even critics of shareholder access, though, may grant that shareholder proposals for reimbursement of proxy election expenses are acceptable because they deal more closely with the election process than with company management. *See, e.g.*, Alexander & Honaker, *supra* note 50, at 766 (noting that such plans may be found less offensive to the "fiduciary decision-making model" because they are "intended to enhance the stockholders' ability to elect new directors, not to make decisions for the directors that are ultimately elected").

55. Preston v. Allison, 650 A.2d 646, 649 (Del. 1994).

56. MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1127 (Del. 2003).

57. Again, the distinction between shareholder proposals involving the election process and proposals that purport to manage corporate affairs is key. The *CA, Inc.* opinion does not go so far as to claim that corporate management is now in the hands of shareholders, though congressional sentiment may support such a move, *see supra* notes 8, 12 and accompanying text.

SEC's influence in the field via its promulgation of corporate governance rules and no-action letters, and ultimately the willingness of the SEC to defer to Delaware courts. Delaware is incredibly influential in the development of corporate law in part because it is the state in which the largest American companies choose to incorporate.[58] More than half of all publicly traded companies in the United States are incorporated in Delaware.[59] Though the DGCL has traditionally been the bedrock of corporate law, the SEC has gained increasing prominence[60] through the passage of the Sarbanes-Oxley Act of 2002.[61] The SEC's enforcement and interpretative role has also increased with respect to its corporate governance rules.[62] The SEC's expanding influence may be greatest in the area of shareholder activism, as many institutional investors are pressing for change outside of the DGCL.[63]

Although the statutes comprising Delaware corporate law are specific in a number of contexts, they are relatively silent in the area of corporate governance.[64] After the Enron scandal, and again during the 2008 financial crisis, the federal government has tried to fill that

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58. Faith Stevelman, *Regulatory Competition, Choice of Forum, and Delaware's Stake in Corporate Law*, 34 DEL. J. CORP. L. 57, 66 (2009) ("Delaware has visibly succeeded in claiming the number one spot in attracting and retaining incorporations. Moreover, the preference for Delaware incorporation is especially notable among the richest and most powerful American corporations—a fact which undoubtedly contributes to the prestige and influence of Delaware corporation law.").

59. The Delaware government's website boasts of the vast number of companies incorporated in Delaware, as well as the state's welcoming environment for those companies. Del. Dep't of State, Division of Corporations: About Agency, http://corp.delaware.gov/about agency.shtml (last visited Feb. 18, 2010).

60. *See, e.g.*, Margaret E. Tahyar, *The Dodd Bill's Effect on Corporate Governance and Executive Compensation Processes*, HARVARD L. SCH. F. ON CORP. GOVERNANCE & FIN. REG., Nov. 24, 2009, http://blogs.law.harvard.edu/corpgov/2009/11/24/the-dodd-bills-effect-on -corporate-governance-and-executive-compensation-processes/#more-5627 ("The project of federalizing major elements of our corporate governance and executive compensation processes continues apace."). Tahyar discusses the potential effects of proposed legislation in the arena of corporate governance, including an expanded role for the SEC. *Id.*

61. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28 & 29 U.S.C.).

62. Stevelman, *supra* note 58, at 90.

63. *Cf. id.* at 95–96 ("These [shareholder activist] forces are operating outside of the traditional framework of state corporate law—that is, without amendment to the DGCL and separate and apart from the judicial development of fiduciary standards. In prior periods, corporate directors, officers, and their advisers could more easily insulate themselves from shareholders' demands and expectations.").

64. *See* Thompson, *supra* note 43, at 776 (noting that there is a space left open within the realm of corporate governance under Delaware law).

void.[65] Much of the federal law in the corporate governance arena can be traced to Rule 14a-8, which provides a means for shareholders to bring proposals to the board to be included in the proxy statements that are then distributed to all of the company's shareholders.[66] When shareholders seek to include a proposal in a company's proxy materials and management wants to exclude it, it is the SEC that often determines who wins.[67] Some of these determinations, however, depend on state and not federal law. At times, then, there are questions that must be answered in the space between Delaware's corporate law and the SEC's oversight of director behavior and proxy solicitation.

On the Delaware law side of the equation, the ability of shareholders to adopt bylaws is in tension with the ability of directors to manage the company unfettered.[68] The tension exists specifically between DGCL Sections 109(b) and 141(a).[69] Section 109(b), which addresses the appropriate content for bylaws, states that "the bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or

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65. *Id.* at 776, 783. *See generally* Junis L. Baldon, *Taking a Backseat: How Delaware Can Alter the Role of the SEC in Evaluating Shareholder Proposals*, 4 ENTREPRENEURIAL BUS. L.J. 105 (2009) (discussing the intertwined roles of federal and state law in corporate governance and the potential effects of an enhanced relationship between the SEC and the Delaware Supreme Court).

66. Thompson, *supra* note 43, at 779.

67. *See, e.g.*, *id.* at 780 ("If management opposes the inclusion of the proposal, which is often the case, management asks the SEC staff for a no-action letter, in effect, the staff's announcement that it would bring no enforcement action against the company were the proposal to be omitted from the company's proxy statement. The agency's response comes in [an SEC no-action letter] sent by a SEC staff member to the parties." (footnote omitted)).

68. *See* Hamermesh, *supra* note 48, at 444 (characterizing the tension in DGCL rules by stating that "the efforts to distinguish by-laws that permissibly limit director authority from by-laws that impermissibly do so have failed to provide a coherent analytical structure"); *see also* Alexander & Honaker, *supra* note 50, at 753 ("Some commentators, however, posited a tension between sections 141(a) and 109(b), suggesting that the provisions of the DGCL, standing alone, would not resolve the question whether the bylaws may place limits on the board's power to manage the corporation.").

69. *See* CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227, 234 (Del. 2008) (discussing the interrelation of DGCL rules and concluding that "[t]he question left unanswered is what is the scope of shareholder action that Section 109(b) permits yet does not improperly intrude upon the directors' power to manage corporation's business and affairs under Section 141(a)").

employees."[70] That section, when read in conjunction with Section 109(a), appears to limit the subject matter that a bylaw can address. Section 141(a), however, provides that "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation."[71] Section 141(a), then, purports to provide for the management of the company's business affairs only by the board of directors.[72] Thus, tension arises when shareholders propose a bylaw that the board of directors contends interferes with its management of the company.

In addition to Delaware law, SEC rules govern certain actions by boards and shareholders. Rule 14a-8 generally allows a board of directors to exclude certain bylaw proposals from the distributed proxy statement, the actual material that the directors send to shareholders.[73] The premise is that this rule helps preserve the board's ability to make ordinary business decisions. In 2006, a portion of the rule, Rule 14a-8(i)(8), was subject to conflicting interpretations by the Second Circuit and the SEC. Rule 14a-8(i)(8) provided that companies may exclude a proposal "[i]f the proposal relates to an election for membership on the company's board of directors or analogous body."[74] In *AFSCME, Employees Pension Plan v. American International Group, Inc.*,[75] a case that involved a similar question to the one ultimately raised in *CA, Inc.*, the Second Circuit was forced to answer whether a shareholder proposal could be excluded under SEC Rule 14a-8(i)(8).[76] The Second Circuit held that a shareholder proposal requiring American International Group (AIG) to allow shareholder nomination and election of candidates for the board of directors could not be excluded from the company's proxy statement.[77] The court held that the 14a-8(i)(8) election exception only applied to bylaw proposals that would affect particular

70. DEL. CODE ANN. tit. 8, § 109 (2009).

71. *Id*. § 141(a).

72. *Id.*

73. 17 C.F.R. § 240.14a-8 (2009).

74. Shareholder Proposals Relating to the Election of Directors, Exchange Act Release No. 34-56914, 72 Fed. Reg. 70,450, 70,453 (Dec. 11, 2007) (codified at 17 C.F.R. § 240.14a-8).

75. AFSCME, Employees Pension Plan v. Am. Int'l Group, Inc., 462 F.3d 121 (2d Cir. 2006).

76. *Id*. at 125.

77. *Id.* at 131.

elections, not the election process generally.[78] The decision was met with a great deal of optimism from advocates of greater shareholder oversight, but scholars waited for the SEC's response.[79]

The SEC condemned the Second Circuit's conclusion and amended the language of Rule 14a-8(i)(8),[80] nullifying the effect of the *AIG* case. The Commission's comments specifically state that proposals such as the one at issue in *AIG* would be excludable under the amended rule.[81] The comments also note that, although this new encapsulation of the rule is more expansive in its application to nominations and procedures, "the changes to the rule text relate only to procedures that would result in a contested election, either in the year in which the proposal is submitted or in subsequent years."[82] The SEC left the door open for proposals, like that in *CA, Inc.*, that make future contested elections more likely but do not necessarily result in any particular election in a given year. Regardless, the conflict between the Second Circuit and the SEC only underscores the murkiness and unpredictability of the law surrounding corporate governance. Indeed, one scholar has gone so far as to claim that "[i]n no other area of corporate governance has the interrelation between state and federal law become more important than the validity of shareholder proposals under Rule 14a-8."[83] Yet it has become increasingly difficult to actually distinguish between state and federal law in the area of corporate governance.[84]

Tension was particularly problematic when Delaware corporate law, the cornerstone of traditional corporate law, conflicted with the SEC's interpretation and enforcement of its own rules. In 2007, to help avoid conflicting interpretations by the Delaware courts and the SEC, Delaware amended its constitution to allow the SEC to certify

78. *Id*. at 129–30.

79. *See, e.g.*, Bebchuk, *Myth*, *supra* note 37, at 708 (noting the importance of the court's opinion but also awaiting the SEC's response).

80. *See* Shareholder Proposals Relating to the Election of Directors, Exchange Act Release No. 34-56914, 72 Fed. Reg. 70,450, 70,453 (Dec. 11, 2007) (codified at 17 C.F.R. § 240.14a-8) (noting the potential confusion the Second Circuit's decision may have caused and the need to clarify the meaning of Rule 14a-8(i)(8)).

81. *Id.* at 70,454.

82. *Id.*

83. Baldon, *supra* note 65, at 106.

84. *See id.* ("[I]n fact, these roles are so intertwined that it becomes difficult to tell a coherent story about discrete federal versus state law and analysis." (quoting Robert B. Ahdieh, *From Federal Rules to Intersystemic Governance in Securities Regulation*, 57 EMORY L.J. 233, 235 (2007))).

questions of law directly to the Delaware Supreme Court.[85] The amendment created an "expedited process for addressing corporate law issues" and was aimed at bringing "greater certainty" to corporate law.[86] *CA, Inc.* was noteworthy because it was the first instance in which the SEC chose to utilize this certification capability.[87] Previously, only other courts could certify questions of law to the Delaware Supreme Court, and it was somewhat unclear whether the SEC would even choose to exercise this ability, as it was considered a showing of deference.[88] Because corporate governance is an area of particularly hot debate, some expected that it would be the area in which the SEC might be most likely to *need* to send questions to the court.[89]

The importance of the SEC's certification of questions, particularly questions relating to corporate governance, cannot be overstated. The sentiment leading up to the *CA, Inc.* decision was that the case would be a landmark determination of key corporate governance questions as well as a means of providing a single voice in

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85. Press Release, Del. Supreme Court, Delaware Constitutional Amendment Enacted Allowing the Securities and Exchange Commission to Bring Questions of Law Directly to the Delaware Supreme Court (May 15, 2007), *available at* http://courts.delaware.gov/Courts/Supreme%20Court/pdf/?deconstamend051507pdf.pdf; *see also* DEL. CONST. art. IV, § 11(8) (amended 2007) (providing the Delaware Supreme Court with the jurisdiction "[t]o hear and determine questions of law certified to it by . . . the United States Securities and Exchange Commission").

86. Press Release, Del. Supreme Court, *supra* note 85; *cf.* J.W. Verret, *Federal vs. State Law: The SEC's New Ability to Certify Questions to the Delaware Supreme Court*, CORP. GOVERNANCE ADVISOR, Mar./Apr. 2008, at 12, 12, *available at* http://ssrn.com/abstract=1156527 ("This ability to provide advisory opinions, if utilized by the SEC, is poised to enhance Delaware's dominance as the state of incorporation for publicly traded corporations.").

87. SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP & AFFILIATES, DELAWARE SUPREME COURT ANSWERS QUESTIONS CERTIFIED BY SEC; REJECTS STOCKHOLDER BYLAW REQUIRING REIMBURSEMENT OF PROXY SOLICITATION EXPENSES 1 (2008), *available at* http://www.skadden.com/Index.cfm?contentID=51&itemID=1426 (noting that this decision marked the first instance of the SEC certifying questions directly to the Delaware Supreme Court); *see also* William D. Johnston, *Del. Court Responds to SEC's First Certified Questions*, VA. LAW. WKLY., Sept. 29, 2008, http://www.valawyersweekly.com/weeklyedition/2008/09/29/del-court-responds-to-sec%E2%80%99s-first-certified-questions/ (detailing the process for the first certification and the subsequent decision).

88. *See* Press Release, Del. Supreme Court, *supra* note 85 ("It is not clear how often the Securities and Exchange Commission will accept Delaware's invitation [to certify questions], particularly in controversial areas of corporate governance." (quoting Jeffrey D. Bauman, Professor, Georgetown University Law Center)).

89. *See* Verret, *supra* note 86, at 12–13 (discussing and predicting the certification of questions dealing with the proposal of bylaws that might limit a board's discretion).

areas that involved overlapping and often contradictory authorities.[90] *CA, Inc.* was anticipated as "the most significant corporate law case in probably 10 years."[91] Professor J.W. Verret of George Mason Law School argued that the court's decision might change securities and corporate law in a manner unseen since the Securities and Exchange Act of 1933.[92] And because the SEC certified the questions to the Delaware Supreme Court, the SEC likely would not have the option to then override the court's decision as it did in *AIG*.[93] Thus, the rationale of the court is important, as it speaks for itself and for the SEC.

II. THE *CA, INC.* DECISION

In *CA, Inc.*, the Delaware Supreme Court helped define the contours of permissible shareholder activism within the context of board of director oversight and company management. The court determined that a shareholder bylaw proposal that called for reimbursement of dissident director candidates was a proper subject matter for a shareholder proposal under Delaware law.[94] That determination reflected the court's belief that such proposals dealt with the process of the election of directors, which is a proper subject for shareholder input.[95] The court found, however, that the proposal violated Delaware law because it left no discretion to the board of directors to decline reimbursement when it would cause the board to violate its fiduciary duties to shareholders.[96] Ultimately, the case

90. *See* Melissa Klein Aguilar, *SEC Sends Proxy Question to Delaware*, COMPLIANCE WKLY., July 15, 2008, http://www.complianceweek.com/article/4258/sec-sends-proxy-question-to-delaware (outlining the various reactions to the SEC's certification of its first question to the Delaware Supreme Court).

91. *Id.* (quoting Charles Elson, Director, Corporate Governance Center at the University of Delaware).

92. *Id.*

93. Indeed, as a result of the *CA, Inc.* decision, both the DGCL and the SEC contemplated rule changes to incorporate the Delaware Supreme Court's decision. The DGCL changes have passed. The SEC proposed its rule change in May, but because of a large number of responses, the final vote will not take place until sometime this year. Jesse Westbrook, *SEC to Delay Proxy-Access Rule, Giving Banks Reprieve*, BLOOMBERG.COM, Oct. 2, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=a2ZCxme0W84Y. For the text of the SEC's proposed rule, see Facilitating Shareholder Director Nominations, Exchange Act Release Nos. 33–9049 & 34-60089, 74 Fed. Reg. 29,024, 29,025 (proposed June 18, 2009) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249, 274).

94. CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227, 237 (Del. 2008).

95. *Id.*

96. *See infra* Part II.B.

articulated a role for shareholders in the nomination process for directors so long as future bylaw proposals carve out sufficient discretion for the board of directors.

A. Factual Background

In March 2008, the American Federation of State, County, and Municipal Employees (AFSCME), a stockholder of CA, proposed a stockholder bylaw (Bylaw) for CA to include in the proxy materials it would distribute during the 2008 proxy season.[97] CA, formerly Computer Associates, had a history of corporate governance shortcomings, and AFSCME, a shareholder activist pension group, proposed the Bylaw partially in response to a series of previous problems.[98] The proposed Bylaw required, most importantly, that CA reimburse a stockholder for the reasonable expenses involved in connection with a stockholder-nominated candidate's run for the CA board of directors.[99] The proposal required reimbursement for expenses of all candidates of the nominating party so long as, among other conditions, one of the nominating party's candidates was successfully elected.[100] The amount reimbursed could not exceed the amount spent by the corporation in connection with the same contested election.[101] This proposal, if successful, would have removed some discretion from the board, which previously had complete discretion regarding the reimbursement of proxy contest expenses.[102]

CA wanted to exclude this proposal from its proxy materials and thus sought permission from the SEC in the form of an SEC no-action letter, which would ensure that the SEC would not take action against CA for the exclusion of the proposal.[103] Because Rule 14a-8 allows companies to exclude proposals that would violate the law of the company's state of incorporation, the SEC received separate opinions from counsel for AFSCME and CA regarding the validity of the

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97. *CA, Inc.*, 953 A.2d at 229.

98. For a discussion of Computer Associates' "weak corporate governance" and its backdating and accounting issues during the early- to mid-2000s, see *supra* notes 1–4 and accompanying text.

99. *CA, Inc.*, 953 A.2d at 229–30.

100. *Id.*

101. *Id.*

102. *Id.*

103. *Id.*

proposed Bylaw under Delaware law.[104] The SEC received conflicting opinions from Delaware counsel regarding the likely outcome under Delaware law, so the SEC exercised its power to certify questions to the Delaware Supreme Court.[105] The first question was whether the proposed Bylaw covered a proper subject for shareholder action under Delaware law. Specifically, the SEC sought a determination of the "scope or reach of the shareholders' power to adopt, alter or repeal the bylaws of a Delaware corporation" and whether the Bylaw fell within that scope.[106] The second question was whether the adoption of the specific proposal would cause CA to violate Delaware law.[107]

B. The Court's Holding and Unresolved Questions

The Delaware Supreme Court held that, although the proposal covered an appropriate subject matter,[108] CA could exclude the proposed Bylaw because its adoption would violate Delaware law by restricting the fiduciary duties of the board of directors to the shareholders.[109] The court first made clear that "[t]he shareholders of a Delaware corporation have the right 'to participate in selecting the contestants' for election to the board. The shareholders are entitled to facilitate the exercise of that right by proposing a bylaw that would encourage candidates other than board-sponsored nominees to stand for election."[110] The court went to great lengths to illustrate that decisions involving reimbursement affect director elections and not simply corporate affairs, and thus do not deserve the same deference usually given to directors under the business judgment rule.[111] In holding that the Bylaw was a proper subject for shareholder action, the court noted that the "purpose of the Bylaw [was] to promote the integrity of [the] electoral process by facilitating the nomination of director candidates by stockholders," thereby reiterating the positive

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104. *See* Baldon, *supra* note 65, at 116–18 (discussing the steps taken by the SEC in attempting to respond to CA's request for a no-action letter).

105. *CA, Inc.*, 953 A.2d at 230.

106. *Id.* at 231–32.

107. *Id.* at 231; *see also* Brett H. McDonnell, *Bylaw Reforms for Delaware's Corporation Law*, 33 DEL. J. CORP. L. 651, 663 (2008) (noting that the SEC certified these two questions).

108. *CA, Inc.*, 953 A.2d at 237.

109. *Id.* at 240.

110. *Id.* at 237 (quoting Harrah's Entm't, Inc. v. JCC Holding Co., 802 A.2d 294, 311 (Del. Ch. 2002)).

111. *Id.* at 234. For further discussion of business judgment deference, see *infra* Part IV.B.1.

potential effects of the Bylaw's underlying purpose.[112] The court viewed these potential effects as laudable, finding the proposed Bylaw's subject matter to be in accord with the court's reverence for the integrity of the election process.

The Delaware Supreme Court went out of its way to explain the importance of the election process and the underlying necessity of protecting shareholder participation in director elections through the Bylaw in question. The court explained that because the Bylaw dealt with the process of electing directors, it covered a subject matter in which the shareholders had a legitimate and protected interest.[113] "The shareholders are entitled to facilitate the exercise of that right by proposing a bylaw that would encourage candidates other than board-sponsored nominees to stand for election," which the Bylaw would achieve.[114]

Despite its apparent admiration for the intent of the Bylaw, the court held that the Bylaw, as worded, violated Delaware law.[115] The Bylaw would have forced CA's board to reimburse successful dissident candidates even when the reimbursement would cause the board to violate its fiduciary duties.[116] The court hypothesized an instance in which a dissident candidate is elected despite running for purely personal reasons.[117] This scenario is improbable given that purely personal motivations are unlikely to command a majority of shareholder votes.[118] Still, the court was adamant about the need to

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112. *CA, Inc.*, 953 A.2d at 237; *see also* Baldon, *supra* note 65, at 118 (noting that the court held the Bylaw proper after its determination that the proposal was process related).

113. *CA, Inc.*, 953 A.2d at 237; *see also* Baldon, *supra* note 65, at 118 (reciting the ways in which the court found the Bylaw process related).

114. *CA, Inc.*, 953 A.2d at 237.

115. *Id.* at 240.

116. *See id.* ("[T]he Bylaw mandates reimbursement of election expenses in circumstances that a proper application of fiduciary principles could preclude. That such circumstances could arise is not far fetched. Under 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 in which 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." (second and third alterations in original) (footnotes omitted)); *see also* Baldon, *supra* note 65, at 119 (noting that "[t]he Court held that the board's fiduciary duties outweighed the merits of the proposed bylaw").

117. *CA., Inc.*, 953 A.2d at 240.

118. *See* Silvers & Garland, *supra* note 36, at 8 ("[I]t appears highly unlikely that in a widely held company a nominee intent upon using his or her directorship to pursue an agenda at odds with the interests of the corporation and its shareholders should be elected."); *see also* Posting of Lisa Fairfax to The Conglomerate, http://www.theconglomerate.org/2008/07/whats-next-for

protect directors' fiduciary duties without explicitly articulating the type of clause that would assure those protections.[119] The requirement that the reimbursement be only for "reasonable" expenses was insufficient because it only enabled the board to determine the "amount of reimbursement [that] is appropriate" and did not "reserve to CA's directors their full power to exercise their fiduciary duty to decide whether or not it would be appropriate . . . to award reimbursement at all."[120] Thus, a situation may arise in which the board's duties to its shareholders would require it to refuse any reimbursement, yet the Bylaw did not carve out this ability.

C. The Court Implies a Fiduciary-Out Clause Could Remedy Its Concerns

Although the Delaware Supreme Court ultimately ruled that the proposed Bylaw could be excluded, it seemingly went out of its way to indicate that the Bylaw might be permissible if it were amended in certain ways, such as by changing its wording to reserve to directors their full fiduciary duties.[121] The court even concluded its opinion by stating that, "[i]n arriving at this conclusion, [this Court] express[es] no view on whether the Bylaw, as currently drafted, would create a better governance scheme from a policy standpoint."[122] The court limited its ruling by noting that the problems are with the Bylaw "as written," thus leaving open the possibility that amending the language would be a sufficient remedy.[123]

.html (July 21, 2008) ("[T]o the extent that a candidate (motivated by personal reasons) is successful, can't that somehow suggest that shareholders believe her service will benefit the corporation? In this regard, it may prove difficult to determine when a candidacy is solely personal . . . .").

119. *See CA, Inc.*, 953 A.2d at 234 ("The question left unanswered is what is the scope of [permissible] shareholder action that . . . does not improperly intrude upon the directors' power to manage corporation's business and affairs. . . . To resolve that issue, the Court must resort to different tools, namely, decisions of this Court and of the Court of Chancery that bear on this question. Those tools do not enable us to articulate with doctrinal exactitude a bright line that divides those bylaws that shareholders may unilaterally adopt . . . from those which they may not.").

120. *Id.* at 240 (emphasis omitted).

121. *See id.* (noting that the Bylaw, as presently drafted, is impermissible because it fails to include a clause reserving directors' right to exercise fiduciary duties); *see also* McDonnell, *supra* note 107, at 664 (noting that the lack of a fiduciary out is damning to a shareholder-proposed bylaw after *CA, Inc.*).

122. *CA, Inc.*, 953 A.2d at 240.

123. *See id.* ("It is in this respect that the proposed Bylaw, *as written*, would violate Delaware law if enacted by CA's shareholders." (emphasis added)); *see also* Joseph Antignani,

Early in the opinion, however, the court hints at the simplest means to bring the Bylaw into compliance with Delaware law.[124] In footnote twenty, the court signaled that something like the inclusion of a fiduciary-out clause might make the proposed Bylaw acceptable.[125] This interpretation is underscored by the court's discussion later in the opinion about the potential dilemma that would arise if a contested election were won by a challenger who ran only out of personal motivations.[126] A fiduciary-out clause would reserve to directors the right to withhold reimbursement in instances in which a candidate clearly ran for election for personal gain.[127]

An important question the Delaware Supreme Court did not answer was *specifically* how AFSCME could amend its proposal to ensure that its adoption would not violate Delaware law. The court, however, indicated a shortcoming in the proposed Bylaw, perhaps pointing shareholders in the proper direction for future proposal language.[128] The next Part of this Note will explain how similar proposals in the future can be constructed to meet the Delaware Supreme Court's requirements.

Note, *Delaware to the Rescue: A Proper Exercise of Deference by the SEC and the Future Implications of* CA, Inc. v. AFSCME, 3 BROOK. J. CORP. FIN. & COM. L. 431, 452 (2009) (arguing that "it is true that a bylaw similar to the one AFSCME proposed (that contains a fiduciary-out clause) is now valid").

124. *See CA, Inc.*, 953 A.2d at 236 n.20 (noting that the process-related nature of the Bylaw could be emphasized by changing the Bylaw's language and including a clause that reserves to directors the ability to exercise fiduciary duties).

125. *See id.* ("[T]he Bylaw could have been phrased more benignly . . . . [I]t would also need to contain a provision that reserves the director's full power to discharge their fiduciary duties."). Though the court does not specifically state that the fiduciary-out clause would be sufficient to make the proposed Bylaw acceptable, the court's opinion seems to indicate that the only basis for allowing the company to exclude the proposal was the fact that the proposal obligated directors to act, in some cases, contrary to their fiduciary duties to shareholders. *See, e.g.*, *id.* at 240 (approving the Bylaw's exclusion "because the Bylaw contains no language or provision that would reserve to CA's directors their full power to exercise their fiduciary duty to decide whether or not [reimbursement] would be appropriate, in a specific case").

126. *See id.* at 239–40 (discussing the "not far fetched" possibility of a candidate running solely for personal reasons).

127. *See* Antignani, *supra* note 123, at 452 ("[A] bylaw similar to the one AFSCME proposed (that contains a fiduciary-out clause) is now valid."). *But see* Posting of Lisa Fairfax to The Conglomerate, *supra* note 118 ("[I]t seems that differentiating between campaigns that are purely personal and those that are not may prove difficult.").

128. For further discussion of the ways in which the inclusion of a fiduciary-out clause is appropriate under Delaware law, see *infra* Part III.

III. THE IMPLIED SOLUTION: A FIDUCIARY-OUT CLAUSE

In *CA, Inc.*, the Delaware Supreme Court signaled how future shareholder bylaws dealing with the election process could satisfy the court's requirement for the protection of directors' fiduciary duties. Specifically, the court's examples of problematic scenarios could all be ameliorated by the inclusion of a fiduciary-out clause, which would permit sufficient director flexibility in those rare instances in which a bylaw would require actions inconsistent with a director's fiduciary duties to the company's shareholders.

A. Fiduciary-Out Clauses: Current Usage and Judicial Treatment

A fiduciary-out clause is simply a means of reconciling certain actions taken by a board of directors with its underlying obligation to shareholders.[129] Used primarily in the merger and acquisition context, fiduciary outs are contract provisions that typically allow a target corporation to renege on the performance of contractual obligations when the board determines that such performance would violate the board's duties to shareholders.[130] An issue arises when an otherwise acceptable board or shareholder action binds the board and prevents it from discharging its fiduciary duties down the line.[131] In the merger context, fiduciary-out clauses were the product of courts requiring boards to invalidate no-shop provisions—which prevented companies from seeking better offers once they had engaged in negotiations with a buyer—and other exclusivity agreements in the event of the

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129. *See* Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 938–39 (Del. 2003) (explaining that fiduciary-out clauses prevent a board from binding itself to actions that may be to the detriment of shareholders). For a general discussion of the role of fiduciary-out clauses in the merger and acquisition context, in which they are used to protect directors' ability to breach an agreement when breaching is in the best interest of shareholders, see generally William T. Allen, *Understanding Fiduciary Outs: The What and Why of an Anomalous Concept*, 55 BUS. LAW. 653 (2000).

130. *See, e.g.*, Allen, *supra* note 129, at 656 (noting the ability of boards to contract around the normal costs of efficient breach because of such provisions); David B. Chubak, Note, *Locking in the Lock-Up?* Orman v. Cullman *& Corporate Deal Protection Measures*, 1 N.Y.U. J.L. & BUS. 457, 465 n.47 (2005) ("A fiduciary-out clause has its basis in the restrictions placed on fiduciaries so that they are not induced into violating their duty to beneficiaries. The section heading states: 'A promise by a fiduciary to violate his fiduciary duty or a promise that tends to induce such a violation is unenforceable on grounds of public policy.'" (quoting RESTATEMENT (SECOND) OF CONTRACTS § 193 (2005))).

131. *See* Allen, *supra* note 129, at 656 (discussing the importance and operation of fiduciary-out clauses in these situations).

inevitable sale of the company.[132] In the context of shareholder-proposed bylaws, fiduciary-out clauses have never been used before.

The Delaware Supreme Court discussed the nature and importance of fiduciary-out clauses in *Omnicare, Inc. v. NCS Healthcare, Inc.*,[133] explaining the difficulties in balancing a director's fiduciary duties and his ability to cede decisionmaking power through certain agreements.[134] In *Omnicare*, the court held that a fiduciary-out clause needed to be included in the agreement between the acquiring company and the target corporation to protect minority shareholders in the event that the board of the target corporation received a superior offer.[135] The board of directors' omission of such a clause thereby invalidated its attempts to create an agreement with a company that had proposed a merger.[136] In the court's view, a fiduciary-out clause was a *necessary* part of the merger agreement and the accompanying deal protections the board had chosen to provide its initial suitor.[137] The court's insistence on the inclusion of a fiduciary out is based on the board's "continuing fiduciary responsibilities to the minority stockholders."[138] The contractual expectations of the merging company "must yield to the supervening responsibility of the directors to discharge their fiduciary duties on a continuing basis."[139]

By analogy, if the Delaware Supreme Court found it necessary to include a fiduciary out in instances in which the board and the majority voting shareholders obtained a lock-up, it makes sense that the court would seek to ensure equal protection of minority shareholders in the event that a candidate's election was not in the best interests of the company. In *Omnicare*, the majority's sentiments seem to indicate that fiduciary outs will be a future requirement for

132. *See, e.g.*, *Omnicare*, 818 A.2d at 938 (describing the requirement for fiduciary-out clauses to prevent a board "from effectively discharging its ongoing fiduciary responsibilities").

133. Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003).

134. *See id.* at 936–39 (concluding that the board could not simply abdicate its fiduciary duties and depend on a shareholder vote in light of the fact that the vote's outcome was a foregone conclusion).

135. *Id.* at 936 ("To the extent that a [merger] contract, or a provision thereof, 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." (alteration in original) (quoting Paramount Commc'ns, Inc. v. QVC Network, Inc., 637 A.2d 34, 51 (Del. 1993))).

136. *Id.* at 939.

137. *Id.*

138. *Id.*

139. *Id.*

actions that uniformly constrain a board's judgment.[140] This makes it more likely that a fiduciary out in a proposal similar to the Bylaw in *CA, Inc.* would satisfy the court's concern that board discretion has been unduly or at least automatically eliminated.

B. When Including Fiduciary-Out Clauses Makes Sense

Including a fiduciary-out clause to protect shareholders makes sense when the clause is in place to prevent boards from binding themselves to the detriment of shareholders. Although a fiduciary-out clause is a proper protection to ensure that a board can always exercise its obligations to shareholders, such a clause should not be seen as a restriction on shareholder action.[141] It is important to note that the discussion of fiduciary duties involved in a potential shareholder bylaw proposal is inherently different than the role of fiduciary duties in a takeover context. As the Delaware Court of Chancery noted in *Unisuper Ltd. v. News Corp.*,[142] fiduciary duties to shareholders should not be used as a defense to mute shareholder proposals and nominations.[143] The logic is that fiduciary duties exist to ensure that directors act in the interests of shareholders. Underlying that assumption, however, is the notion that shareholders cannot always specify the course of action they desire. When, as in instances of a shareholder vote, the shareholders demonstrate their specific desire, it no longer makes sense to allow a board to argue that its fiduciary duties to those shareholders prevent it from following their vote.[144] Thus, when a bylaw is supported by a majority of shareholders

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140. *See id.* at 945–46 (Veasey, C.J., dissenting) (raising the possibility that the inclusion of fiduciary outs may become a more uniform rule in instances limiting director discretion).

141. *See* Unisuper Ltd. v. News Corp., No. 1699-N, 2005 WL 3529317, at *8 (Del. Ch. Dec. 20, 2005) (stating that the use of fiduciary-out clauses as a restriction on shareholder action "misconceives the nature and purpose of fiduciary duties").

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

143. *See id.* at *8 (explaining that, after shareholders have expressly voiced their desires, there is no longer a need for the gap-filling of fiduciary duties).

144. *See, e.g.*, *id.* ("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: Agents frequently have to act in situations in which they do not know exactly how their principal would like them to act. In such situations, the law says the agent must act in the best interests of the principal. When 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." (footnotes omitted)).

and a vote has been cast by a majority of shareholders in favor of a particular candidate, courts should be reluctant to allow the specific demonstration of shareholder preference to be undermined or contradicted by the board of directors' attempt to utilize a fiduciary-out clause. To allow liberal use of a fiduciary-out clause would be to turn the clause against those it was meant to protect.

Because future proposals are likely to heed the Delaware Supreme Court's advice and include fiduciary-out clauses,[145] the next step in the analysis is to choose an appropriate standard of review. The standard that courts use to review board actions when invoking fiduciary-out clauses ultimately will dictate the effect those clauses have. The next Part of this Note will explain why a *Blasius* standard of review, a stringent standard, is necessary to protect the rights of shareholders recognized by the court in *CA, Inc.*

IV. ADVOCATING AN APPROPRIATELY STRICT STANDARD OF REVIEW

If shareholders include fiduciary-out clauses in future bylaw proposals regarding election reimbursement, courts must be wary when directors seek to exercise discretion in using those clauses to block reimbursement.[146] The inclusion of a fiduciary-out clause has the potential to make a shareholder-proposed bylaw useless if a board

145. *See* McDonnell, *supra* note 107, at 668 (noting that one solution to the problem noted in *CA, Inc.* "is for shareholders to include fiduciary duty outs in all bylaw proposals that are potentially subject to this objection (which may well be all bylaw proposals, period)"); *see also* Office Depot, Inc., SEC No-Action Letter, 2009 SEC No-Act. LEXIS 264, at *1 (Mar. 9, 2009) (refusing to concur with the exclusion of a shareholder-proposed bylaw that included a fiduciary-out provision and was otherwise almost identical to the one proposed by AFSCME).

146. *See* McDonnell, *supra* note 107, at 668 (noting that the addition of fiduciary-out clauses to bylaws "leaves boards with a degree of discretion that may go against the very point of these bylaws, which seek to limit board discretion in areas in which the shareholders do not trust the board"); *see also* 1 HAROLD S. BLOOMENTHAL, SECURITIES LAW HANDBOOK § 18:26.20 (2008) (observing that "[a] fiduciary-out clause grants the board broad authority, but presumably permits the proponents [of the candidate] an avenue to challenge whether the board breached its fiduciary duties" when it exercised the fiduciary-out clause). In fact, Professor McDonnell has argued that this potential for directors to abuse any ability to amend or reject shareholder bylaws necessitates the elimination of director fiduciary duties with respect to such bylaws. McDonnell, *supra* note 107, at 669. But the elimination of fiduciary duties, which is McDonnell's suggested fix, would not be necessary if courts invoke a strict standard to scrutinize any director interference with such bylaws.

has discretion in exercising its fiduciary out.[147] The *Blasius* standard of review, reserved for instances in which the board of directors interferes directly with the election process for directors, is the proper standard for judging directors' invocation of a fiduciary-out clause in the reimbursement context.

A. Why the Judicial Standard of Review Matters

If shareholders follow the breadcrumbs left by the Delaware Supreme Court, future proposals will include fiduciary-out clauses to reserve some power to directors, making it more likely that a bylaw will not violate Delaware law by invalidating the directors' fiduciary obligations to the shareholders.[148] This would be a significant step toward greater shareholder participation, but the inclusion of fiduciary-out clauses could render the laudable purpose of the proposed Bylaw moot.[149] Future cases will likely force Delaware courts to determine a standard of review for the exercise of these fiduciary outs,[150] and as the Delaware Supreme Court has itself noted,

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147. *See* Antignani, *supra* note 123, at 452–53 (arguing that "a fiduciary-out clause makes the mandatory reimbursement provision useless" in the event that such clauses lead to protracted litigation and the real possibility that expenses will not be reimbursed).

148. *See, e.g.*, Office Depot, Inc., *supra* note 145, at *1–2 (discussing a shareholder proposal that echoed the *CA, Inc.* proposal but included the language "consistent with its fiduciary duties" to provide the board with the necessary fiduciary out). The SEC concluded that Office Depot could not exclude the proposal. *Id.* at *1. As is the SEC's convention, it did not elaborate on the legal reasoning behind its decision; however, the attached correspondence from the parties demonstrates that the parties believed that the holding of *CA, Inc.* would determine the SEC's decision. *See id.* at *15 ("Both [AFSCME's] and Office Depot's lawyers acknowledge that the legality of the proposed bylaw is resolved under [*CA, Inc.*]. Office Depot's only complaint is that, in its opinion and the opinion of its counsel, the 'fiduciary out' provided in [AFSCME's] proposed bylaw somehow is not good enough to satisfy the requirements set forth in the Delaware Supreme Court's decision.").

149. *See* Posting by Lisa Fairfax to The Conglomerate, *supra* note 118 (noting the "possibility that [the inclusion of a fiduciary out] would enable directors to challenge the payment of expenses for every successful candidate, thereby defeating shareholders' purpose in adopting the bylaw"); *see also* McDonnell, *supra* note 107, at 668 (concluding that if fiduciary outs are required in all proposed bylaws, the result "leaves boards with a degree of discretion that may go against the very point of these bylaws, which seek to limit board discretion in areas in which the shareholders do not trust the board").

150. *See* McDonnell, *supra* note 107, at 668 (noting that "[o]ne fix [to the deficiency of the CA Bylaw] is for shareholders to include fiduciary duty outs in all bylaw proposals"); *see also* Posting by Lisa Fairfax to The Conglomerate, *supra* note 118 (arguing that the potential for protracted litigation over reimbursement might also be a deterrent for those who would otherwise nominate directors).

this determination is critical.[151] The inclusion of fiduciary-out clauses does not make proposals useless as long as courts subject directors' use of such fiduciary outs to a strict standard of review.

Imagine that AFSCME had included the following fiduciary-out clause in the Bylaw: "Reimbursement is mandatory to the extent that the reimbursement is consistent with the directors' fiduciary duties."[152] This clause would have muted the Delaware Supreme Court's primary concern,[153] presumably smoothing the way for including the shareholder proposal in the company's proxy materials and presenting it to the shareholders for a vote. But it is likely that, given the directors' resistance to the inclusion of these bylaws and similar proposals in the first place, the directors will desire to prevent the inclusion of future bylaws and the exercise of the powers contained therein.[154] Thus, the board of directors could use the fiduciary-out clause as a veto, simply refusing to reimburse the "short slate"[155] candidates for the previous contest. This would not only defeat the purpose of the bylaw by making the contests just as expensive for

151. *See* MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1127 (Del. 2003) ("[I]dentification of the correct analytical framework is essential to a proper judicial review of challenges to the decision-making process of a corporation's board of directors."); *see also* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1371 (Del. 1995) (noting that because of the distinction between the leniency of business judgment deference and the exacting nature of heightened forms of scrutiny, "the determination of the appropriate standard of judicial review frequently is determinative of the outcome of [the] litigation" (alteration in original) (quoting Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1279 (Del. 1989))).

152. This language mirrors the language included by shareholders of Office Depot in a proposed bylaw after the *CA, Inc.* opinion. *See* Office Depot, Inc., *supra* note 145, at *1–2 (noting that a proposed bylaw that modifies the reimbursement requirement with the clause "consistent with its fiduciary duties" could not be excluded).

153. Indeed, even when Office Depot attempted to reject the addition of a shareholder bylaw that allowed for reimbursement, the company still acknowledged that the proposal would be permissible with a proper fiduciary-out clause. *See id.* at *5–6 (containing Office Depot's argument that the proposal "does not clearly and unambiguously provide a fiduciary out as required by the Delaware Supreme Court").

154. *See* Posting by Lisa Fairfax to The Conglomerate, *supra* note 118 (discussing the likelihood that the board would utilize the fiduciary-out clause to oppose shareholder nominees); *see also supra* note 103 and accompanying text. As further evidence of the reticence of boards of directors to accept shareholder-proposed bylaws, one can simply review the massive number of no-action letters in which the SEC declines to allow a proposal's exclusion. *See, e.g.*, Syms Corp., SEC No-Action Letter, 2009 SEC No-Act. LEXIS 324 (Apr. 17, 2009); Exxon Mobil Corp., SEC No-Action Letter, 2009 SEC No-Act. LEXIS 608 (Mar. 23, 2009); Office Depot, Inc., *supra* note 145; The Boeing Company, SEC No-Action Letter, 2009 SEC No-Act. LEXIS 156 (Feb. 18, 2009).

155. Short slate candidates are candidates on a slate that covers "less than half of the positions to be contested in the election." McDonnell, *supra* note 107, at 662.

dissident shareholders, but it would also discourage contested elections generally by signaling to future dissident shareholders that there is no chance of reimbursement for waging a proxy contest challenging incumbent directors.

The first question is whether this problem is likely to occur. Is a board of directors likely to oppose the reimbursement of expenditures made on behalf of the dissident slate? Comments by board members and lobbying groups for business management, such as the Business Roundtable, indicate that "boards are congenial and unified entities that would be harmed by the expression of contrary views"[156] and that "boards are likely to oppose the replacement of any of their members with 'outsiders.'"[157] This sentiment would presumably extend to dissident candidates, whose candidacy directors could discourage by refusing to reimburse those who are successful. Indeed, evidence of directors' opposition to any new members and to the ability of shareholders to nominate directors can be found in the multitude of SEC no-action letters sought by boards in response to proposals after the *CA, Inc.* opinion.[158] There is a very real likelihood that, given their incentives, incumbent directors would choose not to reimburse dissident candidates whenever possible. As one scholar noted in response to the *CA, Inc.* decision,

> [v]irtually all bylaws limit board discretion in some way, and with some creativity one should almost always be able to come up with circumstances where doing what the bylaw requires would force the board to act in a way that violates its duty if it had discretion to act as it chose.[159]

Thus, quite possibly, the inclusion of a fiduciary-out clause could undermine the purpose of the proposed Bylaw in the first place.[160]

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156. Robert J. Klein, Note, *The Case for Heightened Scrutiny in Defense of the Shareholders' Franchise Right*, 44 STAN L. REV. 129, 130 (1991).

157. *Id.* ("Incumbent directors of many corporations think that they know best . . . who should comprise the board of directors.").

158. *See, e.g.*, Office Depot, Inc., *supra* note 145, at *1 (informing Office Depot that the SEC would not "express any view regarding the applicability of rule 14a-8" to AFSCME's proposed amendment to the company's bylaws).

159. McDonnell, *supra* note 107, at 664.

160. *See* Posting by Lisa Fairfax to The Conglomerate, *supra* note 118 (noting the "possibility that [the inclusion of a fiduciary out] would enable directors to challenge the payment of expenses for every successful candidate, thereby defeating shareholders' purpose in adopting the bylaw").

It is also important to establish that the court's decision in *CA, Inc.* attributed significant importance to the shareholders' rights to participate in the nomination of director candidates, evident in the extent to which the opinion lauded the shareholder franchise and the foundational role it plays in corporate law. The court stated:

> [T]he unadorned right to cast a ballot in a contest for [corporate] office . . . is meaningless without the right to participate in selecting the contestants. As the nominating process circumscribes the range of choice to be made, it is a fundamental and outcome-determinative step in the election of officeholders. To allow for voting while maintaining a closed selection process thus renders the former an empty exercise.[161]

The court noted that this "unadorned right" becomes worthless if the shareholders cannot meaningfully participate in the nomination of candidates.[162] It follows logically, then, that the court should discourage actions that limit the ability of shareholders to participate in contested director elections, thereby making their right to vote meaningless.

But the court should go one step further. If protecting the selection of candidates is fundamental, as the court granted,[163] and the inclusion of a fiduciary-out clause is necessary to comply with Delaware law, as the court implied,[164] then the court must use a particularly strict standard to review a board's exercise of discretion with respect to the use of that fiduciary-out clause.

B. Blasius*'s Stricter Standard of Scrutiny Is Preferable to More Deferential Standards*

As explained, a weaker standard of scrutiny when board actions directly impede shareholder actions is improper. Invoking a stricter standard of review for director actions is not novel. Delaware courts generally apply one of three broad standards of review: a "deferential review under the business judgment rule," an "intermediate scrutiny applying a reasonableness analysis," and the heightened compelling

161. CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227, 237 (Del. 2008) (quoting Harrah's Entm't, Inc. v. JCC Holding Co., 802 A.2d 294, 311 (Del. Ch. 2002)).

162. *See id.* (noting that the process is meaningless if it does not allow for shareholder participation in the selection of candidates for the board of directors).

163. *See supra* Part II.B.

164. *See supra* Part II.C.

justification review of *Blasius*.[165] Scholars have discussed the proper standard of review when a board of directors attempts to interfere with the shareholders' role in a proxy contest,[166] and some scholars have advocated a stricter standard when a board of directors acts in a manner that inhibits shareholders from undertaking a proxy contest.[167] When a proposal deals not only with the proxy contest but also with the director-election process itself, there is even greater need for a stricter standard of review.[168] Business judgment deference and even some heightened standards of review are not sufficient when reviewing director decisions to reject reimbursement. Only the *Blasius* standard of review provides sufficient protections to the shareholder franchise by requiring a compelling justification before a board of directors can interfere in a shareholder vote or bylaw.

1. *Business Judgment Deference*. In most circumstances, director decisions receive business judgment deference.[169] Under the business deference rule articulated in *Kamin v. American Express Co.*,[170] courts refuse to second-guess the decisionmaking of boards when a board is carrying out its ordinary business decisions.[171] To encourage reasonable risk-taking on the part of directors, courts are loathe to

165. MICHAEL B. TUMAS & MICHAEL K. KELLY, POTTER, ANDERSON, & CORROON LLP, RETHINKING THE BLASIUS STANDARD OF REVIEW: THE IMPLICATIONS OF MERCIER V. INTER-TEL (DELAWARE), INC. 2 (2008), *available at* http://www.potteranderson.com/assets/attachments/Rethinking_the_Blasius_Standard_of_Reveiw.pdf [*sic*].

166. *See, e.g.*, Randall S. Thomas, *Judicial Review of Defensive Tactics in Proxy Contests: When Is Using a Rights Plan Right?*, 46 VAND. L. REV. 503, 557–60 (1993) (addressing what standard of review should be used when incumbent boards attempt to use rights plans to the potential detriment of a dissident election campaign); Warren & Abrams, *supra* note 34, at 652–63 (discussing the importance of *Blasius* as it may interact with *Unocal* and other cases in reviewing defensive measures that have the effect of shareholder disenfranchisement).

167. *See, e.g.*, Thomas, *supra* note 166, at 559 (arguing that a board's use of defensive tactics should receive stricter review when, in particular, such tactics "interfere[] with a shareholder group's ability to communicate with other shareholders or with other important voting rights, such as the right to nominate candidates").

168. For further argument on this point, see *infra* Part IV.C.

169. *See, e.g.*, Kamin v. Am. Express Co., 383 N.Y.S.2d 807, 815 (Sup. Ct. 1976) (holding that, absent bad faith, stockholders may not question a board of directors' exercise of its discretion when the board is carrying out ordinary business decisions, such as declaring dividends); *see also* Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 927–28 (Del. 2003) (noting that "[t]he business judgment rule is a 'presumption that in making a business decision the directors of a corporation acted on an informed basis in good faith and in the honest belief that the action taken was in the best interests of the company'" (quoting Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1373 (Del. 1995))).

170. Kamin v. Am. Express Co., 383 N.Y.S.2d 807 (Sup. Ct. 1976).

171. *Id*. at 812.

interfere with business decisions absent a showing of bad faith.[172] The business judgment rule underlies a central tenet of Delaware corporate law: the need to trust directors generally. Thus, business judgment deference is the default standard under which the Delaware courts review the decisions of the board of directors in managing the company's affairs.[173] This standard makes sense because so much of Delaware corporate law is premised on the notion that managers are bound by their fiduciary duties to shareholders but otherwise must be free to act as they see fit.[174] This standard is incredibly lenient and, as this Note explains, would be an inappropriately permissive standard of review for director actions that interfere with the election process.

2. *Intermediate and Heightened Scrutiny*. Delaware courts have determined that, in certain circumstances, business judgment deference should not be granted.[175] In circumstances in which the action of the board of directors involves potential or inherent conflicts of interest, like a decision to reject a tender offer that would cost the directors their jobs, a higher level of scrutiny is warranted.[176] Thus, the Delaware courts enforce "an enhanced duty which calls for judicial examination at the threshold before protections of the business judgment rule" apply.[177] Courts use this enhanced scrutiny because conflicted directors who stand to gain disproportionately from their own decision bring with them the "omnipresent specter that a board may be acting primarily in its own interests, rather than

172. *See id.* at 812–13 (stating the court's reluctance to interfere with a board's management absent a showing of dishonesty, lest it deter the appropriate exercise of board discretion).

173. For an in-depth discussion of the business judgment rule and a comparison with heightened forms of scrutiny in general, see Klein, *supra* note 156, at 147–57. "The primary rationale for the business judgment rule is that courts are ill suited to review and evaluate the wisdom of complex business decisions." *Id.* at 148.

174. *See* CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227, 232 n.6 (Del. 2008) ("One of the most basic tenets of Delaware corporate law is that the board of directors has the ultimate responsibility for managing the business and affairs of a corporation." (quoting Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281, 1291–92 (Del. 1998)). *See generally* EISENBERG, *supra* note 15, at 539–41 (discussing the interrelation between the standards of conduct and standards of review in corporate law).

175. *See, e.g.*, Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) ("The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts.").

176. *Id.*

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

those of the corporation and its shareholders."[178] There are three key forms of increased scrutiny available to Delaware courts when reviewing board actions that appear detrimental to shareholders;[179] these standards of review vary from an intermediate level of scrutiny to an extremely heightened scrutiny. The court identified the standards in three landmark cases: *Unocal Corp. v. Mesa Petroleum, Co.*,[180] *Weinberger v. UOP, Inc.*,[181] and *Blasius*. These standards of review must be distinguished to explain why the *Blasius* standard is appropriate in the context of fiduciary-out clauses.

Neither the *Weinberger* nor the *Unocal* standard is compatible with the scenario posed by a board of directors' abuse of its fiduciary-out clause. *Unocal* review requires a board of directors that has decided to take defensive measures against a takeover to show that it had, with good faith and upon appropriate investigation, a belief that the takeover posed a threat to the corporation; the board's action must then be "reasonable in relation to the threat posed."[182] The majority of the *Unocal* analysis, however, focuses on the threat of a takeover,[183] an element not present in the shareholder-bylaw proposal and director-election contexts. The proposed Bylaw simply attempts to institute a process through which successful candidates are reimbursed.[184] This change would have the effect of increasing the likelihood of contested elections, but it would not create a threat that should trigger a *Unocal* analysis.[185] Likewise, the typical deal

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178. *Id.*

179. *Compare* Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 661 (Del. Ch. 1988) (holding the board to a burden of demonstrating a compelling justification for actions with the "purpose of impeding the exercise of stockholder voting power"), *with Unocal*, 493 A.2d at 954–55 (explaining that conflicted directors have the burden of showing that their actions were taken in good faith with no desire to perpetuate themselves in office and were "reasonable in relation to the threat posed"), *and Weinberger*, 457 A.2d at 711 (requiring a showing of "[t]he concept of fairness [with] two basic aspects: fair dealing and fair price"). For a detailed discussion of the *Unocal*, *Weinberger*, and *Blasius* standards and their varying levels of heightened scrutiny, see Klein, *supra* note 156, at 147–57.

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

181. Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

182. *Unocal*, 493 A.2d at 955.

183. *See, e.g.*, Williams v. Geier, 671 A.2d 1368, 1377 (Del. 1996) ("A *Unocal* analysis should be used only when a board . . . adopts defensive measures in reaction to a perceived threat.").

184. CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227, 230 (Del. 2008).

185. Recall that *Unocal* analysis is triggered by the threat of a takeover and the use of defensive measures by the board in response to that threat. *See, e.g.*, *Williams*, 671 A.2d at 1377 (noting that a *Unocal* analysis only applies in the context of a board's adoption of defensive measures against a perceived threat to the corporate enterprise).

protections and defensive measures utilized by a board of directors would have little effect after an election.[186] The *Unocal* standard is, of course, a higher standard than the business judgment rule, but the Delaware Supreme Court has recognized that the *Blasius* standard applies more specifically to instances of shareholder disenfranchisement.[187]

The entire fairness test from *Weinberger* requires a showing of both a fair price in a given transaction and fair dealing or process in undertaking that transaction.[188] However, the entire fairness standard is not relevant to the corporate governance context,[189] as there is no transaction or price to take into account. Although the entire fairness test provides heightened scrutiny, it has rarely been utilized outside the takeover context. The situation that this Note addresses would take place after a shareholder vote to accept the proposed bylaw and after a short slate candidate is successfully voted onto the board. Defensive measures at that point would be completely out of place, as would a standard of review meant to deal with them. Instead, attempts by the incumbent board to undermine the election of an individual to the board would be unilateral, unprovoked actions with the taint of both entrenchment and shareholder disenfranchisement. Such actions would necessitate a *Blasius* standard of review.

The *Blasius* standard places upon the board "the heavy burden of demonstrating a compelling justification" for the board action that impeded shareholder voting power.[190] To invoke *Blasius*, "[t]he franchise interest [of shareholders] should clearly be in jeopardy before a court grants it special protection."[191] The board's action

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186. Typical deal protections, such as no-shop provisions, or defensive measures, such as shareholder rights plans for repurchasing shares, simply would have no bearing on the reimbursement of a candidate. Such measures—and an analysis of such measures—are more appropriate in the context in which a proxy contest is waged simultaneous to a tender offer. For further discussion, see Warren & Abrams, *supra* note 34, at 652–53, discussing the general framework as applied in *Unocal*, and Klein, *supra* note 156, at 149–50, addressing the *Unocal* court's standard of review to determine the reasonableness of board action.

187. *See Williams*, 671 A.2d at 1376 ("[T]he . . . standard set forth in *Blasius* is appropriate only where the '"primary purpose' of the board's action [is] to interfere with or impede exercise of the shareholder franchise . . . .'" (third alteration in original) (quoting Stroud v. Grace, 606 A.2d 75, 93 (Del. 1992))); *see also id.* at 1377 (distinguishing between "either unilateral director action in the face of a claimed threat or an act of disenfranchisement" (emphasis omitted)).

188. Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983).

189. *See* Klein, *supra* note 156, at 148 (noting that in the 1980s, with the market for corporate control developing, the entire fairness standard of review became "unsatisfactory").

190. Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 661 (Del. Ch. 1988).

191. Klein, *supra* note 156, at 156.

should come close to "foreclosing effective shareholder action."[192] Chancellor Allen explains his rationale for utilizing a higher degree of scrutiny in such instances, stating:

> [T]he ordinary considerations to which the business judgment rule originally responded are simply not present in the shareholder voting context. That is, a decision by the board to act for the primary purpose of preventing the effectiveness of a shareholder vote inevitably involves the question who, as between the principal and the agent, has authority with respect to a matter of internal corporate governance. . . . Action designed principally to interfere with the effectiveness of a vote inevitably involves a conflict between the board and a shareholder majority. Judicial review of such action involves a determination of the legal and equitable obligations of an agent towards his principal. This is not . . . a question that a court may leave to the agent finally to decide so long as he does so honestly and competently; that is, it may not be left to the agent's business judgment.[193]

Admittedly, "*Blasius*' burden of demonstrating a 'compelling justification' is quite onerous" and should therefore be "applied rarely."[194] Courts have articulated that *Blasius*' onerous standard is appropriate only when the "'purpose of the board's action [is] to interfere with or impede exercise of the shareholder franchise,' and the stockholders are not given a 'full and fair opportunity to vote.'"[195]

C. Blasius *Review Should Be Used when Directors Discourage Contested Elections*

Delaware courts have noted previously that "[t]he corporate election process, if it is to have any validity, must be conducted with scrupulous fairness and without any advantage being conferred or denied to any candidate or slate of candidates."[196] Delaware courts require that "those in charge of the election machinery of a corporation must be held to the highest standards in providing for and conducting corporate elections."[197] A board's decision to refuse

192. *Blasius*, 564 A.2d at 663.

193. *Id.* at 659–60 (footnotes omitted).

194. Williams v. Geier, 671 A.2d 1368, 1376 (Del. 1996). *But see* Chesapeake Corp. v. Shore, 771 A.2d 293, 320 (Del. Ch. 2000) ("[T]he fact that [*Blasius*] is 'onerous' is not a reason not to apply it if the circumstances warrant.").

195. *Williams*, 671 A.2d at 1376 (quoting Stroud v. Grace, 606 A.2d 75, 92 (Del. 1992)).

196. Aprahamian v. HBO & Co., 531 A.2d 1204, 1206 (Del. Ch. 1987).

197. *Id.* at 1206–07.

reimbursement would inherently subordinate the dissident slate; it would effectively signal the incumbent board's commitment to oppose any attempt to facilitate more competitive and responsive director elections.

As the court in *Blasius* noted, "[t]he only justification that can . . . be offered for [such a board] action is that the board knows better than do the shareholders what is in the corporation's best interest."[198] The court continued, however, by arguing that "[w]hile that premise is no doubt true for any number of matters, it is irrelevant . . . when the question is who should comprise the board."[199] The Delaware Supreme Court has since adopted this very logic.[200] A board of directors should not be permitted to assert that it knows better than the shareholders—the proper electorate—whom that electorate should choose as its directors. Such an assertion, given Chancellor Allen's logic in *Blasius*,[201] should necessarily invoke the *Blasius* compelling justification requirement. Because the Delaware Supreme Court defined the right to choose contestants as part of the shareholders' right to vote for directors,[202] it follows that an action taken to undermine the nomination of future directors has the purpose and effect of impeding the exercise of the shareholder franchise. When a board impedes the shareholder franchise, *Blasius* review is appropriate.

The decision by a board to refuse reimbursement to the nominating party of a successful dissident candidate is not a typical business decision. Instead, it is inherently tied to the election process. The *Blasius* standard is more likely to be applied to decisions outside of the ordinary business decisions of the board.[203] Thus, a decision that has the effect of limiting or preventing a portion of shareholder voting likely deserves the protection of the *Blasius* standard of

198. *Blasius*, 564 A.2d at 663.

199. *Id.*

200. *See* MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1128–29 (Del. 2003) (quoting in multiple places Chancellor Allen's opinion in *Blasius*).

201. *Blasius*, 564 A.2d at 663 ("The theory of our corporation law confers power upon directors as the agents of the shareholders; it does not create Platonic masters.").

202. CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227, 237 (Del. 2008).

203. David C. McBride & Danielle Gibbs, *Interference with Voting Rights: The Metaphysics of* Blasius Industries v. Atlas Corp., 26 DEL. J. CORP. L. 927, 935 (2001).

review; the detrimental effect, though perhaps not imminent, is nonetheless guaranteed.[204]

When assessing whether a *Blasius* standard of review is appropriate, one must demonstrate that not only the purpose but also the effect of the action was to the detriment of the shareholder franchise.[205] Succinctly put, did the action thwart a shareholder vote?[206] One may argue that a *Blasius* standard is inappropriate when, as here, the board's action did not interfere with the vote itself; likewise, one could argue that discouraging future elections does not amount to discouraging an imminent contest and therefore does not trigger *Blasius*. Indeed, CA argued that the fact that the proposed Bylaw dealt with corporate funds and would have its effect after the election in essence removed it from the spectrum of shareholder enfranchisement, and thus was outside proper shareholder action.[207] Such arguments, however, ignore the fact that the refusal to reimburse candidates inherently undermines the vote, thus interfering with the voting process going forward.[208]

Another potential criticism of the invocation of the *Blasius* standard is that the *Unocal* standard, or simply a balancing or entire fairness test, would be sufficient. In other words, the courts need not

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204. *See* Chesapeake Corp. v. Shore, 771 A.2d 293, 320 (Del. Ch. 2000) ("Absent confessions of improper purpose, the most important evidence of what a board intended to do is often what effects its actions have.").

205. *See* McBride & Gibbs, *supra* note 203, at 930 ("When assessing whether the *Blasius* standard applies to an individual case, lawyers are often consumed by the question of the defendant's motive or purpose. They sometimes fail to appreciate that courts make an equally important inquiry into whether the defendant's action, whatever its purpose, had the proscribed effect.").

206. *Id.*

207. *See* Broc Romanek, *The Delaware Supreme Court's AFSCME/CA Hearing: All the News Fit to Post*, THECORPORATECOUNSEL.NET, July 10, 2008, http://www.thecorporatecounsel.net/Blog/2008/07/the-delaware-supreme-courts-afscmeca-hearing-all-the-news-fit-to-post.html (noting CA's argument that the "Bylaw mandates a payment of expenses, rather than relates to an election, and control over corporate expenditures is part of the business and affairs of the corporation"). *Compare* Brief of Appellant at 18, *CA, Inc.*, 953 A.2d 227 (No. 329,2008), 2008 WL 2724909, at *15 ("It does not matter that the expenditures nominally concern stockholder voting, rather than other aspects of a company's business operations . . . ."), *with* Brief of Appellee at 12–13, *CA, Inc.*, 953 A.2d 227 (No. 329,2008), 2008 WL 2724908, at *10 ("Because the nomination process is an integral element of the shareholder franchise, the Proposed Bylaw addresses an area that is an appropriate subject matter for shareholder action.").

208. *See* McBride & Gibbs, *supra* note 203, at 931 ("Such selective and one-sided use of [director] power, if permitted, would fundamentally undermine the process of shareholder voting. In addition, a one-sided voting process would surely deter any proxy contestant and undermine the institutional integrity of corporate democracy.").

utilize *Blasius* because its strict standard is unnecessary given *Unocal* and *Weinberger*. This criticism, however, misses the point of *Blasius*. As one study found, "despite the considerable overlap between the *Blasius* standard and [other standards], the *Blasius* standard serves a purpose not served by [the others]."[209] *Blasius* is the only standard of review that recognizes that certain decisions should not qualify as business decisions, and that therefore adopts a sufficiently strict approach to protecting against threats to the shareholder franchise, the bedrock of Delaware corporate law.[210]

Likewise, a company could assert that, when the shareholders have already successfully voted for a dissident candidate, it is logically inconsistent to then argue that the board could interfere with the exercise of that vote after the fact. To invoke *Blasius*, however, the Delaware Supreme Court has held that "a board need not actually prevent the shareholders from attaining any success in seating one or more nominees," nor does the contested election need to "involve a challenge for outright control of the board."[211] Moreover, such an argument ignores the importance of reimbursement as part of the voting process going forward; reimbursement facilitates shareholders' rights to participate in the selection of candidates.[212] By discouraging future contested elections, the board of directors would inherently "impede [the] exercise of the shareholder franchise."[213] The Delaware Supreme Court specifically recognized shareholders' right to choose contestants in an election and noted shareholders' entitlement to encourage the candidacy of nonboard-sponsored nominees.[214] By doing so, the court inherently supported the notion that actions with

209. *Id.* at 929; *see also id.* (assessing the *Blasius* doctrine's usefulness).

210. *See id.* at 944 (noting that *Blasius* applies in circumstances in which *Unocal* cannot and is particularly suited for the conflicts raised by corporate elections).

211. MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1132 (Del. 2003).

212. *See CA, Inc.*, 953 A.2d at 237 (noting that the Bylaw facilitates shareholders' rights to participate in director nominations); *see also* Posting of Lisa Fairfax to The Conglomerate, *supra* note 118 (noting that the potential for costly litigation would be a deterrent for those considering nominating candidates, ultimately undermining the purpose of the Bylaw).

213. Williams v. Geier, 671 A.2d 1368, 1376 (Del. 1996); *see also id.* (noting that *Blasius* is invoked when the board's actions limit the shareholder franchise and shareholders' ability to freely and fully vote). This Note asserts that, by discouraging future candidates from campaigning for a board position, the incumbent board interferes with the shareholders' ability to freely and fully vote insofar as the Delaware Supreme Court understands the right to vote to include the ability to choose the contestants for that election. For a discussion of the meaninglessness of a shareholder's right to vote without the ability to choose the contestants for that election, see *supra* notes 162–63 and accompanying text.

214. *CA, Inc.*, 953 A.2d at 237.

the effect of suppressing shareholders' efforts to encourage alternate candidates would, in effect, thwart the proper exercise of the shareholder franchise by undermining a right that the court specifically delineated.[215]

Another potential criticism of the invocation of the compelling justification standard is that strict scrutiny assumes that the board acted with the *purpose* of disenfranchisement.[216] One could argue that a board that chooses to reject reimbursement does so in good faith and with no specific intent to discourage future contested elections. But it is important to note that, although the *Blasius* standard has only been applied when a given motive is present, it does not require that the directors be acting in bad faith or to the detriment of the shareholders.[217] Indeed, in *Blasius*, the good faith belief of the board was not enough to cure the improper purpose to interfere with the shareholder voting process.[218]

Given the directors' knowledge of the effects of their decision, it is fair to assume that, without compelling justification, the board's intent is to discourage dissident candidates.[219] Logically, if the

215. If the Delaware Supreme Court is not willing to prevent actions that discourage contested election and director nominations, then the importance the court placed on shareholders' rights to choose contestants in an election is undermined. It makes little sense for the court to praise the shareholder franchise with respect to candidate nominations while simultaneously refusing to defend the right to protect those nominations from attack.

216. *See* Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 661 (Del. Ch. 1988) (holding that compelling justification review is appropriate when the "board acts . . . for the primary purpose of impeding the exercise of stockholder voting power").

217. *See id.* at 658, 663 (discussing whether a board that acts in good faith may ever validly act with the purpose of discouraging the proper functioning of the shareholder voting process and finding that when "the action taken [by the board] was taken in good faith, it [still] constituted an unintended violation of the duty of loyalty that the board owed to the shareholders").

218. *Id.* at 663.

219. *See* Chesapeake Corp. v. Shore, 771 A.2d 293, 320 (Del. Ch. 2000) ("Absent confessions of improper purpose, the most important evidence of what a board intended to do is often what effects its actions have."). Asserting director intent in the reimbursement refusal context requires an application of common sense. To assume that the board's purpose is shareholder disenfranchisement requires looking at the effect of a board's decision to refuse reimbursement on shareholder enfranchisement generally. In other words, would the refusal to reimburse candidates systematically cause shareholders to be less likely to fund dissident candidates in a contested board election? Given the logic the Delaware Supreme Court uses to hold that the Bylaw in *CA, Inc.* is a protected element of the shareholder franchise, the undermining of such a proposal would necessarily cause disenfranchisement. Common sense assumes a disenfranchisement purpose when the board knows its actions would have the deleterious effect of discouraging shareholder support for contested elections. *See* Thomas, *supra* note 166, at 553–54 (discussing the sensibility of courts' use of common sense to determine

shareholders know that a board will wield its fiduciary-out clause liberally, the promise of reimbursement is certain to be illusory. And when the effect of a board's action is clear and relatively certain, the board will have "the impossible task of convincing the court that this effect of the [action] was not intended."[220] Courts, of course, are permitted to look past the purported "business" rationale when the clear *effect* of an action is to interfere with the election process.[221] Thus, *Blasius* would be appropriate except in the case in which a compelling justification makes it less likely that the board desired to discourage future dissident candidate nominations.

On the other hand, a court will not invoke *Blasius* scrutiny when shareholders have had a full and fair opportunity to vote and ultimately ratify the board's action.[222] In such an instance, *Blasius* would be inappropriate because the shareholder franchise was exercised. This would be quite distinct from the proposed hypothetical in which the shareholders' only vote was for a candidate who the board then unilaterally chose not to reimburse.

A final potential criticism is that the application of the *Blasius* standard would eliminate the effect of the fiduciary-out clause altogether. One could assert that any protection that a fiduciary-out clause affords to shareholders would be necessarily eliminated by holding the clause to an artificially high standard of review. This argument misses the point, however; Chancellor Allen purposefully avoided articulating a per se rule of invalidity in *Blasius* even when the board acted for entrenchment or shareholder disenfranchisement.[223] Instead, *Blasius* review requires a compelling justification—a high standard, to be sure, but one that enables the board to explain its purpose and intended effect.[224] If a board of directors chose not to reimburse a candidate who ran for personal

whether defensive tactics taken by a board have a severe impact on the dissident candidates in a contested election).

220. McBride & Gibbs, *supra* note 203, at 937.

221. *See id.* at 937–38 (noting instances in which the court has looked past the purported rationale of a poison pill or change-of-control provision when its clear effect was to deter future proxy contests).

222. *See, e.g.*, Stroud v. Grace, 606 A.2d 75, 92 (Del. 1992) ("[Defendant's] shareholders, unlike those in both *Blasius* and *Aprahamian*, had a full and fair opportunity to vote on the Amendments and did so. The result of the vote, ceding greater authority to the board, does not under the circumstances implicate *Unocal* or *Blasius*.").

223. *Blasius*, 564 A.2d at 662.

224. *See id.* (explaining the court's rationale for not choosing a per se rule).

reasons, the compelling justification would be demonstrated.[225] Thus, applying the *Blasius* standard to the exercise of a fiduciary-out clause to prevent reimbursement would not have a drastically limiting effect on directors' legitimate discretion. Moreover, any argument invoking the protection of shareholders as a justification is inherently weakened by the fact that, in the context of reimbursing a successful candidate, a majority of shareholders has voted for the dissident candidate.[226] To allow fiduciary outs without applying a strict standard of review would, in effect, seriously hamper the ability of that majority to cry foul after the election.[227] Thus, to preserve shareholder access to director elections, Delaware courts must utilize the *Blasius* standard of review.[228]

CONCLUSION

In response to the *CA, Inc.* decision, the Delaware General Assembly approved rule changes to incorporate the new role for shareholders in the nomination process of director candidates. These amendments to the DGCL, signed into law by Governor Jack Markell on April 10, 2009, signal a greater role for shareholder activists[229] and codify the *CA, Inc.* decision, ensuring its lasting impact

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225. *See* CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227, 240 n.34 (Del. 2008) (explaining one situation that would likely suffice as a compelling justification for the board to refuse reimbursement to protect against shareholders reimbursing a candidate who ran based on purely personal motivations). *But see* Posting of Lisa Fairfax to The Conglomerate, *supra* note 118 (asserting that it is unlikely that a candidate with purely personal motivations could successfully attain a board position unless he could add value to the company).

226. For a discussion of the impropriety of using a fiduciary-out clause as a limitation on the expressly voiced desires of shareholders, see *supra* Part III.B and note 144.

227. *See* 1 BLOOMENTHAL, *supra* note 146, § 18:26.20 ("A fiduciary-out clause grants the board broad authority, but presumably permits the proponents an avenue to challenge whether the board breached its fiduciary duties. This is not much of an avenue . . . .").

228. It is important to note, before concluding, that the arguments contained herein are applicable specifically in the context of shareholder proposals and attempts by a board of directors to limit the reimbursement of a successful short slate candidate. Most fiduciary-out clauses serve to protect shareholders and thus do not risk the same abuses that a fiduciary out in the *CA, Inc.* context would raise. When fiduciary-out clauses serve to protect shareholder interests more directly, as in *Omnicare*, the same basis for implementing a *Blasius* standard of review is not present. In no way should these arguments be taken to support the concept that compelling justification review should be applied to invocations of a fiduciary-out clause to protect against board action rather than shareholder action.

229. Sheri Qualters, *Changes in Delaware Corporate Law Expected to Aid Activists Change Bylaws, Elect Directors*, N.Y. L.J., Apr. 23, 2009, at 7 (noting that the reimbursement provisions added to Delaware corporate law after the *CA, Inc.* decision "are expected to aid shareholder activists seeking bylaw changes, that boost their ability to nominate and elect directors"); *see*

on the contours of Delaware corporate law. Likewise, the SEC felt compelled to alter its rules after *CA, Inc.*, proposing a rule change that would incorporate the holding of *CA, Inc.* and allow shareholders to propose bylaws that reimburse successful dissident candidates.[230] Thus, in the wake of *CA, Inc.* and the ensuing rule changes it prompted, shareholders will likely avail themselves of their newfound powers during the spring 2010 proxy season.[231] These rule changes indicate the importance of the *CA, Inc.* decision,[232] but the likely uptick in shareholder-proposed bylaws should also illustrate the need for an appropriate standard of review. It is likely that with this increase the SEC will see an influx of requests for no-action letters. And although the Commission might tell complaining companies not to exclude shareholder proposals for candidate reimbursement, the SEC has no power to control the exercise of discretion that directors have over fiduciary-out clauses. Instead, Delaware courts must play the role of arbiter.

Delaware courts, then, will be faced again with the difficult question of just how much discretion the board of directors ought to have in determining whether a particular election contest is in the best interest of the company and its shareholders. The Delaware Supreme Court's decision in *CA, Inc.* signaled its desire for strong protections of shareholders' rights to participate meaningfully in director elections.[233] Underscoring that protection, it follows that any contested election that is not based on purely personal motivations benefits the shareholders because it provides them with greater choice and a voice in determining who manages their company. To protect the rights of shareholders to participate in the selection of

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also ROPES & GRAY LLP, AMENDMENTS TO DELAWARE GENERAL CORPORATION LAW MAY AID ACTIVIST STOCKHOLDERS (2009), http://www.ropesgray.com/delawaregeneralcorporation lawmayaidactiviststockholders/ (describing the provisions of the amendments).

230. Facilitating Shareholder Director Nominations, Exchange Act Release Nos. 33-9046 & 34-60089, 74 Fed. Reg. 29,024 (proposed June 18, 2009) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249, 274).

231. Qualters, *supra* note 229 (predicting that the spring 2010 proxy season will see a dramatic increase in shareholder-proposed bylaws).

232. In the aftermath of *CA, Inc.*, some companies have recognized the inevitability of shareholder participation in the nomination process and have embraced the reimbursement of proxy expenses. *See* Joann S. Lublin, *Fair Fight? Assistance Is Offered in Proxies*, WALL ST. J., Oct. 26, 2009, at B1 (noting that "HealthSouth Corp. is moving to become the first big U.S. business to reimburse activist shareholders for the expense of unseating management-backed directors").

233. *See supra* Part II.B.

director candidates,[234] the Delaware Supreme Court must use heightened scrutiny to review any directorial claim that reimbursement violates the board's fiduciary duties. Specifically, the compelling justification standard of review, articulated in *Blasius*, is necessary given the very high risk that a board would act to entrench itself and deter future candidates' challenges.

Corporate governance reforms need not be accomplished solely via legislative action. By ensuring that directors are accountable to shareholders, courts can give deference to directors' managerial determinations without allowing directors to control the outcomes of their own elections. Ultimately, boards of directors should answer for their choices of executives and their allocation of compensation. The public sentiment clearly favors a greater say for shareholders in the decisions made in corporate boardrooms. But that sentiment calls for a new structure for corporate management in which the shareholders help manage the company. Rather than legislate such an upheaval, shareholder participation can be facilitated within the current structure. Instead of enacting compensation legislation, for example, a standard of review that protects shareholder participation can help shareholders realize the influence they can have on this issue. By assuring that shareholders have a meaningful ability to participate in the election of directors, courts can better uphold the fundamental principles of corporate law without uprooting the established structure.

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234. CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227, 237 (Del. 2008) (explaining the court's rationale for the need for great protection of any embodiment of the shareholder franchise).