

# TAKING A BACKSEAT: HOW DELAWARE CAN ALTER THE ROLE OF THE SEC IN EVALUATING SHAREHOLDER PROPOSALS

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## I. INTRODUCTION

In May 2007, the Delaware General Assembly amended the Delaware State Constitution to permit the Supreme Court of Delaware to accept certified questions from the Securities and Exchange Commission.<sup>1</sup> The amendment reads in relevant part:

To hear and determine questions of law certified to it by other Delaware courts, the Supreme Court of the United States, a Court of Appeals of the United States, a United States District Court, the United States Securities and Exchange Commission, or the highest appellate court of any other state, where it appears to the Supreme Court that there are important and urgent reasons for an immediate determination of such questions by it. The Supreme Court may, by rules, define generally the conditions under which questions may be certified to it and prescribe methods of certification.<sup>2</sup>

The Division of Corporations of Delaware summarized the anticipated consequences of the amendment as follows: "...[t]o bring critical and urgent questions concerning Delaware law to the Delaware Supreme Court. The amendment provides the SEC with access to expedited decisions and greater

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<sup>1</sup> S.B. 62, 144th Gen. Assem., Reg. Sess. (Del. 2007); *see also* Press Release, Supreme Court of Delaware, *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>.

<sup>2</sup> Del. Const. art. IV, § 11(8)

certainty with regard to matters of Delaware corporate law.”<sup>3</sup> In 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. As Professor Robert B. Ahdieh notes, “[u]nder Rule 14a-8, in fact, these roles are so intertwined that it becomes difficult to tell a coherent story about discrete federal versus state law and analysis.”<sup>4</sup> The amendment stands to change radically the dichotomy between state and the federal government, as it relates to corporate governance and shareholder proposals under Rule 14a-8.<sup>5</sup> Under the SEC’s current operation of Rule 14a-8, state actors have been shut out of the interpretative process.<sup>6</sup> Therefore, the amendment to the Delaware State Constitution could be the first in a series of state constitutional amendments that permit the SEC to certify questions to the highest court in the state of incorporation. Moreover, the amendment could represent a shift toward minimizing the role of the SEC in evaluating shareholder proposals, implicating serious federalism concerns.<sup>7</sup>

The amendment to the Delaware State Constitution is a welcomed development. More states should seriously consider adding such an amendment to their respective state constitutions. Furthermore, the SEC should refrain from ruling on the merits of shareholder proposals pursuant to Rule 14a-8 for the following reasons. First, providing state courts an expansive

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<sup>3</sup> Department of State: Division of Corporations, *2007 Amendments to Delaware Corporate Law*, <http://www.corp.delaware.gov/2007amend.shtml> (last visited October 7, 2008).

<sup>4</sup> Robert B. Ahdieh, *From Federal Rules to Intersystemic Governance in Securities Regulation*, 57 EMORY L.J. 233, 235 (2007).

<sup>5</sup> Rule 14a-8(i)(1) provides in relevant part: “Question 9: If I have complied with the procedural requirements, on what other bases may a company rely to exclude my proposal? (1) Improper under state law: If the proposal is not a proper subject for action by shareholders under the laws of the jurisdiction of the company’s organization[.]” See 17 C.F.R. § 240.14a-8(i)(1). The note to 14a-8(i)(1) also contains the following language: “Depending on the subject matter, some proposals are not considered proper under state law if they would be binding on the company if approved by shareholders. In our experience, most proposals that are cast as recommendations or requests that the board of directors take specified action are proper under state law. Accordingly, we will assume that a proposal drafted as a recommendation or suggestion is proper unless the company demonstrates otherwise.” See *id.*

<sup>6</sup> Robert B. Ahdieh, *The Dialectical Regulation of Rule 14a-8: Intersystemic Governance in Corporate Law*, 2 J. BUS. & TECH. L. 165, 172 (2007) (noting that “the SEC’s operationalization of Rule 14a-8 has not included any mechanism of state involvement”).

<sup>7</sup> See e.g., Donna M. Nagy, *Judicial Reliance on Regulatory Interpretation in SEC No-Action Letters: Current Problems and a Proposed Framework*, 83 CORNELL L. REV. 921, 1009-1012 (1998) (noting that courts should be reluctant to afford great deference to interpretations of state law by the SEC because SEC staff are not experts in state law governing corporate governance).

role in the interpretation of state law is consistent with the text of the Rule. The text seems to envision a cross-jurisdictional framework to foster cooperation between the state and federal government.<sup>8</sup> Contrary to the text of the Rule, however, the SEC has put itself in the forefront of applying Rule 14a-8 at the exclusion of state actors.<sup>9</sup> Second, state courts have developed the requisite expertise in interpreting and applying their own statutes concerning corporate governance. As previously noted, the SEC has not clearly articulated a role for state courts in the operation of Rule 14a-8. Nor has Congress sought to engage state courts that have the expertise and experience to resolve ambiguous issues of state law.<sup>10</sup> Third, in terms of efficiency, a clear interpretation of state law through the certified-question amendment to the Delaware State Constitution will eliminate the need for protracted litigation. State courts will be able to set doctrinal rules via precedential authority to govern future cases and provide greater guidance for the SEC when issuing no-action letters, which often lack substantive analysis of the applicable state law.<sup>11</sup> The ambiguous no-action letters generally leave the parties unclear as to their responsibilities toward each other. Therefore, to avoid the inefficiencies and contradictions arising from the current use of Rule 14a-8, the amendment to the Delaware State Constitution may represent the initial step toward a more active role for state courts in interpreting state law and an improved system for evaluating the validity of shareholder proposals overall.

In this article, Part II discusses the operation of Rule 14a-8 and the process by which the SEC evaluates shareholder proposals. Part II-A also discusses the application of Rule 14a-8 by the SEC and federal courts and the problems that result, which include a lack of substantive analysis by the SEC and federal injections into state law governing shareholder proposals. Part II-B outlines the implications of the amendment on Rule 14a-8 and the SEC. Part II-B also discusses the issues that the amendment was intended to address. Part III discusses the case of *CA, Inc. v. AFSCME Employees Pension Plan*, the first case to be brought to the Delaware Supreme Court by the SEC pursuant to the amendment's certification provision, and its effect on future SEC and federal court adjudications. Part IV concludes the note, summarizing the effect that the amendment to the Delaware Constitution will have on the interplay between the SEC and Delaware's court system.

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<sup>8</sup> Ahdieh, *supra* note 4, at 234 (noting that "Rule 14a-8 creates one of the most significant opportunities for cross-jurisdictional engagement in U.S. securities law").

<sup>9</sup> Ahdieh, *supra* note 5.

<sup>10</sup> *See id.*; *see e.g., Securities and Exchange Commission v. May*, 229 F.2d 123 (2d Cir. 1956) (congressional delegations of authority to SEC to make rules constitutional).

<sup>11</sup> Ahdieh, *supra* note 5, at 177.

## II. RULE 14A-8 AND SEC EVALUATION OF SHAREHOLDER PROPOSALS

A shareholder proposal is defined as a “recommendation or requirement that the company and/or its board of directors take action, which the shareholder intends to present at a meeting of the company’s shareholders.”<sup>12</sup> Shareholders owning at least \$2,000 in market value or 1% of the company’s securities are entitled to submit a proposal to be included on the company’s proxy card at the next shareholders’ meeting.<sup>13</sup> An eligible shareholder may only submit one proposal per a shareholders meeting, and the proposal, accompanied by a supporting statement, may not exceed 500 words.<sup>14</sup> Provided the shareholder meets the threshold requirements, the company will ordinarily place the proposal on the proxy card at the next shareholders’ meeting. The company, however, can object to the proposal for a number of reasons, including if the proposal is improper under state law of the relevant jurisdiction.<sup>15</sup> If the company declines to include the proposal in its proxy materials, the company can request a no-action letter from the SEC’s Division of Corporation Finance pursuant to Rule 14a-8(j).<sup>16</sup>

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<sup>12</sup> 69 AM JUR.2D Securities Regulation-Federal § 642; *see also* 17 C.F.R. § 240.14a-8(a).

<sup>13</sup> 17 C.F.R. § 240.14a-8(b)-(b)(1).

<sup>14</sup> 17 C.F.R. § 240.14a-8(c)-(d).

<sup>15</sup> Rule 14a-8, *supra* note 5. Rule 14a-8 also permits a company to exclude a shareholder proposal for the following reasons: (1) if a proposal, if implemented, causes the company to violate any state, federal or foreign law that it is subject to; (2) if the proposal or supporting statement is contrary to any of the SEC’s proxy rules; (3) if the proposal is a product of personal grievances or special interest; (4) if the proposal relates to operations that account for less than 5 percent of the company’s total assets at the end of the most recent fiscal year, and less than 5 percent of its net earnings and gross sales for its most recent fiscal year, and is not significantly related to the company’s business; (5) if the company would lack the power or authority to implement the proposal; (6) if the proposal relates to an election for membership on the company’s board of directors; (7) if the proposal deals with a matter relating to the company’s ordinary business operations; (8) if the proposal conflicts with one of the company’s own proposals to be submitted to shareholders at the same meeting; (9) if the company has already substantially supplemented the proposal; (10) if the proposal substantially duplicates another proposal already submitted by another proponent that will be included in the company’s proxy materials for the same meeting; (11) if the proposal deals with substantially the same subject matter as another proposal or proposals that has or have been previously included in the company’s proxy materials within the preceding 5 calendar years; and (12) if the proposal relates to specific amounts of cash or stock dividends. *See e.g.*, 17 C.F.R. § 240.14a-8.

<sup>16</sup> 17 C.F.R. § 240.14a-8(j)(1)-(2); *see also Apache Corp. v. New York City Employees’ Ret. Sys.*, No. H-08-1064, 2008 WL 1821728, at \*2-\*3 (S.D. Tex. April 22, 2008) (describing the process in which defendant obtained a no-action letter from the SEC); Nagy, *supra* note 7, at 939 (noting that companies that omit shareholder proposals often request no-action letters in support of their decisions).

If a no-action letter is granted, the shareholder can request review by the Commission. Although the Commission retains discretion to review the issuance of a no-action letter, a grant of a no-action letter by the SEC generally serves as the catalyst to civil litigation.<sup>17</sup> In the majority of cases, the Division of Corporate Finance makes a staff recommendation to the Commission to decline to review the matter. The Commission generally accepts the recommendation without qualification.<sup>18</sup> If the Commission declines to engage in review, direct judicial review at the federal appellate level is barred.<sup>19</sup> If the Commission does review the decision to issue a no-action letter, however, direct judicial review at the federal appellate level is available.<sup>20</sup> In reaction to the issuance of an adverse no-action letter, a small minority of plaintiff shareholders have challenged the constitutionality of the SEC's ability to promulgate rules as an improper delegation of Congress' legislative power.<sup>21</sup> Challenges to the constitutionality of the SEC's rule-making authority have been uniformly rejected.<sup>22</sup> The more common course of action for shareholders after receiving a no-action letter is to initiate a direct action in federal court to avoid the potential foreclosure of judicial review.<sup>23</sup> Therefore, federal courts are often compelled to examine the rationale underlying the SEC's decision to issue a no-action letter, thereby opening the door to protracted litigation and an unguided endeavor into state law.

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<sup>17</sup> See e.g., *Apache Corp.*, at \*3 (defendant filed for declaratory judgment after receiving a favorable no-action letter from the SEC); see also *Medical Comm. for Human Rights v. SEC*, 432 F.2d 659 (D.C. Cir. 1970) (plaintiff commenced litigation challenging the SEC's authority after receiving adverse no-action letter), *vacated as moot*, 404 U.S. 403 (1972); see also *New York City Employees' Ret. Sys. v. SEC*, 45 F.3d 7, 10 (2d Cir. 1995) (appeal from a Commission affirming the disposition of a no-action letter).

<sup>18</sup> Thomas P. Lemke, *The SEC No-Action Letter Process*, 42 BUS. LAW. 1019, 1039 (1987).

<sup>19</sup> 15 U.S.C. § 77i (1994); Nagy, *supra* note 7, at 945 (noting that judicial review is foreclosed under the Securities Act and the Administrative Procedure Act because there is no final agency decision to review) (citing *Kixmiller v SEC*, 492 F.2d 641, 643-644 (D.C. Cir. 1974)).

<sup>20</sup> See *id.*

<sup>21</sup> See e.g., *SEC v. Transamerica Corp.*, 163 F.2d 511 (3d Cir. 1947); see also *May*, 229 F.2d at 123; *United States v. Guterma*, 189 F. Supp. 265 (S.D.N.Y. 1960).

<sup>22</sup> See *id.*; see also *United Paperworkers Int'l Union v. International Paper Co.*, 801 F. Supp. 1134, 1145 (S.D.N.Y. 1992) (noting that the express congressional goal of "enlightening" the shareholder is served by SEC rule) (citing *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 385 (1970)).

<sup>23</sup> See *Apache Corp.*, *supra* note 17.

A. *The Problematic Application of Rule 14a-8 by the SEC and Federal Courts.*

The federal court endeavors into state law in evaluating the validity of shareholder proposals are hindered by the lack of substantive analysis provided by no-action letters issued by the SEC. SEC no-action letters are often brief, in many cases only comprising of 3-4 sentences. The following response is typical of the SEC's response to complex Rule 14a-8 issues presented by shareholder proposals under state law:

The proposal recommends that the board adopt cumulative voting. There appears to be some basis for your view that Pfizer may exclude the proposal under rule 14a-8(i)(2). We note that in the opinion of your counsel, implementation of the proposal would cause Pfizer to violate state law. Accordingly, we will not recommend enforcement action to the Commission if Pfizer omits the proposal from its proxy materials in reliance on rule [sic] 14a-8(i)(2).<sup>24</sup>

In response to criticism that no-action letters are too succinct and do not address the underlying legal dispute between adverse parties, the SEC contends that no-action letters are informal responses and not intended to be an official statement by the SEC on the current state of the law.<sup>25</sup> Accordingly, federal courts have afforded little deference to no-action letters.<sup>26</sup> Federal courts have concluded that no-action letters are at most, "nonbinding, persuasive authority."<sup>27</sup> Notwithstanding the SEC's issuance of a no-action

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<sup>24</sup> See Pfizer SEC No-Action Letter, 2008 WL 653392 (March 7, 2008).

<sup>25</sup> See 17 C.F.R. § 202.1(d).

<sup>26</sup> See e.g., *Amalgamated Clothing & Textile Workers Union v. SEC*, 15 F.3d 254, 257 (2d Cir. 1994); see also *Am. Fed'n of State, County, and Mun. Employees v. Am. Int'l Group, Inc.*, 361 F. Supp.2d 344 (S.D.N.Y. 2005), *overruled on other grounds*, 462 F.3d 121 (2d Cir. 2006).

<sup>27</sup> See *Amalgamated*, 15 F.3d at 257. A secondary question of judicial deference to SEC no-action letters arises when considering the Supreme Court's holdings in *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984). Under the two-step analytical framework of *Chevron*, a court must first ask whether congressional intent can be clearly ascertained from the text of the statute. If so, that is the end of the analysis. If congressional intent is silent or ambiguous and an agency has promulgated a regulation or interpretation of the statute, a court must ask the second question of whether the regulation or interpretation is based on a permissible construction of the statute. Unless the regulation or interpretation is arbitrary,

letter, federal courts still must “independently analyze the merits of a dispute even when affirming the SEC’s conclusion.”<sup>28</sup>

With federal courts exercising their authority to hear cases as a matter of first instance, irrespective of a SEC no-action letter, the question emerges about whether the SEC should be engaged in the practice of evaluating shareholder proposals under state law at all. No-action letters issued by the SEC do not adequately explain the legal doctrine and analysis underlying its legal conclusions under state law. Nor do no-action letters purport to “impose or fix a legal relationship upon any of the parties” involved in the litigation.<sup>29</sup> Although the SEC contends that no-action letters are merely interpretive of the applicable Securities Exchange Act Rules, shareholders and companies alike often believe that no-action letters are dispositive of the underlying legal issue.<sup>30</sup> In many cases where a party seeks a no-action letter from the SEC, numerous documents are enclosed stating the arguments for and against excluding the shareholder proposals.<sup>31</sup> Many of the documents enclosed read similar to briefs on the merits filed in civil court.<sup>32</sup> Moreover, while a no-action letter serves as a relatively low-cost alternative to federal court litigation, it can be a timely endeavor. The more novel or complex the shareholder proposal and the applicable state law, the longer the SEC will take to issue the letter.<sup>33</sup>

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capricious, or otherwise unreasonable, a court must give the agency regulation or interpretation controlling authority. *See id* at 842-843. In the context of no-action letters, the D.C. and Second Circuits have held that no-action letters do not rise to the level of SEC rule-making or agency adjudication. *See* *Roosevelt v. E.I. DuPont de Nemours & Co.*, 958 F.2d 416, 427 (D.C. Cir. 1992); *New York City Employees’ Ret. Sys.*, 45 F.3d at 7; *Amalgamated*, 15 F.3d at 257-258.

<sup>28</sup> *See Apache Corp.*, at \*4 (citing *New York City Employees’ Ret. Sys. v. Brunswick Corp.*, 789 F. Supp. 144, 146 (S.D.N.Y. 1992)).

<sup>29</sup> *See Amalgamated*, 15 F.3d at 257.

<sup>30</sup> Nagy, *supra* note 7, at 954 (noting that “securities law practitioners and their clients generally regard the regulatory interpretations in no-action letters as a source of law”); *see also* Jill E. Fisch, *From Legitimacy to Logic: Reconstructing Proxy Regulation*, 46 VAND. L. REV. 1129, 1151 (1993) (noting that the SEC creates a “federal common law as to what constitutes a proper subject for shareholder action.”).

<sup>31</sup> Electronic Arts, Inc. SEC No-Action Letter, 2008 WL 2191145 (May 23, 2008) (82 pages of documents filed).

<sup>32</sup> *See e.g.*, J.P. Morgan Chase & Co. SEC No-Action Letter, 2008 WL 809040 (March 24, 2008).

<sup>33</sup> Lemke, *supra* note 18, at 1030 (noting that parties filing for no-action letters can expect to wait between 30 and 60 days and that novel or complex issues can take an indefinite amount of time); *see also* Lanny A. Schwartz, *Suggestions for Procedural Reform in Securities Market Regulation*, 1 BROOK. J. CORP. FIN. & COM. L. 409 (2007).

Despite the cost savings at the front-end, a no-action letter is often the springboard to protracted federal court litigation.<sup>34</sup> Federal court proxy litigation often proceeds past the pleadings and into discovery, which can be a timely and expensive process.<sup>35</sup> Federal courts are then left to interpret the relevant state law of incorporation without any meaningful guidance from the SEC.<sup>36</sup> Moreover, while federal courts are often up to the task of interpreting state law, in many cases they are compelled to interpret state law in which they lack the requisite expertise to consistently reach the appropriate disposition.<sup>37</sup> Rather than engage in guesswork, some federal courts have certified questions involving shareholder proxy laws to state courts when the issue is overly complex or the state law is ambiguous.<sup>38</sup> Yet even with certification available in most states, federal courts are more likely to engage in their own independent analysis of state law without engaging state courts, which have more experience and expertise with state corporate governance statutes.<sup>39</sup>

As a result of the federal occupation of state law as it relates to shareholder proposals, state courts are forced to address errors made by federal courts and the SEC on the back-end. Such an occurrence is contrary to the text

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<sup>34</sup> Steven M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 630-631 (2006) (noting that “shareholder insurrection” remains a costly undertaking and requires support from a large number of investors).

<sup>35</sup> Ahdeih, *Dialectical Regulation*, *supra* note 6 (citing Mark D. West, *The Pricing of Shareholder Derivative Actions in Japan and the United States*, 88 N.W.U. L. REV. 1436, 1463 (1994); *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, 778-779 (2007)).

<sup>36</sup> *See infra*, note 26; *see* Ahdieh, *supra* note 35, at 172 n.51 (commenting that “[i]n lieu of actual state law, the Division of Corporation Finance will occasionally make vague references to considerations of policy”) (citing Pac.-Telesis Group, SEC No-Action Letter, 1989 WL 245523 (Feb. 2, 1989)).

<sup>37</sup> Ahdieh, *supra* note 35, at 180 (noting that Rule 14a-8 grants the SEC and the federal courts have “near-complete autonomy from relevant state authorities, be they legislatures, regulators, or courts” in determining how to handle suits concerning shareholder proposals); *see also* Ahdieh, *Intersystemic Governance*, at 236 (arguing that “[i]f consistency of interpretation is to be maintained, it is necessary for state legislators and judges, on the one hand, and the SEC staff, on the other, to align their expectations of what is possible—and desirable—in the proxy solicitation process”) (citing Robert B. Ahdieh, *Law’s Signal: A Cueing Theory of Law in Market Transition*, 77 S. CAL L. REV. 215, 230-233 (2004)).

<sup>38</sup> The use of certified questions by federal courts seems to indicate support for states to develop a certification mechanism for the SEC. *See Int’l Board of Teamsters Gen. Fund v. Fleming Cos., Inc.*, 173 F.3d 863 (10<sup>th</sup> Cir. 1999), certified question answered, 975 P.2d 907 (Okla. 1999); *In re UnitedHealth Group, Inc. Shareholder Derivative Litigation*, Nos. 06CV1216JMR/FLN, 06CV1697JMR/FLN, 2006 WL 3456666, at \*1 (D. Minn. Nov. 29, 2006), certified question answered, 754 N.W.2d 544 (Minn. 2008) (certified question on shareholder derivative suits); *see also* Ahdieh, *supra* note 36.

<sup>39</sup> *Id.*

of Rule 14a-8, which seems to contemplate cross-jurisdictional cooperation.<sup>40</sup> In fact, as Professor Nagy notes, Rule 14a-8 rests solely on an interpretation of state law and the SEC does not have the required expertise and experience with state law.<sup>41</sup> Therefore, it is incumbent on the SEC and the federal courts to create a role for state courts in the interpretation of Rule 14a-8 as it relates to the validity of shareholder proposals. Professor Ahdieh, however, notes that the present situation may have results contrary to Rule 14a-8. According to Professor Ahdieh, while the SEC and federal courts are “nominally free to assert whatever interpretation of state law [they] elect in assessing the permissibility of shareholder proposals, state courts, as well as legislatures, are likely to disregard cavalier interpretations.”<sup>42</sup>

The supposed framework for Rule 14a-8, as indicated by its text, is for states to interpret their own laws of corporate governance to provide guidance to the SEC and federal courts to resolve disputes involving shareholder proposals. Although federal courts are required to examine state law as a part of their judicial function, the SEC often refuses to take a definitive position on the validity of a shareholder proposal when an ambiguous state law is involved.<sup>43</sup> In many cases, this hinders the ability of state courts to develop much-needed precedent in the area of corporate governance.<sup>44</sup> The actions of the SEC also reduce the likelihood that state legislatures will address issues of corporate governance.<sup>45</sup> Simply put, the concern for federal courts is accuracy in their use of state law. For the SEC, however, the concerns are accuracy and substantive analysis. In sum, when federal courts or the SEC erroneously apply state law via Rule 14a-8, state courts must correct their mistakes. Such a situation imposes substantial costs on state courts and creates inconsistent

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<sup>40</sup> See *infra*, note 5. It should also be noted, however, that Rule 14a-8 does not contain an explicit requirement that the federal courts or the SEC defer to state court interpretations of state law. See *e.g.*, 17 C.F.R. § 240.14a-8

<sup>41</sup> Nagy, *supra* note 7, at 1011.

<sup>42</sup> Ahdieh, *Dialectical Regulation*, *supra* note 6, at 181 (citing Robert B. Ahdieh, *Between Dialogue and Decree: International Review of National Courts*, 79 N.Y.U. L. REV. 2029, 2078 n.214 (2004)).

<sup>43</sup> See *id.* at 173 (citing Transcript of Roundtable Discussion Regarding Federal Proxy Rules & State Corporation Law, available at <http://www.sec.gov/spotlight/proxyprocess/proxy-transcript050707.pdf> (May 7, 2007)).

<sup>44</sup> Brent H. McDonnell, *Shareholder Bylaws, Shareholder Nominations, and Poison Pills*, 3 BERKELEY BUS. L.J. 205, 256 (2006) (“The SEC’s willingness to allow companies to exclude bylaw proposals goes a long way to helping explain [the] lack of precedent”).

<sup>45</sup> See Fisch, *supra* note 30 (“State legislatures have become accustomed to leaving the regulation of the voting process to the SEC and defer to that agency’s expertise”).

legal precedent, resulting in an inefficient and erratic relationship between the state and federal courts and the SEC.<sup>46</sup>

*B. The Implications of the Amendment to the Delaware State Constitution on Rule 14a-8 and the SEC.*

Thus far, commentators have universally hailed the passage of the recent amendment to the Delaware State Constitution permitting the SEC to certify questions of state law to the Delaware Supreme Court.<sup>47</sup> Some commentators see the amendment as a mechanism to return state courts and legislatures to the forefront of interpreting state law as it relates to shareholder proposals under Rule 14a-8.<sup>48</sup> Other commentators view the amendment as a mechanism to foster cross-jurisdictional cooperation between the federal government and state courts.<sup>49</sup> The general consensus, however, is that the amendment will alter the dynamic of federal and state relations as it relates to the application of Rule 14a-8.<sup>50</sup>

The amendment was adopted to address a myriad of problems. First, the Delaware General Assembly sought to permit the Delaware Supreme Court to provide definitive answers to the SEC about questions concerning Delaware law.<sup>51</sup> This is a response partly to the SEC's reluctance to take an authoritative stance on issues involving ambiguous state law.<sup>52</sup> Second, the Delaware General Assembly hoped to eliminate the likelihood of the SEC submitting erroneous interpretations of Delaware corporate law to the public. The justification for the latter concern is twofold. One, "[b]y most accounts,

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<sup>46</sup> Professor Ahdieh describes the inefficiency as an "unending series of repeat plays, each requiring action and reaction by the SEC and state courts or legislatures...." Ahdieh, *supra* note 42.

<sup>47</sup> Fredrick H. Alexander et. al., *Corporate Governance: The View From Delaware*, SN071 ALI-ABA 147, 163 (Feb. 21-22, 2008) ("SEC access to the Delaware Supreme Court may be a significant development given the current climate of stockholder activism and 14a-8 proposals touching on questions of Delaware law"); Ahdieh, *Intersystemic Governance*, *supra* note 4, at 235 ("Delaware's recent amendment of its constitution to allow the SEC to directly certify questions to the Delaware Supreme Court holds even greater promise"). Professor Larry E. Ribstein of the University of Illinois College of Law notes in his blog entitled "Ideoblog" that his enthusiasm for the amendment is based on his view that the SEC should not rule on the merits of shareholder proposals, but that should be left to state courts and legislatures. See [http://busmovie.typepad.com/ideoblog/2007/05/delaware\\_to\\_tak.html](http://busmovie.typepad.com/ideoblog/2007/05/delaware_to_tak.html) (last visited October 8, 2008).

<sup>48</sup> Professor Ribstein is particularly receptive of this view. See *id.*

<sup>49</sup> Professor Ahdieh adopts this view of the amendment. Ahdieh, *supra* note 37.

<sup>50</sup> See *infra*, note 45.

<sup>51</sup> See *infra*, note 1.

<sup>52</sup> See *infra*, note 36.

Delaware law is the preeminent authority in corporate law principles.”<sup>53</sup> Therefore, many states courts refer to Delaware jurisprudence when interpreting their own statutes of corporate governance and often follow the judicial analysis promulgated by Delaware courts.<sup>54</sup> Two, “[m]ore than 80 percent of the companies that have reincorporated during the past quarter century have migrated to Delaware.”<sup>55</sup> The high number of companies incorporated in Delaware makes a clear statement of the law imperative—both for overall functionality of those companies and the attractiveness of Delaware as a potential state of incorporation.<sup>56</sup> Accordingly, the Delaware legislature has historically provided Delaware courts immense discretion to fashion legal rules and remedies to address difficulties associated with corporate governance.<sup>57</sup>

Article 4, § 11(8) is a continuation of the deferential treatment the Delaware legislature affords Delaware courts. Moreover, § 11(8) represents a formalization of the relationship between Delaware and the SEC. Although § 11(8) only permits one-way communication between Delaware courts and the SEC, it presents an opportunity to synthesize the requirements of corporations under both federal and Delaware law. What may emerge is a coherent set of regulations governing shareholder proposals that encapsulates elements of both federal and state law. As such, the ultimate success of § 11(8) will depend primarily on the willingness of the SEC to have questions certified to the Delaware Supreme Court.<sup>58</sup>

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<sup>53</sup> David W. Ware, Note, *Shareholders’ Right to Review the Adoption and Continuation of a Takeover Defense Plan: Is the Fleming Decision Dead on Arrival?*, 2000 U. ILL. L. REV. 1053, 1063 (2000) (citing Ernest L. Folk, III, *THE DELAWARE GENERAL CORPORATION LAW*, at xii (1972); Leo Herzel & Laura D. Richman, *Foreword, Delaware’s Preeminence by Design*, in *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS* F1, F-1 to F-10 (2d. ed. Supp. 1991 & 1992)).

<sup>54</sup> *Id.* at 1064.

<sup>55</sup> *Id.*

<sup>56</sup> Dale Oesterle, *Delaware’s Takeover Statute of Chills, Pills, Standstills, and Who Gets Iced*, 13 DEL. J. CORP. L. 879, 883-884 (1988) (“Because Delaware is the corporate home of 56% of the Fortune 500 firms and 45% of the firms listed on the New York stock exchange, any change in the Delaware corporate code affects a substantial number of shareholders”).

<sup>57</sup> *See* Ware, *supra* note 53, at 1064 (“...the Delaware legislature has had to place in Delaware courts to fashion appropriate limits on many corporate transactions and activities”).

<sup>58</sup> Certified questions are entitled to *de novo* review. *See Save Our Creeks v. City of Brooklyn Park*, 699 N.W.2d 307, 309 (Minn. 2005); *see also Hislop v. Dep’t of Social Welfare*, 388 A.2d 428, 429 (Vt. 1978) (noting that in some cases, courts can address issues not certified to it).

III. *CA, INC. v. AFSCME EMPLOYEES PENSION PLAN*

In *CA, Inc. v. AFSCME Employees Pension Plan*, the SEC invoked § 11(8) to certify two questions to the Delaware Supreme Court.<sup>59</sup> Corporate law practitioners noted the quickness in which the decision was issued—the SEC certified the question on June 27, 2008 and an opinion was issued on July 17, 2008—thereby alleviating concerns that the certification process would prove too cumbersome.<sup>60</sup> Practitioners also noted that the substantive nature of the decision and the unanimous vote of the Court.<sup>61</sup> The certification process under § 11(8) has shown itself to be fast, efficient, and able to produce clear substantive legal doctrine and rules. Thus, the early returns of § 11(8) show a tremendous amount of promise.

A. *Case Overview*

In *AFSCME*, AFSCME, a CA stockholder, submitted a proposed stockholder bylaw for CA to include in its proxy materials for its 2008 annual meeting of stockholders.<sup>62</sup> The proposal, if adopted, required CA to reimburse a stockholder or group of stockholders for reasonable expenses incurred by nominating a candidate or number of candidates in a contested election of directors to the corporation's board of directors.<sup>63</sup> Afterwards, CA informed the SEC's Division of Corporate Finance of its intention to exclude AFSCME's proposed bylaw from its proxy materials.<sup>64</sup> CA requested a no-action letter from the SEC stating that the Division would refrain from taking any enforcement proceedings against CA if it excluded AFSCME's proposal.<sup>65</sup> AFSCME issued a response to CA's request for a no-action letter, seeking the contrary legal conclusion.<sup>66</sup> As a result, the Division was faced with conflicting legal interpretations of Delaware law.<sup>67</sup> The Division certified the following two questions to the Delaware Supreme Court: (1) Is the AFSCME proposal a proper subject for action by shareholder as a matter of Delaware law? (2) Would the AFSCME proposal, if adopted, cause CA to violate any

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<sup>59</sup> 953 A.2d 227 (Del. 2008).

<sup>60</sup> William D. Johnson, *Del. Court responds to SEC's first certified questions*, VIRGINIA LAWYERS WEEKLY, at <http://www.valawyersweekly.com/weeklyedition/2008/09/29/del-court-responds-to-sec's-first-certified-questions/> (last visited November 12, 2008).

<sup>61</sup> *Id.*

<sup>62</sup> 953 A.2d at 229.

<sup>63</sup> *Id.* at 230.

<sup>64</sup> *Id.*

<sup>65</sup> *Id.*

<sup>66</sup> *Id.*

<sup>67</sup> *Id.*

Delaware law to which it is subject?<sup>68</sup> The first question, according to the Court, also raised two additional concerns. The first concern was the “scope or reach of the shareholders’ power to adopt, alter, or repeal the bylaws of a Delaware corporation.”<sup>69</sup> The second was “whether the [b]ylaw at issue [fell] within that permissible scope.”<sup>70</sup>

To address the first question, the Court cited §§ 109(b) and 102(b)(1) of the Delaware General Corporate Law as essential to its analysis.<sup>71</sup> AFSCME relied on those two provisions in asserting that the bylaw “[related] to the right of the stockholders meaningfully to participate in the process of electing directors, a right that necessarily ‘includes the right to nominate an opposing slate.’”<sup>72</sup> In response, CA contended that § 109(b) was “not dispositive, because it [could not] be read in isolation from, and without regard to, Section [*sic*] 102(b)(1).”<sup>73</sup> Additionally, CA argued that the proposed bylaw curtailed the “substantive decision-making authority of CA’s board to decide whether or not to expend corporate funds for a particular purpose, here, reimbursing director election expenses.”<sup>74</sup> According to CA, § 102(b)(1) required any limitation placed on the authority of the board of directors be enumerated in the certificate of incorporation.<sup>75</sup> Thus, CA argued, the proposed bylaw could only be contained in CA’s certificate of incorporation and fell outside the type of bylaws permitted by § 109(b).<sup>76</sup>

In addressing the parties’ arguments concerning the first question, the Court noted that “[i]t is well-established Delaware law that a proper function of bylaws is not to mandate how the board should decide specific substantive business decisions, but rather, to define the process and procedures by which those decisions are made.”<sup>77</sup> In its rejoinder to the Court’s

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<sup>68</sup> *Id.* at 231.

<sup>69</sup> *Id.* at 232.

<sup>70</sup> *Id.*

<sup>71</sup> *Id.* at 233; *see also* Del. Code Ann. tit. 8, § 109(b) which provides that “...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 employees.”; Del. Code Ann. tit. 8, § 102 (b)(1) states in relevant part: “[a]ny provision for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders, or any class of the stockholders....; if such provisions are not contrary to the laws of this State. Any provision which is required or permitted by any section of this chapter to be stated in the bylaws may instead be stated in the certificate of incorporation.”

<sup>72</sup> *Id.* (internal quotations omitted).

<sup>73</sup> *Id.* at 234.

<sup>74</sup> *Id.*

<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

<sup>77</sup> *Id.* at 234-235.

substantive/procedure distinction, CA asserted that the proposed bylaw limited the board's discretion to decide whether to grant reimbursement in contested board elections.<sup>78</sup> Moreover, CA argued that because the proposed bylaw required the mandatory expenditure of corporate funds, the proposed bylaw was not merely procedural and process-oriented, but substantive and outside the scope of what was permissible under § 109(b).<sup>79</sup>

The Court, however, found CA's argument unconvincing. In response, the Court stated:

Because the Bylaw [*sic*] is couched as a command to reimburse...it lends itself to CA's criticism. But the Bylaw's wording, although relevant, is not dispositive of whether or not it is process-related....By saying this we do not mean to suggest that this Bylaw's reimbursement component can be ignored. What we do suggest is that a bylaw [*sic*] that requires the expenditure of corporate funds does not, for that reason alone, become automatically deprived of its process-related character.<sup>80</sup>

The Court concluded that the proposed bylaw had "the intent and the effect of regulating the process for electing directors of CA."<sup>81</sup> Accordingly, the Court answered the first question in the affirmative and held that the proposed bylaw at issue was a proper subject for shareholder action.

After establishing that the AFSCME's proposed bylaw did not violate the Delaware General Corporate Law or CA's Certificate of Incorporation, the Court turned its attention to the second question of whether the proposed bylaw violated state statutory or common law. The Court began by stating that "[o]ne 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."<sup>82</sup> Under that fundamental proposition, the Court examined the proposed bylaw and the potential burden it placed on CA's board of directors. The Court noted that in two similar cases it invalidated contracts that required "a board to act or not act in such a fashion that would limit the exercise of their fiduciary duties."<sup>83</sup> Though the prior cases concerned

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<sup>78</sup> *Id.* at 236.

<sup>79</sup> *Id.*

<sup>80</sup> *Id.* at 236 (footnotes omitted).

<sup>81</sup> *Id.*

<sup>82</sup> *Id.* at 232 n.6 (citing *Quickturn Design Systems, Inc. v. Shapiro*, 721 A.2d 1281, 1291-92 (Del. 1998)).

<sup>83</sup> *Id.* (citing *Paramount v. QVC*, 637 A.2d 34 (Del. 1994); *Quickturn*, 721 A.2d at 1291).

contracts limiting the actions of the board, the Court found the logic of the prior cases fully applicable to AFSCME's proposed bylaw. The Court stated, "the internal governance contract—which here takes the form of a bylaw—is one that would also prevent the directors from exercising their full managerial power in circumstances where their fiduciary duties would otherwise require them to deny reimbursement to a dissident slate."<sup>84</sup>

AFSCME contended that the results reached in the prior cases were inapplicable because the proposed bylaw did not limit the discretion of CA's board in considering reimbursements for contested election.<sup>85</sup> Instead, the bylaw precluded the board from considering reimbursements at all. Therefore, the CA board would not be prevented from fulfilling its fiduciary duty because the issue of reimbursements would be removed entirely from the board's duties.<sup>86</sup> The Court found AFSCME's argument unpersuasive. The Court held that the board's fiduciary duties outweighed the merits of the proposed bylaw. According to the Court:

It is in this respect that the proposed Bylaw [*sic*], as written, would violate Delaware law if enacted by CA's stockholders. As presently drafted, the Bylaw would afford CA's directors full discretion to determine what *amount* of reimbursement is appropriate, because the directors would be obligated to grant only the 'reasonable' expenses of a successful short slate. Unfortunately, that does not go far enough, 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 it would be appropriate, in a specific case, award reimbursement at all.<sup>87</sup>

Accordingly, the Court concluded that the bylaw violated Delaware law and was invalid as a result.

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<sup>84</sup> *Id.* at 239.

<sup>85</sup> *Id.*

<sup>86</sup> *Id.*

<sup>87</sup> *Id.* at 240 (emphasis in the original).

## B. *The Potential Influence of AFSCME on the SEC No-action Letter Process and Federal Court Adjudication*

Unlike the reaction to the passage of the amendment, reaction to the Delaware Supreme Court's opinion in *AFSCME* has been mixed. One commentator notes as a result of *AFSCME*, the amendment will not result in a change in federal and state authorities as it relates to Rule 14a-8.<sup>88</sup> Specifically, the commentator noted that “[e]ven with this new route of communication, Delaware is not talking about the key questions in a way that would persuade future federal lawmakers to leave room for state law.”<sup>89</sup> In other words, the decision did not make a transcendent announcement on the relationship between federal and state authorities. Rather the court in *AFSCME* merely recited a well-known principle of corporate governance—“shareholders get to vote on the less important matters of process in bylaws with no barriers permitted to be inserted by directors, but can only speak on the more important matters if the directors first propose an amendment to the corporation’s charter.”<sup>90</sup> Another commentator further notes that *AFSCME* leaves the underlying legal question—how to determine whether a proposed bylaw forces a board to violate their fiduciary duties—largely unsettled.<sup>91</sup> Thus, the question is whether the amendment, post-*AFSCME*, despite its efficiencies and opportunity for state court resolution, will produce the substantive clear statements on the law it was intended to produce. A second question arises, however, about whether the disposition in *AFSCME* will actually change the method in which the SEC adjudicates cases via no-action letters.

### 1. *The Effect of AFSCME on SEC Adjudication*

In response to the first question, other commentators have noted that the objectives of *AFSCME* may have been twofold: (1) to produce a substantive resolution to questions certified by the Court to the SEC; and (2) to protect Delaware’s institutional advantages over corporate governance that it has developed through its statutory framework and case authority.<sup>92</sup> Professor Thompson has gone as far as stating that the motivation underlying *AFSCME*

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<sup>88</sup> Robert B. Thompson, *Defining the Shareholder’s Role, Defining a Role for State Law: Folk at 40*, 33 DEL. J. CORP. L. 771, 784 (2008).

<sup>89</sup> *Id.*

<sup>90</sup> *Id.*

<sup>91</sup> Brett H. McDonnell, *Bylaw Reforms for Delaware’s Corporation Law*, 33 DEL. J. CORP. L. 651, 668 (2008); see also Lawrence A. Hamermesh, *Introduction: The Delaware General Corporation Law for the 21st Century*, 33 DEL. J. CORP. L. 611, 613 (2008).

<sup>92</sup> See generally Thompson, *supra* note 88.

may have been to maintain and even expand the ability of Delaware courts to dictate corporate governance law.<sup>93</sup> According to Thompson:

The most dramatic advantage for Delaware, when compared to a federal corporation law, comes in providing the gap filling that is necessarily required for any law. Today, most American judge-made corporate law occurs in Delaware and it is not likely that the federal system can match what Delaware creates in this realm. Ten judges, located for the most part along two hallways in one city, make and develop Delaware corporate law. These jurists are repeat players, in that most of the workload of the five members of the Delaware Court of Chancery arises in corporate law and a significant part of the workload for the five Delaware Supreme Court justices derives from corporate law as well. Because of this work and their own prior experiences, these judges have an expertise in corporate law that can be seen, for example, in discussions of valuation and other deal-related issues that arise. The typical federal judge who gets an occasional corporate case as part of a docket dominated by criminal and immigration matters is simply not going to have the same expertise to bring to a dispute about corporate issues. Delaware judges interact with the corporate academic and professional community in a way that is not replicated in other fields.<sup>94</sup>

Thus, in some sense, it is accurate to state that the goal of the amendment and *AFSCME* is not solely to produce accurate statements on Delaware law, but to also protect Delaware's place as the preeminent jurisdiction for corporate law.

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<sup>93</sup> *Id.* at 775.

<sup>94</sup> *Id.* (citing Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 166 (2004) (noting that seventy-five percent of the cases filed in the Delaware Court of Chancery over a two year period were corporate cases)); *see also* Steven J. Cleveland, *Process Innovation in the Production of Corporate Law*, 41 U.C. DAVIS L. REV. 1829, 1841 (2008) (noting that § 11 allows for Delaware courts to retain its competitive advantage over corporate governance law).

Those two goals, however, are entirely consistent with the cross-jurisdictional collaboration envisioned by Rule 14a-8. As previously discussed, the text of Rule 14a-8 indicates that the statutory guidepost is state law.<sup>95</sup> Additionally, the application of Rule 14a-8 is dependent on the interpretation of state law, indicating that the interpretation of state law by state courts takes priority under Rule 14a-8.<sup>96</sup> Alternatively stated, under Rule 14a-8, federal courts and the SEC are supposed to take their cues from state court determinations of state laws regarding corporate governance. *AFSCME* does not depart from that understanding, nor does the amendment.

Moreover, criticism that *AFSCME* did not produce the transcendent legal pronouncement to alter the federal and state relationship under Rule 14a-8 is unwarranted. First, and the most obvious observation, is that *AFSCME* may not have produced the correct factual circumstances for such a pronouncement. The issue in *AFSCME* was disposed of by the Delaware Supreme Court using a well-established common-law principle.<sup>97</sup> Second, as evident from the text and syntax of Rule 14a-8, it is not incumbent on the state courts to assert their authority to promulgate rules of corporate governance. Rather, the SEC and federal courts are obligated under Rule 14a-8 to limit their encroachment on state corporate governance law. The Delaware Supreme Court's need to protect its institutional advantages from federal encroachment highlights the increasing intrusions of the SEC and federal courts into state law.

## 2. *The Monsanto No-Action Letter*

The second question, whether *AFSCME* will change the method in which the SEC disposes of cases via no-action letters, is unclear. One early indication that the amendment may change the no-action letter process is that the SEC did, in fact, take advantage of the amendment. Yet, in a no-action letter citing *AFSCME*, the SEC did not provide the detailed explanation that was expected.<sup>98</sup> The shareholder proposal at issue in the Monsanto no-action letter contained a provision that proposed to establish a requirement forcing the directors of Monsanto, a Delaware corporation, to take an oath of allegiance to the United States Constitution.<sup>99</sup> Proponents of the proposal intended to include it as a part of Monsanto's 2008 proxy statement.<sup>100</sup> Special counsel to Monsanto rejected the proposal for a number of reasons. First and most notably, special counsel found the proposal problematic because "it would limit the directors' exercise of their fiduciary duties."<sup>101</sup> Citing

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<sup>95</sup> See 17 C.F.R. § 240.14a-8(i)(1).

<sup>96</sup> See Nagy, *supra* note 7, at 1010-11.

<sup>97</sup> See Thompson, *supra* note 87, at 784.

<sup>98</sup> See Monsanto Co., SEC No-Action Letter, 2008 WL 5433185, at \*1 (Nov. 7, 2008).

<sup>99</sup> *Id.* at \*15-\*16.

<sup>100</sup> *Id.*

<sup>101</sup> *Id.* at \*14.

*AFSCME*, special counsel noted that the proposed bylaw would constitute an “internal governance contract” that would require “the directors to subordinate their fiduciary duties to act in the best interests of the Company and its shareowners to a supervening duty to act in a manner consistent with the oath contemplated by the Proposed Bylaw [*sic*].”<sup>102</sup> Special counsel elaborated in the following way:

Because the Proposed Bylaw could result in a circumstance in which the Board's obligation to act in accordance with its fiduciary duties would be compromised by a concomitant duty to comply with the Proposed Bylaw, the Proposed Bylaw, under the principles of CA, would be found to be invalid. . . . 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 where the proxy contest is motivated by personal or petty concerns, or to promote interests that do not further, or are adverse to, those of the corporation, the board's fiduciary duty could compel that reimbursement be denied altogether.” [*sic*].<sup>103</sup>

In response, proponents of the proposal sought review from the SEC and requested that the agency takes steps to compel Monsanto to include the proposal with the corporation's 2008 proxy materials.

According to proponents of the proposal, an oath of allegiance was necessary and did not constitute “unreasonable or unfair qualifications” because Monsanto had influence throughout every level of the federal government.<sup>104</sup> Additionally, proponents of the proposal pointed to the fact that given Monsanto's status as one of the world's largest agribusinesses, an oath of allegiance was needed to ensure that Monsanto's board of directors would adhere to the laws and interests of the United States.<sup>105</sup> The proponents of the proposals were also concerned about the presence of foreign nationals on the board of Monsanto.<sup>106</sup> Yet foreign nationals, who voluntarily subjected

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<sup>102</sup> *Id.*

<sup>103</sup> *Id.* at \*14.

<sup>104</sup> *Id.* at \*5.

<sup>105</sup> *Id.* at \*5-\*6.

<sup>106</sup> *Id.* at \*6.

themselves to the laws of the United States, were irrelevant to Monsanto's adoption of standards to govern the behavior of its corporate directors.<sup>107</sup>

Proponents of the proposal also took issue with Monsanto's contention that an oath to the United States Constitution "would impermissibly restrict the directors' exercise of their fiduciary duties."<sup>108</sup> First, proponents of the proposal responded that high-ranking government officials regularly serve on boards of trustees.<sup>109</sup> Second, proponents of the proposal noted that if a trustee complied with a fiduciary duty that violated the Constitution, then it would result in an "unlawful action" which would be inconsistent with a fiduciary duty.<sup>110</sup> Finally, the proponents of the proposal urged that the proposal was consistent with Rules 14a-8(i)(3) and 14a-8(i)(6). The proposal was consistent with the Rules because the proposal did not create or imply any authority "to represent directors as agents of the U.S. government."<sup>111</sup> Nor did the proposal enumerate an enforcement mechanism for use against a dissenting trustee.<sup>112</sup>

In response, special counsel relying on *AFSCME* and the Delaware Chancery Court's disposition in *Stroud v. Grace*, reiterated that the proposal "(1) impose[d] an unreasonable and unfair qualification on directors and (2) would require the directors to violate their fiduciary duties."<sup>113</sup> Special counsel also contested whether the proposal was consistent with Rules 14a-8(i)(3) and 14a-8(i)(6) by asking whether a director of a Delaware corporation, after taking an oath of allegiance to the United States and Constitution, would have an obligation to "support and defend the Constitution of the United States against all enemies, foreign and domestic?"<sup>114</sup> Special counsel also noted that the proposal did not include sufficient information to determine what constitutes a violation of the proposal.<sup>115</sup> Accordingly, special counsel urged the SEC to withhold enforcement action against Monsanto.

After considering the various arguments asserted by Monsanto and proponents of the proposal, the SEC summarized its findings as follows:

There appears to be some basis for your view that Monsanto may exclude the proposal under rule 14a-8(i)(2). We note that in the opinion of your counsel, implementation of the proposal would cause Monsanto to violate state law. Accordingly,

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<sup>107</sup> *Id.* at \*6.

<sup>108</sup> *Id.* at \*7.

<sup>109</sup> *Id.* at \*5.

<sup>110</sup> *Id.*

<sup>111</sup> *Id.*

<sup>112</sup> *Id.*

<sup>113</sup> *Id.* at \*2; see also *Stroud v. Grace*, No. 10719, 1990 WL 176803, at \*1 (Del. Ch. Nov. 1, 1990), *rev'd on other grounds*, 606 A.2d 75 (Del. 1992).

<sup>114</sup> Monsanto No-Action Letter, *supra* note 98, at \*3.

<sup>115</sup> *Id.* at \*3.

we will not recommend enforcement action to the Commission if Monsanto omits the proposal from its proxy materials in reliance on rule 14a-8(i)(2). In reaching this position, we have not found it necessary to address the alternative bases for omission upon which Monsanto relies.<sup>116</sup>

At first glance, the SEC's disposition in the Monsanto no-action does not seem any different than the no-action letter issued in Pfizer.<sup>117</sup> The seemingly lack of substantive analysis in the Monsanto no-action letter may expose § 11 and the court's decision in *AFSCME* to the charge that the amendment and *AFSCME* did nothing to affect the method in which the SEC uses no-action to dispose of shareholder proposal disputes. Yet the shareholder proposal in Monsanto fell squarely within the court's disposition in *AFSCME*. Thus, with a clear governing rule articulated by the Delaware Supreme Court, there was no reason for the SEC to engage in an extended discussion of case authority. Despite the view of some commentators to the contrary, the rule announced by the court in *AFSCME* was clear—shareholder bylaws may define procedure and process, but not the substantive business decisions to be made by a corporation's board.<sup>118</sup> While the court refrained from providing the specificity urged by Professor McDonnell to determine when a proposed bylaw encroaches on the authority of board members to make substantive business decisions, the court may have implicitly recognized that it will determine what constitutes an invalid bylaw on a fact-specific basis.<sup>119</sup> Following the court's lead in *AFSCME*, the SEC determined that given the particular facts concerning the Monsanto no-action letter, the proposal fell squarely within the rule announced in that case.

Criticism of the SEC has mainly centered on its willingness to issue pronouncements of state law without sufficient guidance from state courts.<sup>120</sup> While the Monsanto no-action letter seems contrary to that criticism, it may not be indicative of an impending change in the SEC no-letter process. The

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<sup>116</sup> *Id.* at \*1.

<sup>117</sup> See generally Pfizer SEC No-Action Letter, *supra* note 24.

<sup>118</sup> See *AFSCME*, 953 A.2d at 232-33.

<sup>119</sup> Richard C. Morrisey, *Eighth Annual Institute on Securities in Europe: A Contrast in EU and U.S. Provisions*, 1712 PLI/Corp 921, 937 (2009) (“The Court's decision makes clear that bylaws may not “mandate how the board should decide specific substantive business decisions, but may “define the process and procedures by which those decisions are made. Where the line will be drawn between those bylaws that mandate substantive decisions and bylaws that are procedural likely will be decided by the Delaware courts on a case-by-case basis in the future.”) (internal quotations omitted).

<sup>120</sup> See Ahdieh, *supra* note 35, at 172 n.51.

opportunity still exists for the SEC to go astray and continue to issue pronouncement of state law with minimal state guidance. Moreover, unlike Monsanto, not every shareholder proposal dispute will fall squarely within a recently defined rule by the Delaware Supreme Court. To that effect, even with the presence of §11, the SEC should take better efforts to explain the rationale underlying its dispositions. Furthermore, § 11 operates as a constraint on the SEC's ability to freelance with state law. First, as previously noted, the amendment creates an avenue for the SEC to forward questions of state law to the Delaware Supreme Court.<sup>121</sup> Second, as *AFSCME* and the Monsanto no-action letter demonstrates, the amendment permits the Delaware Supreme Court to develop a line of precedent to govern future shareholder proposal disputes.<sup>122</sup> As in Monsanto, the amendment allows for adverse parties to cite applicable case precedent for the SEC to rely on in making its adjudication. Thus, the decision of the SEC has some discernible precedential basis.

### 3. Federal Treatment of Future SEC No-Action Letters

Another issue related to how the SEC handles no-action procedure going forward is what treatment federal courts will give to no-action letters. As previously noted, federal courts do not afford much weight to no-action letters.<sup>123</sup> SEC no-action letters do not receive the benefit of *Chevron* deference and federal courts review no-letter cases *de novo*.<sup>124</sup> Yet it is axiomatic that state court determinations are entitled to immense deference by federal courts.<sup>125</sup> Thus, a question emerges concerning whether federal courts will afford deference to the SEC when its no-action letters are supported by a certified question resolved by a state court. Although there is little research on the issue, the method in which federal courts certify questions to state courts may prove illustrative in how federal courts may treat SEC no-action letters

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<sup>121</sup> See generally 2007 Amendments to Delaware Corporate Law, *supra* note 3.

<sup>122</sup> See McDonnell, *supra* note 44.

<sup>123</sup> See e.g., *Amalgamated*, 15 F.3d at 257; see also *American International Group*, 361 F. Supp.2d at 344.

<sup>124</sup> See *Roosevelt*, 958 F.2d at 427; *New York City Employees' Ret. Sys.*, 45 F.3d at 7; *First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938, 939 (1995) (noting that questions of law are decided on a *de novo* basis).

<sup>125</sup> See, e.g., *Erie R.R. v. Tompkins*, 304 U.S. 64, 78 (1938) (holding that there is no general federal common law and that federal courts are obligated to apply state law in diversity cases); see also *Rooker v. Fidelity Trust Co.*, 263 U.S. 413 (1923); *District Court of Columbia Court of Appeals v. Feldman*, 460 U.S. 462 (1983); *Johnson v. DeGrandy*, 512 U.S. 997, 1005-1006 (1994) ("a party losing in state court is barred from seeking what in substance would be appellate review of the state judgment in a United States District Court, based on the losing party's claim that the state judgment itself violates the loser's federal rights"); *Hagerty v. Succession of Clement*, 749 F.2d 217, 220 (5th Cir. 1984), *cert denied*, 474 U.S. 968 (1985) (holding that a plaintiff cannot seek a reversal of a state court judgment by filing a federal court action).

that are supplemented by a resolved certified question by the Delaware Supreme Court.

Although the United States Supreme Court has not issued a definitive standard for when federal courts should certify a question to a state court, the Fifth Circuit has developed a widely -used set of criterion.<sup>126</sup> According to the Fifth Circuit, the relevant considerations are: (1) most importantly, the closeness of the question and the existence of sufficient sources of state law—statutes, judicial decisions, Attorney General's opinions—to allow the federal court to make a principled, rather than a conjectural, conclusion; (2) the degree to which considerations of comity are relevant in light of the particular issue and case to be decided; and (3) delay, and the possible inability to frame the issue, so as to produce a helpful response from the state court.<sup>127</sup> If one or more of those factors become relevant, then a federal court should certify the question and submit it to the state court.<sup>128</sup> Moreover, when there is uncertainty about the status of state law, the federal courts should militate in favor of certifying a question to the state court.<sup>129</sup> Once a state court answers a certified question, the state court resolution is treated as authoritatively establishing the applicable state law.<sup>130</sup>

SEC certification under § 11 seemingly addresses the elements federal courts consider when deciding to certify a question to the Delaware Supreme Court. The first element of the Fifth Circuit's analysis—the closeness of the question and the existence of sufficient sources of state law—alternatively stated, the presence of ambiguity in state law—is addressed by the fact that the relevant state actor, the Delaware Supreme Court, is permitted to issue authoritative pronouncements of state law. Under both § 11 and the federal court certification procedure, the standard for permitting a state court to certify a question is seemingly the same—“where we find no state law precedent on point and where the public policy aims are conflicting the case may properly

<sup>126</sup> See, e.g., *Williamson v. Elf Aquitaine, Inc.*, 138 F.3d 546, 549 (5th Cir. 1998); see also *State of Fla. ex rel. Shevin v. Exxon Corp.*, 526 F.2d 266, 274-75 (5th Cir. 1976), cert. denied, 429 U.S. 829 (1976).

<sup>127</sup> *Id.*

<sup>128</sup> *Id.*

<sup>129</sup> See, e.g., *Fiat Motors of North America, Inc. v. Mayor and Council of City of Wilmington*, 619 F. Supp. 29, 34 (D. Del. 1985) (citing *Hatfield v. Bishop Clarkson Memorial Hospital*, 701 F.2d 1266, 1268 (8th Cir. 1983) (en banc); *Kershner v. Mazurkiewicz*, 670 F.2d 440 (3d Cir. 1982); *Lillard v. Delaware State Hospital for the Chronically Ill*, 552 F. Supp. 711, 722 (D. Del. 1982)); see also *Barnes v. Atlantic & Pacific Life Ins. Co. of America*, 514 F.2d 704, 705 n.4 (5th Cir. 1975) (“[w]hen the state law is in doubt especially on the underlying public policy aims, it is in the best administration of justice to afford the litigants a consistent final judicial resolution by utilizing the certification procedure.”).

<sup>130</sup> *Clay v. Sun Ins. Office Limited*, 363 U.S. 207, 212 (1960) (citing *Allegheny County v. Frank Mashuda Co.*, 360 U.S. 185, 189 (1959); *Meredith v. City of Winter Heaven*, 320 U.S. 228, 236 (1943)).

be certified to the state court.”<sup>131</sup> Having the state court act as the final arbiter of state law—which occurs under both § 11 and federal court certification procedure—is consistent with the traditional notions of comity and the roles assigned to federal and state courts in our bifurcated legal system.<sup>132</sup>

Furthermore, as it relates to comity, Rule 14a-8 anticipates that state courts will receive the paramount role in defining its own laws of corporate governance.<sup>133</sup> The certification process enumerated in § 11, assuming that it is properly employed by the SEC, gives the Delaware Supreme Court the first opportunity to dispose of the legal ambiguity with finality.<sup>134</sup> The fact that federal courts are likely to develop their own interpretations of state corporate governance law without guidance from state courts is contrary to the conventional understanding that state courts are the conclusive authority of state law.<sup>135</sup> While § 11 is unlikely to deter federal courts from deciding cases where state law is unclear, it may be helpful in eliminating duplicative state and federal proceedings—federal courts make pronouncements after construing unclear state law and state courts must correct the erroneous pronouncements in later cases.<sup>136</sup> As § 11 permits, the Delaware Supreme Court will have the opportunity to address unclear state law on the front-end, in order to eliminate subsequent erroneous interpretations of Delaware state law by federal courts and the SEC.<sup>137</sup> Moreover, the Delaware Supreme Court will have an opportunity to develop a line of precedent that governs future SEC and federal court resolutions without the need for protracted litigation and time-consuming ventures to discern unclear state law.<sup>138</sup>

In particular, with comity, Delaware has additional advantages because of its expertise and preeminence in corporate governance law. First, as it relates to corporate governance law, the Delaware Supreme Court has issued

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<sup>131</sup> *Hatfield*, 701 F.2d at 1267. Neither the SEC nor the Delaware Supreme Court have determined the procedure or conditions in which the Delaware Supreme Court may hear a certified question from the SEC. The amendment allows for the court to “define generally the conditions under which questions may be certified to it and prescribe methods of certification.” Del. CONST. art. 4, § 11(8).

<sup>132</sup> *Hatfield*, 701 F.2d at 1268 (citing *Vandenbark v. Owens-Illinois Glass Co.*, 311 U.S. 538 (1941)) (“[t]he state court ruling is binding on the federal courts and must be applied to this case regardless of the stage the case has reached”).

<sup>133</sup> See Nagy, *supra* note 41, at 1011.

<sup>134</sup> See generally 2007 Amendments to Delaware Corporate Law, *supra* note 3

<sup>135</sup> See *Hatfield*, 701 F.2d at 1268.

<sup>136</sup> See Nagy, *supra* note 41, at 1011.

<sup>137</sup> See Ahdieh, *Dialectical Regulation*, at 181 (“By seeking greater and more thorough input by knowledgeable parties, meanwhile, the Division [of Corporate Finance] might not face any more difficult a task of analysis. . . . While this will require an increased investment of time on the front-end, this initially steep learning curve will eventually be climbed, permitting the resolution of no-action requests both expeditiously and meaningfully”) (emphasis in original).

<sup>138</sup> See McDonnell, *supra* note 44.

a number of opinions cited as persuasive authority in other jurisdictions.<sup>139</sup> Additionally, due to Delaware's status as the preeminent jurisdiction for incorporation, Delaware courts have developed a long line of precedent to govern a number of different areas, resulting in more corporations reincorporating in Delaware and "greater predictability with respect to legal affairs."<sup>140</sup> Second, federal courts, because of the abundance of states that have adopted Delaware corporate statutory framework and their lack of expertise in corporate law, have found the opinions of Delaware particularly persuasive in addressing corporate law issues.<sup>141</sup> Thus, because of Delaware's expertise, experience, and trend-setting corporate statutory framework, federal courts may pay more attention and ultimately defer to answers of certified questions by the Delaware Supreme Court contained in SEC no-action letters.

The third prong of the Fifth Circuit's analysis—the possibility of delay—is not at issue with a SEC no-action letter. In most cases, it is the adverse parties that seek adjudication through the SEC no-action letter process because of its cost effectiveness.<sup>142</sup> Thus, the voluntary nature of litigants to participate in the SEC no-action letter process alleviates concerns about potential delays in adjudication and the onerous burdens that may result. Moreover, *AFSCME* has proven that the timeframe for a certified question to be answered by the Delaware Supreme Court is relatively short, complete with

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<sup>139</sup> Demetrios G. Kaouris, *Is Delaware Still A Haven for Incorporation*, 20 DEL. J. CORP. L. 965-976 (1995) (citing *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) and noting that the decision has been cited in California, Indiana, Iowa, North Carolina, and Texas); *but see*, William J. Carney & George B. Shepherd, *The Mystery of Delaware Law's Continuing Success*, SOCIAL SCIENCE RESEARCH NETWORK, Dec. 18, 2008, available at: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=999477#](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=999477#) (challenging the view that Delaware is the preeminent jurisdiction for corporate law).

<sup>140</sup> Kaouris, *supra* note 139, at 977 (citing Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 469 n.1, 484 (1987)). Kaouris also notes that due to large number of cases filed with Delaware courts, there is a higher likelihood that Delaware courts "have addressed a particular problem or issue than other state courts." *Id.* (citing Lewis S. Black, Jr., *Why Corporations Choose Delaware* 3, 9 (1993)); *see also* Jens Dammann & Henry Hansmann, *Globalizing Commercial Litigation*, 94 CORNELL L. REV. 1, 13-14 (2008) (noting that corporate law cases comprise three quarters of the caseload for the Delaware Chancery Court).

<sup>141</sup> *See International Ins. Co. v. Johns*, 874 F.2d 1447, 1459 n.22 (11th Cir. 1989) (noting that Florida relies on Delaware corporate law when interpreting its own corporate statutes); *see also IBS Financial Corp. v. Seidman & Associates, LLC*, 136 F.3d 940, 949-50 (3d Cir. 1998) (noting that New Jersey relies on Delaware corporate law); *In re Ivan F. Boesky Securities Litigation*, 129 F.R.D. 89, 97 (S.D.N.Y. 1990) (noting that Delaware is the "fountainhead of American corporations" and that Delaware courts "are known for their expert exposition of corporate law."); *Hilton Hotels Corp. v. ITT Corp.*, 978 F. Supp. 1342, 1346 (D. Nev. 1997) (noting that Nevada relies on Delaware law to interpret its own corporate law).

<sup>142</sup> *See Lemke, supra* note 18, at 1022.

a substantive analysis of the legal issue at hand.<sup>143</sup> As a result, the Delaware Supreme Court promotes both judicial economy and prevents unnecessary delay in the adjudication of shareholder proposal disputes. Through the SEC no-action letter process, when supported by an answered certified question, litigants receive a well-developed substantive resolution of the legal issue at minimal cost.<sup>144</sup>

Having rendered § 11 certification roughly analogous to the certification procedure used by federal courts, there is no reason why the federal courts should continue to treat SEC no-action letters as persuasive, non-binding authority.<sup>145</sup> Between federal certification and certification under § 11, the only difference is the actor initiating the certification process. The Delaware Supreme Court, the ultimate arbiter of Delaware state law, is given the principal position in interpreting state law under § 11. Conversely, with the presence of the certification under § 11, if federal courts do not afford sufficient deference to SEC no-action letters, those courts risk discounting the resolutions of state courts—here, the Delaware Supreme Court. Such a result would be inconsistent with what is required by Rule 14a-8 and the traditional respect afforded by federal courts toward state court decisions.<sup>146</sup>

#### IV. CONCLUSION

Section 11 of the Delaware State Constitution presents an opportunity for greater inter-jurisdictional cooperation, which was originally envisioned in Rule 14a-8. Furthermore, the amendment stands to eliminate the difficulties associated with SEC no-action letters and federal court adjudications. The amendment puts the Delaware Supreme Court in the forefront of determining its own law of corporate governance, leaving federal courts and the SEC to adhere to the court's determination of state law. As a result, litigants receive substantive treatment of their disputes by a state court that has developed the requisite expertise to handle a great majority of corporate issues submitted to it. In addition to the substantive nature of the court's opinions, the court has shown the ability to respond to certified questions in a timely and efficient manner. § 11 is also consistent with the federal certification process, providing some indicia that the state court determination as contained in a no-action

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<sup>143</sup> See Johnson, *supra* note 60, at <http://www.valawyersweekly.com/weeklyedition/2008/09/29/del-court-responds-to-sec's-first-certified-questions/>.

<sup>144</sup> *Id.*

<sup>145</sup> See *Amalgamated*, 15 F.3d at 257; but see Nagy, *supra* note 7, at 967.

<sup>146</sup> This is not an argument for *Chevron* deference. Rather, this argument relies more on the traditional notions of comity and federal court respect for state court adjudications. In essence, the focus of the federal court's respect should be on the state court and not the SEC's role as an administrative agency. In that sense, the presence of the SEC is irrelevant, particularly when the state court has issued its interpretation of the state law at issue.

letter is entitled to some deference in accordance with traditional notions of comity and federal-state court relations.

