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Stephen M. Bainbridge
UCLA School of Law

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ARTICLES

REVITALIZING SEC RULE 14a-8'S ORDINARY BUSINESS EXCLUSION: PREVENTING SHAREHOLDER MICROMANAGEMENT BY PROPOSAL

*Stephen M. Bainbridge**

Who decides what products a company should sell, what prices it should charge, and so on? Is it the board of directors, the top management team, or the shareholders? In large corporations, of course, the answer is the top management team operating under the supervision of the board. As for the shareholders, they traditionally have had no role in these sort of operational decisions. In recent years, however, shareholders have increasingly used SEC Exchange Act Rule 14a-8 (the so-called "Shareholder Proposal Rule") to not just manage but even micromanage corporate decisions.

The Rule permits a qualifying shareholder of a public corporation registered with the SEC to force the company to include a resolution and supporting statement in the company's proxy materials for its annual meeting. In theory, Rule 14a-8 contains limits on shareholder micromanagement. The Rule permits management to exclude proposals on a number of both technical and substantive bases, of which the exclusion of proposals relating to ordinary business operations under Rule 14a-8(i)(7) is the most pertinent for present purposes. Rule 14a-8(i)(7) is intended to permit exclusion of a proposal that "seeks to 'micro-manage' the company by probing too deeply into matters of a complex nature upon which shareholders, as a group, would not be in a position to make an informed judgment."

Unfortunately, court decisions have largely eviscerated the ordinary business operations exclusion. For example, corporate decisions involving "matters which have significant policy, economic or other implications inherent in them" may not be excluded as ordinary business matters. This creates a gap through which countless proposals have made it onto corporate proxy statements.

* William D. Warren distinguished Professor of Law, UCLA School of Law. I thank James R. Copland for his assistance and William A. Klein and the participants at an NYU School of Law/Stern School of Business workshop for their constructive comments.

This Article proposes an alternative standard that is not only grounded in relevant state corporate law principles but is easier to administer than the existing judicial tests. Under it, courts first look to the state law definition of ordinary business matters. The court then determines whether the matter is one of substance rather than procedure. Only proposals passing muster under both standards should be deemed proper.

INTRODUCTION

Who decides what products a company should sell, what prices it should charge, and so on? Is it the board of directors, the top management team, or the shareholders? In large corporations, of course, the traditional answer is the top management team operating under the supervision of the board.[1] As for the shareholders, they traditionally have had no role in these sort of operational decisions.[2]

This allocation of decision-making power follows from the basic principle that public corporations are not shareholder democracies.[3] Although shareholders nominally own the corporation,[4] they possess very few control rights normally associated with ownership.[5] Instead, corporate law assigns virtually plenary decision-making authority to the board of directors and the subordinate managers to whom the board properly delegates authority.[6]

This allocation of authority is essential if the corporation is to be run efficiently. Just as a large city cannot be run as a New England town

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1. *See, e.g.*, *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 761 n.490 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006) (explaining that "the law recognizes that corporate boards, comprised as they traditionally have been of persons dedicating less than all of their attention to that role, cannot themselves manage the operations of the firm, but may satisfy their obligations by thoughtfully appointing officers, establishing or approving goals and plans and monitoring performance"); *see also* CORP. LAWS COMM., ABA, CORPORATE DIRECTOR'S GUIDEBOOK 2 (6th ed. 2011) ("The key challenge for directors is to oversee the corporation's activities and strategy by utilizing effective oversight processes and making informed decisions, without becoming day-to-day managers."); Joshua R. Mourning, *The Majority-Voting Movement: Curtailing Shareholder Disenfranchisement in Corporate Director Elections*, 85 WASH. U. L. REV. 1143, 1143 (2007) ("Directors, acting as a board, are empowered under state law to make corporate decisions and all the while must keep the interest of the corporation—and thereby also its shareholders—foremost in their collective mind.").

2. *See, e.g.*, Rude v. Cook Inlet Region, Inc., 294 P.3d 76, 97 (Alaska 2012) (explaining that "under Alaska law, the board of directors, not shareholders[,] has the right to make both day-to-day and long-term management and operational decisions" (alteration in original)); CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 232 (Del. 2008) (explaining that it "is well-established that stockholders of a corporation subject to the DGCL may not directly manage the business and affairs of the corporation, at least without specific authorization in either the statute or the certificate of incorporation").

3. *See* Christian C. Day et al., *Riding the Rapids: Financing the Leveraged Transaction Without Getting Wet*, 41 SYRACUSE L. REV. 661, 677 (1990) ("Corporations, after all, are not democracies."); Jason Iuliano, *Do Corporations Have Religious Beliefs?*, 90 IND. L.J. 47, 81 (2015) ("As anyone who has interacted with corporations knows, they are not democracies.").

4. In fact, "shareholders do not own the corporation in the traditional sense of the word. Instead they own the residual claim to the corporation's income and assets." William K. Sjostrom, Jr. & Young Sang Kim, *Majority Voting for the Election of Directors*, 40 CONN. L. REV. 459, 467 n.44 (2007).

5. *See* MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 172 (1995) ("Shareholders in [public] firms do not actively manage the corporation; nor do they even set broad policy objectives."). For an overview of the limited control rights possessed by shareholders, see *id.* at 174–77.

6. *See supra* note 1 and accompanying text.

meeting, a large corporation is a poor candidate for direct democracy.[7] There simply are too many widely dispersed shareholders who have varying degrees of information about the company, differing goals and investment time horizons, and competing ideas about optimal business practices for their preferences to be aggregated efficiently.[8] Accordingly, state corporate law traditionally has given primary decision-making authority to the board and the managers to whom the board properly delegates authority.[9] As the Delaware General Corporation Law puts it, the "business and affairs" of a corporation "shall be managed by or under the direction of a board of directors."[10]

In contrast to state law's allocation of authority, the federal Securities and Exchange Commission (SEC) has tried to effectuate a limited form of "corporate democracy" through its proxy rules.[11] Its principal tool in this effort is Rule 14a-8 ("the Shareholder Proposal Rule" or "the Rule"), which allows shareholders meeting certain procedural requirements to place proposals on the corporation's proxy statement and have those proposals voted on at the company's annual shareholder meeting.[12]

Absent Rule 14a-8, there would be no vehicle for shareholders to put proposals on the issuer's proxy statement.[13] Shareholders' only practicable

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7. *See* TW Servs., Inc. v. SWT Acquisition Corp., Nos. 10427, 10298, 1989 WL 20290, at *8 n.14 (Del. Ch. Mar. 2, 1989) (stating that "a corporation is not a New England town meeting; directors, not shareholders, have responsibilities to manage the business and affairs of the corporation").

8. *See generally* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 Nw. U. L. REV. 547, 552–74 (2003) (explaining how factors such as asymmetric information, disparate interests, and collective action problems require that corporations are run by a central decision-making body rather than as a democracy).

9. *See, e.g.*, Gorman v. Salamone, C.A. No. 10183-VCN, 2015 WL 4719681, at *4 n.18 (Del. Ch. July 31, 2015) (stating "a Delaware corporation is a board-centric entity"); *In re* Schmitz, 285 S.W.3d 451, 459 (Tex. 2009) (noting "the principle that a corporation should be run by its board of directors, not a disgruntled shareholder or the courts").

10. DEL. CODE ANN. tit. 8, § 141(a) (2015); *see, e.g.*, *In re* CNX Gas Corp. S'holders Litig., C.A. No. 5377-VCL, 2010 WL 2291842, at *15 (Del. Ch. May 25, 2010) (observing that "director primacy remains the centerpiece of Delaware law, even when a controlling stockholder is present"). Because Delaware is far and away the leading choice as the state of incorporation for public companies, its corporate law effectively sets the "terms of corporate governance in the United States." Kent Greenfield, *Democracy and the Dominance of Delaware in Corporate Law*, 67 LAW & CONTEMP. PROBS. 135, 135 (2004). Accordingly, unless otherwise specified, references to corporate law herein refer to the relevant provisions of Delaware statutes and case law.

11. *See* Cent. Foundry Co. v. Comm'r, 49 T.C. 234, 249 (1967) ("The proxy rules promulgated by the SEC were plainly intended to promote corporate democracy . . . .").

12. *See* Harwell Wells, *"Corporation Law Is Dead": Heroic Managerialism, Legal Change, and the Puzzle of Corporation Law at the Height of the American Century*, 15 U. PA. J. BUS. L. 305, 340 (2013) ("SEC Rule 14a-8, which mandates inclusion of such proposals, was first adopted in 1942, in what could be seen as a late burst of New Deal enthusiasm for grassroots (shareholder) democracy; the requirement is still sometimes referred to as the 'Town Hall rule.'"); *see also infra* notes 87–92 and accompanying text (describing Rule 14a-8 and the overall proxy process in more detail).

13. Rule 14a-8 grew out of the SEC's goal that the federal proxy rules should "replicate the old-style annual meeting that was personally attended by shareholders." Jill E. Fisch, *From Legitimacy to Logic: Reconstructing Proxy Regulation*, 46 VAND. L. REV. 1129, 1142

alternative would be to conduct a proxy contest in favor of whatever proposal they wished to put forward.[14] From the proponent's prospective, the chief advantage of the Shareholder Proposal Rule is that it is inexpensive.[15] The proponent need not pay any of the printing and mailing costs (all of which must be paid by the corporation) or otherwise comply with the expensive panoply of regulatory requirements.[16]

In the three or four decades following the Shareholder Proposal Rule's adoption, the Rule was a tool mainly of gadflies and social activists.[17] Shareholder proposals were rare[18] and almost uniformly defeated by wide margins.[19] Up until the 1980s, the process thus "amounted to little more than a nuisance for corporate management."[20] Much of the law governing shareholder proposals developed during this period in which the stakes were low.[21]

In contrast, today the stakes are quite high, as the volume of shareholder proposals has increased dramatically over the last two decades.[22] Proponents are no longer just gadflies and social justice warriors but now include major institutional investors such as hedge funds and both union and government pension funds.[23] Although most proposals still fail to

(1993). The SEC believed that shareholders had a preexisting state law right to make proposals at the annual meeting, but it was unclear under then-existing law whether the board of directors had an obligation to solicit proxies with respect to a proposal of which it had been informed. *Id.* at 1143–44.

14. *See* Jeffrey N. Gordon, *Proxy Contests in an Era of Increasing Shareholder Power: Forget Issuer Proxy Access and Focus on E-Proxy*, 61 VAND. L. REV. 475, 479 (2008) ("A shareholder may undertake an independent proxy solicitation on behalf of any matter to be voted on at the annual meeting, but access to the issuer's proxy statement is nevertheless highly prized.").

15. *See* DENNIS R. HONABACH & MARK A. SARGENT, PROXY RULES HANDBOOK § 5:48, Westlaw (database updated Dec. 2015) (observing that "the shareholder proposal rule has provided shareholders with a relatively cheap, federally mandated vehicle for expressing their views on issues of corporate governance").

16. *See* Gordon, *supra* note 14, at 479 (explaining that the rule allows "shareholder proponents [to] avoid the costs of producing and distributing an independent proxy statement").

17. *See* Harwell Wells, *A Long View of Shareholder Power: From the Antebellum Corporation to the Twenty-First Century*, 67 FLA. L. REV. 1033, 1083 (2015) ("In the late 1960s, the gadflies would be joined by 'social issues' activists, often church-managed funds and later funds specially organized to engage in socially responsible investing, that again aimed to use shareholder proposals for broader progressive ends.").

18. *See* Myron P. Curzan & Mark L. Pelesh, *Revitalizing Corporate Democracy: Control of Investment Managers' Voting on Social Responsibility Proxy Issues*, 93 HARV. L. REV. 670, 676 (1980) (observing that during the "three decades" after Rule 14a-8 was adopted "shareholder proposals were relatively rare").

19. *See* Alan R. Palmiter, *The Shareholder Proposal Rule: A Failed Experiment in Merit Regulation*, 45 ALA. L. REV. 879, 883 (1994) ("As of 1981, only two contested shareholder proposals of the thousands submitted had ever won.").

20. *Id.*

21. *See id.* ("Until recently, the stakes presented by Rule 14a-8 . . . have been low.").

22. *See* 2 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 10:26 (2016) ("The number of shareholder proposals submitted to publicly held companies has been increasing.").

23. *See* Wells, *supra* note 17, at 1092–93 (discussing increased use of shareholder proposals by institutional investors).

receive majority shareholder support, a growing number do.[24] This is true not only for laggard firms, but also increasingly for successful ones.[25] As a result, all corporate directors and managers now must take shareholder proposals quite seriously.[26]

With the rising volume of proposals came a dramatic shift in their subject matter. Historically, most shareholder proposals focused on issues of corporate social responsibility.[27] However, over the last two decades, a growing number of proposals have focused on corporate governance questions.[28] Today, many proposals address issues traditionally regarded as board or management prerogatives, as a substantial number effectively seek to manage or even micromanage corporate decisions.[29] This shift has become especially prominent in the growing use of shareholder proposals by hedge funds seeking to affect changes in management personnel or corporate strategy of targeted companies.[30] However, Rule 14a-8 was never intended to permit shareholders to micromanage a corporation.[31] At an early stage in the Rule's development, the SEC added a specific exclusion—today codified as Rule 14a-8(i)(7)—permitting the corporation

24. *See, e.g.*, Mizuki Hayashi, *Corporate Ownership and Governance Reforms in Japan: Influence of Globalization and U.S. Practice*, 26 COLUM. J. ASIAN L. 315, 325 (2013) ("52.3 percent of shareholder proposals within U.S. Russell 3000 companies are related to corporate governance, and 37.2 percent of them received majority support in 2011.").

25. Martin Lipton, *Dealing with Activist Hedge Funds*, CLS BLUE SKY BLOG (June 21, 2013), http://clsbluesky.law.columbia.edu/2013/06/21/dealing-with-activist-hedge-funds/ ("No company is too big to become the target of an activist, and even companies with sterling corporate governance practices and positive share price performance, including outperformance of peers, may be targeted.") [https://perma.cc/J27R-3DFN].

26. *See, e.g.*, Randall S. Thomas & James F. Cotter, *Shareholder Proposals in the New Millennium: Shareholder Support, Board Response, and Market Reaction*, 13 J. CORP. FIN. 368 (2007) (reporting on an empirical survey finding that boards of directors are increasingly responsive to shareholder proposals, such as those relating to takeover defenses).

27. *See* Donald E. Schwartz, *Defining the Corporate Objective: Section 2.01 of the ALI's Principles*, 52 GEO. WASH. L. REV. 511, 519 & n.35 (1984) ("Shareholder proposals have ranged over a broad span of social issues, including the marketing of infant formula in less developed countries, opposition to producing profitable military hardware, making loans to the government of South Africa, using animals in medical research, and many other highly profitable business activities.").

28. *See* Carol Goforth, *Proxy Reform as a Means of Increasing Shareholder Participation in Corporate Governance: Too Little, but Not Too Late*, 43 AM. U. L. REV. 379, 429–30 (1994) ("Shareholder proposals on corporate governance issues have garnered dramatically increased levels of support.").

29. *See* Zhong Xing Tan, *Stewardship in the Interests of Systemic Stakeholders: Re-Conceptualizing the Means and Ends of Anglo-American Corporate Governance in the Wake of the Global Financial Crisis*, 9 J. BUS. & TECH. L. 169, 211 (2014) (noting that "hedge funds . . . commonly seek to influence board decisions on ordinary business decisions").

30. *See* Wells, *supra* note 17, at 1097 ("Taking larger stakes in publicly held firms than did the more traditional institutional investors and employing a wider array of strategies—shareholder proposals, proxy fights, and litigation for example—hedge funds pushed more aggressively for changes in corporate strategies and management than had investors of the previous decades.").

31. *See infra* notes 87–92 and accompanying text; *see also* HONABACH & SARGENT, *supra* note 15, § 5:46 ("Rule 14a-8(i)(7) declares that [a] shareholder may not use the shareholder proposal process to micromanage the corporation.").

to exclude from its proxy statement any proposal dealing "with a matter relating to the company's ordinary business operations."[32] Unfortunately, this exclusion has provided largely illusory limitations on shareholder proposals, because court decisions have largely eviscerated it. In particular, courts routinely have held that corporate decisions involving "matters which have significant policy, economic or other implications inherent in them" may not be excluded as ordinary business matters,[33] which creates a gap through which numerous proposals have made it onto corporate proxy statements.[34]

Whether Rule 14a-8(i)(7) was to be rendered entirely toothless was recently tested in *Trinity Wall Street. v. Wal-Mart Stores*, *Inc.*[35] Trinity timely submitted a proposal for inclusion in Wal-Mart's 2014 proxy statement that, if adopted, would have broadly requested Wal-Mart's board of directors to "develop and implement standards" by which management would decide "whether to sell a product that (1) 'especially endangers public safety'; (2) 'has the substantial potential to impair the reputation of Wal-Mart'; and/or (3) 'would reasonably be considered by many offensive to the family and community values integral to the Company's promotion of its brand.'"[36] When Wal-Mart refused to include the proposal in its proxy statement, Trinity sued in federal court seeking an injunction requiring Wal-Mart to include the proposal.[37]

Despite the proposal's seeming breadth, the Third Circuit deemed Trinity's proposal to be aimed directly at Wal-Mart's sale of rifles with high capacity magazines, reflecting Trinity's concern with "the profusion of mass murders and gun violence in American society."[38] In addition, although Trinity had carefully worded its proposal so it could claim that the proposal transcended ordinary business matters, the court refused to "allow drafters to evade Rule 14a-8(i)(7)'s reach by styling their proposals as requesting board oversight or review."[39] Instead, the court held that it must

32. 17 C.F.R. § 240.14a-8(i)(7) (2015).

33. Austin v. Consol. Edison Co., 788 F. Supp. 192, 194 (S.D.N.Y. 1992).

34. *See* David M. Lynn, *The Dodd-Frank Act's Specialized Corporate Disclosure: Using the Securities Laws to Address Public Policy Issues*, 6 J. BUS. & TECH. L. 327, 354 (2011) (noting that "the SEC Staff has, through the no-action letter process, determined that certain proposals could not be excluded under Rule 14a-8(i)(7) when the[y] relate to a wide range of policy issues, thereby permitting the proposal and supporting statement to be included in an issuer's definitive proxy statement and be subject to a shareholder vote").

35. 792 F.3d 323 (3d Cir.), *cert. dismissed*, 136 S. Ct. 499 (2015). Trinity Church Wall Street is an Episcopal parish headquartered in New York City that owns Wal-Mart stock and meets the qualifications to use Rule 14a-8 to put proposals on Wal-Mart's proxy statement. *Id.* at 327.

36. *Id.*

37. *Id.* at 331.

38. James H. Cooper, *Why Trinity Church and Wal-Mart Went to Federal Court*, TRINITY CHURCH WALL ST. (Dec. 2, 2014), https://www.trinitywallstreet.org/blogs/news/why-trinity-church-and-wal-mart-went-federal-court [https://perma.cc/MLL3-WBFB].

39. *Trinity*, 792 F.3d at 344.

identify the intended "ultimate consequence" of the proposal, which in this case was to pressure Wal-Mart to stop selling high capacity firearms.[40]

To determine whether the proposal so understood constituted an excludable ordinary business matter, the court applied a two-part test:

> Under the first step, we discern the "subject matter" of the proposal. Under the second, we ask whether that subject matter relates to Wal-Mart's ordinary business operations. If the answer to the second question is yes, Wal-Mart must still convince us that Trinity's proposal does not raise a significant policy issue that transcends the nuts and bolts of the retailer's business.[41]

Applying that standard, the court concluded that Wal-Mart properly could exclude the proposal from its proxy statement.[42]

Although the court posited that its standard would allow exclusion of proposals that are "too entwined with the fundamentals of the daily activities of a [company] running its business,"[43] the court's approach lacks administrability, predictability, and certainty.[44] As a result, *Trinity* stands as yet another in a long series of failures. As we shall see, the SEC and courts have failed to apply the exclusion consistently over time, flip-flopping repeatedly on major interpretative issues.[45] The various tests developed by both the agency and courts have all failed to offer coherence, let alone certainty and predictability.[46] *Trinity* failed to put the law on a more sound footing. Indeed, because the SEC has now indicated that it will not defer to *Trinity*, but rather will continue to apply its current standard,[47] the law is less certain than it was before *Trinity*.

A better test is needed and this Article offers one. Part I reviews the relationship between Rule 14a-8 and the state law rules governing the allocation of decision-making authority within the corporation. Part II then

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40. *Id.* at 342.

41. *Id.* at 341 (citations omitted).

42. *See infra* Part I.A (discussing the court's holding in detail).

43. *Trinity*, 792 F.3d at 347.

44. *See infra* Part I.A (setting out my criticisms in detail).

45. *See* Patricia R. Uhlenbrock, Note, *Roll Out the Barrel: The SEC Reverses Its Stance on Employment-Related Shareholder Proposal Under Rule 14a-8—Again*, 25 DEL. J. CORP. L. 277, 279 (2000) (noting an SEC pattern "of inconsistency in interpreting the ordinary business operations exception under 14a-8(i)(7)").

46. *See generally* J. Robert Brown, Jr., *The Politicization of Corporate Governance: Bureaucratic Discretion, the SEC, and Shareholder Ratification of Auditors*, 2 HARV. BUS. L. REV. 501, 510 (2012) ("Disconnected from state law and devoid of any real standards, application of the 'ordinary business' exclusion developed in an ad hoc and inconsistent fashion that could result in tenuous determinations."); Sung Ho (Danny) Choi, *It's Getting Hot in Here: The SEC's Regulation of Climate Change Shareholder Proposals Under the Ordinary Business Exception*, 17 DUKE ENVTL. L. & POL'Y F. 165, 173 (2006) ("The ordinary business exception has had a confusing history; the exception's vague language and inconsistent SEC interpretation has resulted in much debate and litigation.").

47. SEC Staff Legal Bulletin No. 14H (CF), 2015 WL 6503673, at *6 (Oct. 22, 2015) ("The Division intends to continue to apply Rule 14a-8(i)(7) as articulated by the Commission and consistent with the Division's prior application of the exclusion, as endorsed by the concurring judge, when considering no-action requests that raise Rule 14a-8(i)(7) as a basis for exclusion.").

reviews and critiques the *Trinity* decision. Finally, Part III sets out my proposed alternative test.

I. RULE 14a-8 AND THE ALLOCATION OF DECISION-MAKING AUTHORITY IN THE CORPORATION

The following part provides background information on Rule 14a-8, including the Rule's purpose and how it differs from states' traditional model of board-centric governance.

A. The SEC's Intent for the Rule to Promote Shareholder Democracy

As many courts and commentators have recognized, the SEC proxy rules seek to effectuate a scheme of "corporate democracy."[48] SEC Rule 14a-8—the so-called "Shareholder Proposal Rule"—is a central tool for accomplishing that goal.[49] In brief, the Rule permits a qualifying shareholder of a public corporation registered with the SEC to force the company to include a resolution and supporting statement in the company's proxy materials for its annual meeting.[50] To be sure, most of these proposals are phrased as recommendations,[51] but they nevertheless have become a powerful tool for influencing corporate decision making.[52]

48. *See, e.g.*, Med. Comm. for Human Rights v. SEC, 432 F.2d 659, 674 (D.C. Cir. 1970), *vacated as moot*, 404 U.S. 403 (1972) (noting "the concepts of corporate democracy embodied in the proxy rules"); Frank D. Emerson & Franklin C. Latcham, *Further Insight into More Effective Stockholder Participation: The Sparks-Withington Proxy Contest*, 60 YALE L.J. 429, 430 (1951) (citing the proxy contest at the Sparks-Withington Company as providing "examples of how the SEC's proxy rules in general promote 'corporate democracy'"); Note, *Disclosure of Payments to Foreign Government Officials Under the Securities Acts*, 89 HARV. L. REV. 1848, 1855 (1976) ("The Securities Exchange Act also reflects an intent to promote shareholder democracy in its authorizing the SEC to regulate proxy solicitation.").

49. *See* Daniel E. Lazaroff, *Promoting Corporate Democracy and Social Responsibility: The Need to Reform the Federal Proxy Rules on Shareholder Proposals*, 50 RUTGERS L. REV. 33, 37 (1997) (arguing that "the SEC has attempted to strike the difficult balance between enhancing corporate democracy through Rule 14a-8 and preventing undue harassment of, or interference with, the primary profit-making function of American business"); *cf.* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 85–86 (1991) (arguing that Rule 14a-8 is actually an "anti-democratic device").

50. For a more detailed overview of Rule 14a-8 and its various requirements, see STEPHEN M. BAINBRIDGE, CORPORATE LAW 294–302 (3d ed. 2015).

51. SEC Rule 14a-8(i)(1) allows the corporation to exclude from its proxy statement any proposal that "is not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization." 17 C.F.R. § 240.14a-8(i)(1) (2015). In a note on that provision of the Rule, however, the SEC takes the position, "[M]ost proposals that are cast as recommendations or requests that the board of directors take specified action are proper under state law. Accordingly, [the SEC] will assume that a proposal drafted as a recommendation or suggestion is proper unless the company demonstrates otherwise." *Id.*

52. *See* Thomas Lee Hazen & Lissa Lamkin Broome, *Board Diversity and Proxy Disclosure*, 37 U. DAYTON L. REV. 39, 45 (2011) (observing that "the shareholder proposal rule has proven a powerful tool for shareholders desiring to voice concerns").

B. The Clash Between the Federal Goal of Shareholder Democracy and the State Model of Board-Centric Governance

The SEC's efforts in this area are wholly inconsistent with the corporate governance structure created by state law. The SEC and its supporters claim that the proxy rules simply effectuate rights that shareholders have under state law.[53] However, shareholder control rights are extremely limited,[54] and under state law, shareholders "play an essentially passive and reactive role."[55] Further, decision-making authority is vested in the board of directors, which typically delegates much of that authority to corporate officers and employees.[56] As such, the corporation can hardly be described as a democracy.[57]

As I have argued elsewhere at book length, the separation of ownership and control is not a bug but rather an essential feature of corporate governance.[58] Indeed, numerous commentators now accept that "corporate governance is best characterized as based on 'director primacy.'"[59] In particular, there is growing agreement that "Delaware jurisprudence favors director primacy in terms of the definitive decisionmaking power, while simultaneously requiring directors to be ultimately concerned with the shareholders' interest."[60]

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53. *See* Roosevelt v. E.I. du Pont de Nemours & Co., 958 F.2d 416, 421 (D.C. Cir. 1992) (stating that Congress intended that the SEC's proxy rules "bolster the intelligent exercise of shareholder rights granted by state corporate law").

54. *See* DOOLEY, *supra* note 5, at 181 (explaining that shareholders "have no authority to initiate action on such fundamental questions as whether the corporation shall sell its assets, merge with another firm or, under most statutes, even amend its charter").

55. *Id.*

56. *See supra* notes 6–8 and accompanying text (discussing boards of directors' governance role).

57. *See supra* note 3 and accompanying text (noting the undemocratic nature of the corporation).

58. *See generally* STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE (2008) (describing the corporate governance model known as director primacy).

59. Larry E. Ribstein, *Why Corporations?*, 1 BERKELEY BUS. L.J. 183, 196 (2004); *see also* JEAN JACQUES DU PLESSIS ET AL., PRINCIPLES OF CONTEMPORARY CORPORATE GOVERNANCE 9 (2d ed. 2011) ("Until very recently, the 'shareholder primacy model' and 'stakeholder primacy model' of corporate governance have been the most prominent models, but Stephen Bainbridge, in his excellent work, *The New Corporate Governance in Theory and Practice*, analyzes these theories and provides some exciting new perspectives on corporate governance models by expanding on the 'director primacy model' that he developed recently."); Seth W. Ashby, *Strengthening the Public Company Board of Directors: Limited Shareholder Access to the Corporate Ballot vs. Required Majority Board Independence*, 2005 U. ILL. L. REV. 521, 533 ("Although theorists have long debated how to best describe the public company, a new theory of the firm has emerged that appears more complete than its predecessors: Professor Stephen M. Bainbridge's model of director primacy.").

60. Kevin L. Turner, *Settling the Debate: A Response to Professor Bebchuk's Proposed Reform of Hostile Takeover Defenses*, 57 ALA. L. REV. 907, 927 (2006). Turner notes that "the Delaware jurisprudence, while not explicitly affirming 'director primacy,' does implicitly leave the directors to make decisions with shareholders expressing their views only in specific and limited situations." *Id.* at 927–28.

C. Why the States' Model of Board-Centric Governance Is the Correct Choice

As Kenneth Arrow explained in work that provided the foundation on which the director primacy model was constructed, all organizations must have some mechanism for aggregating the preferences of the organization's constituencies and converting them into collective decisions.[61] These mechanisms fall on a spectrum between "consensus" and "authority."[62] Consensus-based structures are designed to allow all of a firm's voting stakeholders to participate in decision making.[63] Authority-based decision-making structures are characterized by the existence of a central decision maker to whom all firm employees ultimately report and who is empowered to make decisions unilaterally without the approval of other firm constituencies.[64] Such structures are best suited for firms whose constituencies face information asymmetries and have differing interests.[65] It is because the corporation demonstrably satisfies those conditions that vesting the power of fiat in a central decision maker—i.e., the board of directors—is the essential characteristic of its governance.[66]

Shareholders have widely divergent interests and distinctly different access to information.[67] To be sure, most shareholders invest in a

61. *See* KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 68–69 (1974) (discussing organizational decision making). It seems appropriate to recount the basic normative argument in favor of director primacy for the benefit of new readers, while keeping the statement as brief as possible and incorporating by reference works in which the argument is laid out in detail. As one critic of the director primacy model observed, "the exigencies of law review scholarship entail repeating the same argument in multiple articles before going on to apply that argument to specific topics." Brett McDonnell, *Professor Bainbridge and the Arrowian Moment: A Review of* The New Corporate Governance in Theory and Practice, 34 DEL. J. CORP. L. 139, 141 (2009). Accordingly, as Michael Stokes Paulsen observed in a similar situation, "[t]he result is a certain amount of borderline-self-plagiarism, for which I hereby apologize—and which this general footnote hopefully mitigates to the extent necessary." Michael Stokes Paulsen, *The Priority of God: A Theory of Religious Liberty*, 39 PEPP. L. REV. 1159, 1162 n.5 (2013).

62. ARROW, *supra* note 61, at 68–69.

63. *See* Michael P. Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW. 503, 520 (1989) (arguing that the "decisional default rules of partnership law, which emphasize the partners' equal rights to participate in the management of the business, closely resemble Arrow's Consensus model").

64. *See* ARROW, *supra* note 61, at 69 (providing examples of authority-based decision-making structures).

65. *See* McDonnell, *supra* note 61, at 154 ("Consensus works where all team members have identical interests and identical information.").

66. *See id.* ("In a large corporation, no major constituency group comes close to achieving identical interests or identical information."); *see also* Dooley & Veasey, *supra* note 63, at 520 (explaining that "the statutory scheme of centralizing corporate authority in the board and relegating the stockholders to a passive role is intended to economize on the costs of decision making within the firm").

67. *See generally* Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 579–93 (2006) (setting out a number of ways in which shareholders' interests may conflict). In addition to Arrow's information and incentive criteria, an authority-based decision-making structure is essential to the public corporation due to the collective action problems inherent in attempting to involve many thousands of decision makers, which necessarily prevent shareholders from operating the corporation by

corporation expecting financial gains, but once uncertainty is introduced, shareholder opinions on which course will maximize share value are likely to vary widely.[68] In addition, shareholder investment time horizons vary from short-term speculation to long-term buy-and-hold strategies, which in turn is likely to result in disagreements about corporate strategy.[69] Likewise, shareholders in different tax brackets are likely to disagree about such matters as dividend policy, as well as the merits of allowing management to invest the firm's free cash flow in new projects.[70]

As to Arrow's information condition, shareholders traditionally lacked incentives to gather the information necessary to actively participate in decision making.[71] A rational shareholder will expend the effort necessary to make informed decisions only if the expected benefits outweigh the costs of doing so.[72] In light of the length and complexity of corporate disclosure documents, the effort incurred by shareholders in making informed decisions is quite high (as are the opportunity costs).[73] In contrast, the expected benefits of becoming informed are quite low, as most shareholders' holdings are too small to have a significant effect on the vote's outcome.[74] Accordingly, corporate shareholders are rationally apathetic.[75]

Many commentators argue that the rise of institutional investors radically alters the foregoing analysis, stating that such investors have greater abilities to gather information and superior incentives to do so vis-à-vis retail investors.[76] There is no doubt that institutional investors—or, more

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consensus. *See* Jana Master Fund, Ltd. v. CNET Networks, Inc., 954 A.2d 335, 340 (Del. Ch. 2008) (noting that "with ownership diffused among so many holders, there exists a problem of collective action").

68. *See* Anabtawi, *supra* note 67, at 578 n.76 (explaining that "differences of opinion over how to maximize shareholder value" is a source of "shareholder division").

69. *See* Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733, 745–46 (2007) (explaining why shareholders often have different time horizons for maximization).

70. *See* Anabtawi, *supra* note 67, at 578 n.170 (explaining that shareholders can have differing "preferences for income versus growth and tax status").

71. *See* Keith N. Hylton, *An Economic Theory of the Duty to Bargain*, 83 GEO. L.J. 19, 55 n.115 (1994) ("Both the excessive cost of keeping all the shareholders informed and the individual shareholders' 'free rider' incentive to let the other shareholders bear the costs of participating in corporate affairs induce rationally apathetic shareholder behavior towards corporate decisions.").

72. *See Jana Master Fund*, 954 A.2d at 340 ("Individual investors have too little 'skin in the game' to rationally devote the time and energy necessary to keep themselves aware of the details of the corporation's performance or to campaign for corporate change.").

73. *See* Zohar Goshen, *Shareholder Dividend Options*, 104 YALE L.J. 881, 902 (1995) (observing that "the costs of shareholder voting include the cost of informing shareholders and opportunity costs").

74. *See* Patrick J. Straka, *Executive Compensation Disclosure: The SEC's Attempt to Facilitate Market Forces*, 72 NEB. L. REV. 803, 835 (1993) (arguing that small shareholders' costs will outweigh the benefits of making an informed decision).

75. *See Jana Master Fund*, 954 A.2d at 340.

76. *See, e.g.*, Lee Harris, *The Politics of Shareholder Voting*, 86 N.Y.U. L. REV. 1761, 1785–86 (2011) ("[I]nstitutional investors . . . do not need shorthand to sort through information that may be expensive, or otherwise difficult, to procure. Rather, these institutions have the resources, the ability, and the duty to stay apprised of the content of

precisely, a subset thereof—have become more active in corporate governance.[77] Yet, many classes of institutional investors remain mostly passive or, at best, followers.[78] In addition, important classes of the most active institutions—most notably government and union pension funds—have strong incentives to pursue private benefits at the expense of other investors.[79] Finally, as discussed below, hedge fund activism increasingly tends to entail micromanagement of decisions that these institutional investors are poorly equipped to make.[80]

In sum, the public corporation succeeds in large part because it provides a hierarchical decision-making structure well suited to the problem of operating a large business enterprise with numerous employees, managers, shareholders, creditors, and other inputs.[81] In such an enterprise, someone must be in charge: "Under conditions of widely dispersed information and the need for speed in decisions, authoritative control at the tactical level is essential for success."[82] As we have seen, that someone is the board of directors, not the shareholders.[83]

Strong limits on shareholder control are essential if that optimal allocation of decision-making authority is to be protected.[84] This includes

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shareholder proposals."); Joseph W. Yockey, *On the Role and Regulation of Private Negotiations in Governance*, 61 S.C. L. REV. 171, 181 (2009) ("Through their large holdings, institutional investors are thought to be able to overcome the rational apathy problem presented by diffuse individual shareholders."); *cf.* Jill E. Fisch, *Class Action Reform: Lessons from Securities Litigation*, 39 ARIZ. L. REV. 533, 540–41 (1997) (arguing institutional investors are better situated than retail investors to monitor corporations).

77. *See* Pamela Park, *Corporate Governance 2013: Shareholder Activists Demand Voices in the Boardroom and Changes to Corporate Strategy*, WESTLAW CORP. GOVERNANCE DAILY BRIEFING, 2014 WL 241758 (Dec. 26, 2013) ("Shareholder activists took an increasingly prominent role in corporate governance this year, as companies in a whole range of industries faced pressure from hedge funds and institutional investors to make leadership and strategic changes.").

78. *See* Roberta Romano, *Less Is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. REG. 174, 179 (2001) ("The fact that in contrast to public pension funds, private pension and mutual funds do not engage in activism has been explained by the competitive nature of the industry, or more pejoratively, as cost-conscious private funds' free-riding on the expenditures of activist public funds."); Anna Sandor, *Leveraging International Law to Incentivize Value-Added Shareholding: Why Foreign Sovereign Wealth Funds* Still *Matter and How They Can Improve Shareholder Governance*, 46 GEO. J. INT'L L. 947, 961 (2015) ("Other institutional investors, such as mutual funds, are similarly critiqued for their penchant for passive investment.").

79. *See* Romano, *supra* note 78, at 231–32 (discussing incentives of managers of such funds to pursue private benefits).

80. *See infra* Part II.

81. Given the collective action problems inherent with such a large number of potential decision makers, the differing interests of shareholders, and their varying levels of knowledge about the firm, it is "cheaper and more efficient to transmit all the pieces of information once to a central place" and to have the central office "make the collective decision and transmit it rather than retransmit all the information on which the decision is based." ARROW, *supra* note 61, at 68 nn.3–4.

82. *Id.* at 69.

83. *See supra* notes 3–6 and accompanying text (discussing allocation of decision-making authority within the corporation).

84. If the foregoing analysis has explanatory power, it might fairly be asked, why do we observe any shareholder voting rights at all? For a discussion of that question, explaining

both limits on direct shareholder decision making and limits on shareholder oversight of the board, because giving shareholders a power of review differs little from giving them the power to make management decisions in the first place.[85] As Arrow explained:

> Clearly, a sufficiently strict and continuous organ of [accountability] can easily amount to a denial of authority. If every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem.[86]

D. How Rule 14a-8 Changes the Allocation of Authority Within Corporate Governance

In principle, Rule 14a-8 contains protections designed to prevent it from being used as a tool for effectuating a shift in the locus of corporate decision making from the board to the shareholders. As the D.C. Circuit explained, the Rule's drafters recognized that "management cannot exercise its specialized talents effectively if corporate investors assert the power to dictate the minutiae of daily business decisions."[87] Accordingly, the Rule contains several eligibility requirements designed to ensure that shareholder proponents have some minimum amount of skin in the game.[88] In addition, the Rule contains thirteen substantive bases for excluding a proposal.[89]

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why corporate law allows only shareholders to participate in corporate decision making (to the limited extent it does so) and not other constituencies, see Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 603–16 (2006).

85. *See* John D. Donovan, Jr., *Derivative Litigation and the Business Judgment Rule in Massachusetts:* Houle v. Low, 34 BOS. B.J., Nov.–Dec. 1990, at 22, 27 (observing that "the power to review constitutes the power to decide").

86. ARROW, *supra* note 61, at 78.

87. Med. Comm. for Human Rights v. SEC, 432 F.2d 659, 679 (D.C. Cir. 1970), *vacated as moot*, 404 U.S. 403 (1972).

88. *See generally* Palmiter, *supra* note 19, at 886 ("Many of the rule's access conditions seek to ensure an orderly solicitation process so that shareholder proposals do not choke the company-funded proxy mechanism or interfere with management's solicitation efforts."). For example, Rule 14a-8(b)(1) limits eligibility to use the Rule to shareholders who have owned at least 1 percent or $2,000, whichever is less, of the issuer's voting securities for at least one year prior to the date on which the proposal is submitted. *See* 17 C.F.R. § 240.14a-8(b)(1) (2015). Rule 14a-8(c) provides that a shareholder may only submit one proposal per corporation per year. *See* 17 C.F.R. § 240.14a-8(c). There is no limit to the number of companies to which a proponent can submit proposals in a given year, however, nor is there any limit on the number of proposals a company may be obliged to include in its proxy statement. *See* BAINBRIDGE, *supra* note 50, at 296 (discussing eligibility requirements under the Rule).

89. *See* 17 C.F.R. § 240.14a-8(i) (setting out substantive bases for excluding a proposal); *see also* Palmiter, *supra* note 19, at 888 (explaining that the substantive exclusions "of Rule 14a-8 filter out vexatious, illegal, deceptive, and unintelligible proposals"). If the registrant believes the proposal can be excluded from its proxy statement, it must notify the SEC that the registrant intends to exclude the proposal. *See* 17 C.F.R. § 240.14a-8(j)(1) ("If the company intends to exclude a proposal from its proxy materials, it must file its reasons with the Commission no later than 80 calendar days before it files its definitive proxy statement and form of proxy with the Commission."). A copy of the notice must also be sent to the proponent. *See id.* If the SEC staff agrees that the proposal can be excluded, it issues a so-called "no-action letter," which states that the staff will not recommend that the SEC bring an enforcement proceeding against the issuer if the proposal is excluded. *See generally*

The substantive ground for exclusion most directly relevant for present purposes is Rule 14a-8(i)(7), which permits exclusion of proposals relating to ordinary business operations.[90] This exclusion is intended to "to relieve the management of the necessity of including in its proxy material security holder proposals which relate to matters falling within the province of management."[91] Specifically, Rule 14a-8(i)(7) permits exclusion of a proposal that "seeks to 'micro-manage' the company by probing too deeply into matters of a complex nature upon which shareholders, as a group, would not be in a position to make an informed judgment."[92]

II. THE *TRINITY* DECISION

The SEC added the ordinary business exception to the Rule to give "recognition to the principle of corporate law that management of the business . . . is vested in its Board of Directors."[93] Unfortunately, implementing this seemingly simple proposition has proven to be one of the most challenging aspects of Rule 14a-8's jurisprudence.[94] In large part, the problem arises from the SEC's and courts' inability to develop a satisfactory definition of "ordinary business."[95] In addition, the SEC and courts have insisted that whatever "ordinary business" means, the exclusion does not permit exclusion of proposals involving "matters which have

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Donna M. Nagy, *Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters: Current Problems and a Proposed Framework*, 83 CORNELL L. REV. 921, 929–66 (1998) (describing the no-action process). However, if the staff determines that the proposal should be included in management's proxy statement, the staff notifies the issuer that the SEC may bring an enforcement action if the proposal is excluded. Whichever side loses at the staff level can ask the SEC Commissioners to review the staff's decision. After review by the Commissioners, the losing party can seek judicial review by the U.S. Circuit Court of Appeals for the District of Columbia, but these reviews are quite rare. *See Med. Comm. for Human Rights*, 432 F.2d at 666 (discussing appellate review of SEC review of a staff determination). If management is the losing party at the staff level, it typically acquiesces in the staff's decision. If the proponent loses at the staff level, the proponent typically seeks injunctive relief in federal district court. *See, e.g.*, Amalgamated Clothing & Textile Workers Union v. SEC, 15 F.3d 254, 257 (2d Cir. 1994) (holding that a proponent who believes that the registrant improperly excluded a proposal may seek judicial determination in a federal district court).

90. 17 C.F.R. § 240.14a-8(i)(7) (permitting exclusion of a "proposal [that] deals with a matter relating to the company's ordinary business operations").

91. Solicitation of Proxies, 18 Fed. Reg. 6646, 6647 (proposed Oct. 20, 1953) (to be codified at 17 C.F.R. pt. 240).

92. Apache Corp. v. N.Y.C. Emps. Ret. Sys., 621 F. Supp. 2d 444, 450 (S.D. Tex. 2008) (quoting Amendments to Rules on Shareholder Proposals, 63 Fed. Reg. 29,106, 29,108 (May 28, 1998)).

93. N.Y.C. Emps. Ret. Sys. v. Brunswick Corp., 789 F. Supp. 144, 146–47 (S.D.N.Y. 1992).

94. *See* Lazaroff, *supra* note 49, at 62 (noting that "the scope of the ordinary business exception remains perhaps the most perplexing issue in Rule 14a-8 jurisprudence").

95. *See, e.g.*, Trinity Wall St. v. Wal-Mart Stores, Inc., 792 F.3d 323, 346 (3d Cir. 2015) (complaining that "the Commission has adopted what can only be described as a 'we-know-it-when-we-see-it' approach"); *see also* Grimes v. Centerior Energy Corp., 909 F.2d 529, 531 (D.C. Cir. 1990) (stating that "the phrase 'ordinary business operations' . . . has no precise definition"); *Apache Corp.*, 621 F. Supp. 2d at 449 ("The term 'ordinary business operations' escapes formal definition.").

significant policy, economic or other implications inherent in them,"[96] which substantially reduces the number of proposals excludable as mundane. These difficulties threaten to render the ordinary business exclusion largely ineffective.[97] *Trinity Wall Street v. Wal-Mart Stores, Inc.*[98] thus provided a crucial test of whether the exception retained any teeth as a limitation on institutional investor micromanagement.

A. Background on the Ordinary Business Exclusion

When Rule 14a-8 was originally adopted, it contained no exceptions other than an implied one requiring that the proposal be a proper one for shareholder action.[99] In 1953, the Rule was amended to include the exclusion for ordinary business matters now codified as Rule 14a-8(i)(7).[100] In doing so, the SEC recognized that permitting shareholders to advance proposals relating to ordinary business matters would be inconsistent with the bedrock state corporate law principle that "leaves the conduct of ordinary business operations to corporate directors and officers rather than the shareholders."[101]

The SEC believed that state law "is rarely conclusive as to what is or is not ordinary business," which led the SEC staff and courts to develop a federal standard to define the term.[102] A critical moment in that process came in 1976, when the SEC expressed concern that the ordinary business exception was being used to omit proposals "that involve matters of considerable importance to the issuer and its security holders."[103] To address that concern, the SEC issued administrative guidance positing that the ordinary business exception did not permit exclusion of "matters which have significant policy, economic or other implications inherent in

96. Austin v. Consol. Edison Co., 788 F. Supp. 192, 194 (S.D.N.Y. 1992) (quoting Adoption of Amendments Relating to Proposals by Security Holders, 41 Fed. Reg. 52,994, 52,998 (1976)).

97. As I have observed elsewhere:

> Under current law, the ordinary business exclusion is essentially toothless. The SEC requires companies to include proposals relating to stock option re-pricing, sale of genetically modified foods and tobacco products by their manufacturers, disclosure of political activities and support to political entities and candidates, executive compensation, and environmental issues. Obviously, however, these sort of ordinary business decisions are core board prerogatives.

Stephen M. Bainbridge, *Preserving Director Primacy by Managing Shareholder Interventions*, *in* RESEARCH HANDBOOK ON SHAREHOLDER POWER 231, 246 (Jennifer G. Hill & Randall S. Thomas eds., 2015).

98. 792 F.3d 323 (3d Cir.), *cert. dismissed*, 136 S. Ct. 499 (2015).

99. *See* Solicitation of Proxies Under the Act, Exchange Act Release No. 3347, 7 Fed. Reg. 10,655, 10,656 (Dec. 22, 1942) (adopting the original rule).

100. *See* Uhlenbrock, *supra* note 45, at 285 (discussing the history of the exclusion).

101. Amalgamated Clothing & Textile Workers Union v. Wal-Mart Stores, Inc., 821 F. Supp. 877, 883 (S.D.N.Y. 1993).

102. Proposed Amendments to Rule 14a-8, Exchange Act Release No. 19,135, 47 Fed. Reg. 47,420, 47,429 (Oct. 26, 1982) [hereinafter 1982 Proposing Release].

103. Proposed Amendments to Rule 14a-8, Exchange Act Release No. 12,598, 41 Fed. Reg. 29,982, 29,984 (July 20, 1976).

them."[104] As an example of a proposal that should not have been excluded as ordinary business, the SEC cited "a proposal that a utility company not construct a proposed nuclear power plant."[105] In the future, the SEC opined, "proposals of that nature, as well as others that have major implications, [would] be considered beyond the realm of an issuer's ordinary business operations."[106]

The 1976 guidance specifically endorsed a two-prong test for determining whether a proposal could be excluded under the ordinary business exception: "where proposals involve business matters that [1] are mundane in nature and [2] do not involve any substantial policy or other considerations, the subparagraph may be relied upon to omit them."[107] Over the next sixteen years, however, the test was applied haphazardly, especially with respect to employee benefits, employment discrimination, and related matters.[108]

In 1992, perhaps motivated by a desire to provide greater certainty, the SEC for the first time adopted a bright-line position that effectively excluded an entire category of social issue proposals. Cracker Barrel Old Country Stores attempted to exclude a shareholder proposal calling on the board of directors to include sexual orientation in its antidiscrimination policy.[109] In a no-action letter issued by the SEC's Division of Corporation Finance ("Cracker Barrel no-action letter"), the SEC took the position that all employment-related shareholder proposals—including those raising social policy issues—could be excluded under the ordinary business exclusion.[110]

Subsequent litigation developed two issues. First, if a shareholder proponent sued a company whose management relied on the Cracker Barrel no-action letter to justify excluding an employment-related proposal from the proxy statement, should the reviewing court defer to the SEC's position? In *Amalgamated Clothing & Textile Workers Union v. Wal-Mart Stores, Inc.*,[111] a federal district court held that deference was not required and, moreover, that proposals relating to a company's affirmative action policies were not per se excludible as ordinary business under Rule 14a-8(i)(7).[112]

Second, was the SEC's position in the Cracker Barrel no-action letter valid? In other words, could the SEC properly apply the Cracker Barrel

104. Adoption of Amendments Relating to Proposals by Security Holders, Exchange Act Release No. 12,999, 10 SEC Docket 1006, 1012 (Nov. 22, 1976).

105. *Id.*

106. *Id.*

107. *Id.*

108. *See* Phillip R. Stanton, Recent Development, *SEC Reverses Cracker Barrel No-Action Letter*, 77 WASH. U. L.Q. 979, 983 (1999) ("During this period, the SEC applied this two-part test in a manner that was, according to many commentators, neither consistent nor appropriate.").

109. Cracker Barrel Old Country Store, Inc., SEC No-Action Letter, [1992–1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,418, 77,284–85 (Oct. 13, 1992).

110. *Id.* at 77,287.

111. 821 F. Supp. 877 (S.D.N.Y. 1993).

112. *See id.* at 889–92 (discussing issues of deference and regulatory interpretation).

no-action letter's interpretation in internal agency processes, such as when issuing a no-action letter? In *New York City Employees' Retirement System v. SEC*,[113] the district court ruled that the SEC's Cracker Barrel position was itself invalid because the SEC had failed to comply with federal administrative procedures in promulgating the position.[114] The Second Circuit reversed, thereby allowing the SEC to apply its Cracker Barrel position internally, but in doing so concurred with the lower court's view that the Cracker Barrel no-action letter was not binding on courts.[115]

In 1998, the SEC adopted amendments to Rule 14a-8 that, among other things, reversed its Cracker Barrel position.[116] In promulgating this change, the SEC emphasized that employment discrimination was a consistent topic of public debate and restated its belief that Rule 14a-8(i)(7) did not permit exclusion of proposals that raise significant social policy issues.[117] Proposals broadly relating to issues such as affirmative action and other employment discrimination matters thus generally are not excludable.[118]

*B. Pre-*Trinity *Applications of the Exclusion*

As the ordinary business exclusion has developed, it has become increasingly clear that "ordinary" does not mean "ordinary" in the dictionary sense of the word. As the *Trinity* Court noted, for example, "the term 'ordinary business' continues to 'refer[] to matters that are not necessarily "ordinary" in the common meaning of the word' and 'is rooted in the corporate law concept providing management with flexibility in directing certain core matters involving the company's business and operations.'"[119] As such, "the opaque term 'ordinary business' . . . is neither self-defining nor consistent in its meaning across different corporate contexts."[120]

Much of the problem relates to the inherently subjective nature of the public policy prong of the test. In *Austin v. Consolidated Edison Co. of New York*,[121] for example, the plaintiffs put forward a proposal recommending that the company allow employees to retire with full

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113. 843 F. Supp. 858 (S.D.N.Y. 1994), *rev'd*, 45 F.3d 7 (2d Cir. 1995).

114. *Id.*

115. *N.Y.C. Emps. Ret. Sys.*, 45 F.3d at 11–14.

116. *See* Amendments to Rules on Shareholder Proposals, Exchange Act Release No. 40,108, 63 Fed. Reg. 29,106, 29,106 (May 28, 1998) [hereinafter 1998 Adopting Release].

117. *Id.*

118. For example, in *N.Y.C. Emps. Ret. Sys. v. Dole Food Co.*, 795 F. Supp. 95 (S.D.N.Y. 1992), the proponent offered a proposal requesting Dole to study the potential impact on the company of various pending national health care reform proposals. Dole relied on Rule 14a-8(i)(7) to exclude the proposal, among other provisions. The court rejected Dole's argument. Although employee benefits generally are an ordinary business matter, "a significant strategic decision" as to employee benefits fell outside the scope of ordinary business matters. *Id.* at 100.

119. Trinity Wall St. v. Wal-Mart Stores, Inc., 792 F.3d 323, 340 (3d Cir. 2015) (quoting 1998 Adopting Release, *supra* note 116).

120. *Id.* at 337.

121. 788 F. Supp. 192 (S.D.N.Y. 1992).

benefits after thirty years of service regardless of age.[122] The court authorized the issuer to exclude the proposal as impinging on an ordinary business matter.[123] Instead of grounding its holding on deference to the board's authority over employee benefits, the court observed that the issue of "enhanced pension rights" for workers "has not yet captured public attention and concern as has the issue of senior executive compensation."[124] In other words, the proposal was excluded not because it attempted to micromanage company human relations policy, but because the issue got less press and regulatory attention than senior executive compensation. Likewise, the SEC refused to issue a no-action letter authorizing Eli Lilly & Co. to exclude a shareholder proposal relating to drug pricing.[125] As with the pension benefits at issue in *Austin*, "corporate pricing decisions would seem to fall within the core of business decisions delegated to management rather than to shareholders."[126] Unlike the plaintiffs in *Austin*, however, the Eli Lilly proponent succeeded because "the shareholder argued that media attention to the issue of fairness in drug pricing had made it a 'crucial national issue.'"[127] The implication of such cases is that the significance of a proposal turns at least in part on whether its subject matter has become a routine story for CNBC or CNN.[128]

In other cases, such as *Amalgamated Clothing & Textile Workers Union v. Wal-Mart Stores, Inc.*,[129] congressional attention on the issue has been cited as evidence of its significance. In *Amalgamated Clothing*, the shareholders' proposal called "for Wal-Mart's directors to prepare and distribute reports about Wal-Mart's equal employment opportunity ('EEO') and affirmative action policies, programs and data, along with a description of Wal-Mart's efforts to (1) publicize its EEO policies to suppliers; and (2) purchase goods and services from minority- and female-owned suppliers."[130] In concluding that the proposal raised significant policy issues, the court cited "the continual interest of Congress in employment discrimination since 1964, which was most recently underscored in the Civil Rights and Glass Ceiling Acts of 1991."[131]

122. *See id.* at 193 ("On December 30, 1991, plaintiffs' counsel presented to defendant for inclusion in its proxy materials a proposed corporate resolution endorsing various changes in the pension rights of defendant's employees, most significant of which is one that would permit employees to retire with no actuarial reduction of their pension rights after 30 years of service, regardless of age.").

123. *See id.* at 196 (holding that "the disputed pension proposal fits comfortably within the exception for 'ordinary business operations'").

124. *Id.* at 195.

125. *See* Fisch, *supra* note 13, at 1158 (describing the Eli Lilly no-action letter).

126. *Id.*

127. *Id.*

128. *See, e.g.*, Stanton, *supra* note 108, at 991–92 (noting that the SEC bases its analysis on whether "the issue has either become or ceased being the subject of significant press attention, legislative debate, or public concern").

129. 821 F. Supp. 877 (S.D.N.Y. 1993).

130. *Id.* at 879.

131. *Id.* at 891.

The court's reliance on evidence of congressional interest is at least as flawed as the reliance other courts have placed on media attention. Among other things, the court failed to explain "why a matter of interest to Congress should ipso facto be an appropriate subject for shareholder voting."[132] As another commentator similarly observed:

> Even though the SEC staff attempts to substantiate [its decisions] by stating that there has been increased legislative interest in the particular area addressed by the proposal, it does not specify such interest. Further, although legislative interest may be some evidence of the presence of a substantial policy issue, legislative interest alone does not sufficiently define the contours of a substantial policy issue. The problem with equating "legislative interest" with "substantial policy issue" is that, even if we accept that legislative interest is evidence of a substantial policy issue, the question remains: When does it become a substantial policy issue? When a bill is introduced? When it is passed by the House? By the Senate? When it is signed into law?[133]

With tests such as these in use, it is no wonder that the ordinary business exclusion attracted a reputation for being opaque.

C. The Trinity *Litigation*

Although the proponent in *Trinity* was not a hedge fund but rather a charity more typical of the original corporate social responsibility activists, the case provided an important test of Rule 14a-8(i)(7)'s ability—if any remained—to prevent shareholders from micromanaging corporations. In 2013, disturbed by the recent mass shooting at Sandy Hook Elementary School in nearby Connecticut, "Trinity resolved to use its investment portfolio to address the ease of access to rifles equipped with high-capacity magazines (the weapon of choice of the Sandy Hook shooter and other mass murderers)."[134] Trinity chose Wal-Mart as its initial target.[135] In reliance on Rule 14a-8, Trinity timely submitted the following proposal for inclusion in Wal-Mart's 2014 annual proxy statement:

> Resolved:
>
> Stockholders request that the Board amend the Compensation, Nominating and Governance Committee charter . . . as follows:
>
> "27. Providing oversight concerning [and the public reporting of] the formulation and implementation of . . . policies and standards that determine whether or not the Company should sell a product that:
>
> 1) especially endangers public safety and well-being;
>
> 2) has the substantial potential to impair the reputation of the Company; and/or

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132. Palmiter, *supra* note 19, at 882 n.13.

133. Kevin W. Waite, Note, *The Ordinary Business Operations Exception to the Shareholder Proposal Rule: A Return to Predictability*, 64 FORDHAM L. REV. 1253, 1265 (1995).

134. Trinity Wall St. v. Wal-Mart Stores, Inc., 792 F.3d 323, 328 (3d Cir.), *cert. dismissed*, 136 S. Ct. 499 (2015).

135. *Id.*

> 3) would reasonably be considered by many offensive to the family and community values integral to the Company's promotion of its brand."[136]

Wal-Mart notified the SEC that it intended to omit the proposal, relying on Rule 14a-8(i)(7).[137] After evaluating Wal-Mart's request and Trinity's response thereto, the SEC staff issued a no-action letter on grounds "that the proposal relates to the products and services offered for sale by the company" and was therefore excludable under the ordinary business exception.[138] Trinity then filed a lawsuit in the U.S. District Court for the District of Delaware, seeking an injunction requiring Wal-Mart to include the proposal in its proxy statement for the upcoming annual meeting.[139] The district court granted the injunction, finding that the proposal was not subject to the exception because

> Trinity's Proposal seeks to have Wal-Mart's *Board* oversee the development and effectuation of a Wal-Mart policy. While such a policy, if formulated and implemented, could (and almost certainly would) shape what products are sold by Wal-Mart, the Proposal does not itself have this consequence. As Trinity acknowledges, the outcome of the Board's deliberations regarding dangerous products is beyond the scope of the Proposal. Any direct impact of adoption of Trinity's Proposal would be felt at the Board level; it would then be for the Board to determine what, if any, policy should be formulated and implemented.
>
> . . . .
>
> Moreover, to the extent the Proposal "relat[es] to such matters" as which products Wal-Mart may sell, the Proposal nonetheless "*focus[es] on sufficiently significant social policy issues*" as to not be excludable, because the Proposal "*transcend[s] the day-to-day business matters and raise[s] policy issues so significant that it would be appropriate for a shareholder vote*." The significant social policy issues on which the Proposal focuses include the social and community effects of sales of high capacity firearms at the world's largest retailer and the impact this could have on Wal-Mart's reputation, particularly if such a product sold at Wal-Mart is misused and people are injured or killed as a result. In this way, the Proposal implicates significant policy issues that are appropriate for a shareholder vote.[140]

136. *Id.* at 329–30. At the time Trinity submitted its proposal, Wal-Mart had a policy of limiting, or, in some cases, even prohibiting sales of products management regarded as not being family friendly, such as music CDs and video games depicting sex or violence. *See id.* at 329. The policy also limited the sale of handguns and high capacity rifle magazines when sold separately from a firearm. *See id.* In Trinity's view, this policy of "respect[ing] family and community interests" was inconsistently applied, because it did not extend to prohibiting the sale of rifles with high capacity magazines, which Trinity claimed "facilitate[s] mass killings." *Id.* at 330.

137. *See* Wal-Mart Stores, Inc., SEC No-Action Letter, 2014 WL 409085, at *1 (Jan. 30, 2014).

138. *Id.*

139. *See* Trinity Wall St. v. Wal-Mart Stores, Inc., 75 F. Supp. 3d 617 (D. Del. 2014), *rev'd*, 792 F.3d 323, *cert. dismissed*, 136 S. Ct. 499.

140. *Id.* at 630–31 (alteration in original).

The Third Circuit reversed.[141]

D. The Trinity *Standard*

In reversing the lower court's decision, the Third Circuit stated that it was employing "a two-part analysis."[142] The test it adopted, however, is more accurately described as having three prongs. First, the court must "discern the 'subject matter' of the proposal."[143] Second, the court asks whether the subject matter identified in the first step "relates" to ordinary business operations.[144] Third, assuming a positive answer to the second question, the court must determine if the proposal nevertheless raises "a significant policy issue that transcends the nuts and bolts of the retailer's business."[145] In turn, this third step encompasses two subsidiary inquiries: (1) does the proposal implicate a significant social issue or public policy and (2) does the proposal's subject matter "transcend" the company's ordinary business.[146]

1. Discerning the Subject Matter of the Proposal Under *Trinity*

Although Trinity's proposal made clear its opposition to firearms sales,[147] Trinity claimed it was "not seeking to 'determine what products should or should not be sold by the Company.'"[148] Instead, Trinity asserted that the proposal was really about governance, as well as corporate standards and public safety,[149] arguing that

> 1. [it] addresses corporate governance through Board oversight of important merchandising policies and is substantially removed from particularized decision-making in the ordinary course of business;
> 2. [it] concerns the Company's standards for avoiding community harm while fostering public safety and corporate ethics and does not relate exclusively to any individual product; and
> 3. [it] raises substantial issues of public policy, namely a concern for the safety and welfare of the communities served by the Company's stores.[150]

Ultimately, the district court decided in Trinity's favor, but the court acknowledged that the proposal "could (and almost certainly would) shape

141. *Trinity*, 792 F.3d at 324.
142. *Id.* at 341.
143. *Id.*
144. *Id.*
145. *Id.*
146. *See id.* at 345 ("We think the inquiry [under the third prong] is again best split into two steps.").
147. *See id.* at 330 ("The narrative part of the proposal makes clear it is intended to cover Wal-Mart's sale of certain firearms.").
148. *Id.* at 331.
149. *See id.* at 329 ("Trinity drafted a shareholder proposal aimed at filling the governance gap it perceived.").
150. *Id.* at 331 (alterations in original).

what products are sold by Wal-Mart."[151] Nevertheless, the district court deferred to Trinity's extremely careful wording of the proposal, which requested action by the board—rather than management—and characterized the requested action as a board review of corporate policies rather than a specific decision.[152]

In contrast, the Third Circuit refused to elevate form over substance, holding that the lower court's approach would "allow drafters to evade Rule 14a-8(i)(7)'s reach by styling their proposals as requesting board oversight or review."[153] Instead, the court held substance is to control over form, and "clever drafting" therefore cannot rescue an improper proposal.[154] After separating the substantive wheat from the form chaff, the court must next determine the intended "*ultimate* consequence" of the proposal[155]:

> For us, the subject matter of Trinity's proposal is how Wal-Mart approaches merchandising decisions involving products that (1) especially endanger public-safety and well-being, (2) have the potential to impair the reputation of the Company, and/or (3) would reasonably be considered by many offensive to the family and community values integral to the company's promotion of the brand. A contrary holding—that the proposal's subject matter is "improved corporate governance"—would allow drafters to evade Rule 14a-8(i)(7)'s reach by styling their proposals as requesting board oversight or review. We decline to go in that direction.[156]

In so holding, the court wisely rejected the lower court's ruling[157] that a proposal falls outside the Rule 14a-8(i)(7) exclusion if it merely asks the board to develop a policy or review the application of extant policies to various products.

Unfortunately, the Third Circuit's approach lacks certainty and predictability. In particular, it is not obvious how one determines the "ultimate consequence" of a proposal.[158] As a result, despite the court's repeated condemnation of "clever drafting,"[159] the holding may simply encourage proponents to engage in increasingly clever efforts to obfuscate their intentions, while making it harder for firms to determine ex ante if the proposal will be excludable.[160]

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151. Trinity Wall St. v. Wal-Mart Stores, Inc., 75 F. Supp. 3d 617, 630 (D. Del. 2014), *rev'd*, 792 F.3d 323, *cert. dismissed*, 136 S. Ct. 499.

152. *See Trinity*, 792 F.3d at 331 ("Trinity has carefully drafted its Proposal.").

153. *Id.* at 344.

154. *Id.* at 341.

155. *Id.* at 342.

156. *Id.* at 344 (citation omitted).

157. *See supra* text accompanying note 140 (quoting district court opinion).

158. *Trinity*, 792 F.3d at 342.

159. *Id.* at 341 (emphasis omitted).

160. In evaluating the risk that *Trinity* will fail to end clever drafting from affecting the outcome of a proposal dispute, it seems probative that SEC no-action letters in this area have often reached inconsistent results that depend largely on minor semantic tweaks in the wording of the proposal in question. *See* Choi, *supra* note 46, at 177 ("SEC no-action letter decisions often appear to turn on semantic, not substantive, differences in shareholder proposals.").

2. Is the Identified Subject Matter One of Ordinary Business?

In the second step, the court asks whether the subject matter identified in the first step "relates" to ordinary business operations.[161] As the court read the rule, the word "relates" does considerable work: "In short, so long as the subject matter of the proposal *relates*—that is, bears on—a company's ordinary business operations, the proposal is excludable unless some other exception to the exclusion applies."[162] A proposal related to—or bearing on—the decision of which products the company should sell is thus excludable even if the "proposal doesn't direct management to stop selling a particular product or prescribe a matrix to follow."[163] This step should prevent proponents from evading the ordinary business exclusion by careful wording of the proposal to avoid suggesting specific changes or recommending particular outcomes.[164]

161. *Trinity*, 792 F.3d at 341.

162. *Id.* at 344–45.

163. *Id.* at 344. As the court further explained:

> A retailer's approach to its product offerings is the bread and butter of its business. As *amicus* the National Association of Manufacturers notes, "Product selection is a complicated task influenced by economic trends, data analytics, demographics, customer preferences, supply chain flexibility, shipping costs and lead-times, and a host of other factors best left to companies' management and boards of directors." Though a retailer's merchandising approach is not beyond shareholder comprehension, the particulars of that approach involve operational judgments that are ordinary-course matters.

Id. (citations omitted) (quoting Brief for the National Ass'n of Manufacturers as Amicus Curiae in Support of Appellant at 12, *Trinity*, 792 F.3d 323 (No. 14-4764)); *see also* Brief of Amicus Curiae Retail Litigation Center, Inc. Supporting Appellant and Supporting Reversal at 11, *Trinity*, 792 F.3d 323 (No. 14-4764) ("The understanding of consumer behavior and careful tailoring of product mix is central to the success or failure of a given retailer."). Indeed, even proposals bearing on strategic decisions relating to product line issues—such as a proposal that the company sell all or substantially all of the corporation's assets—likely would be excludable under Rule 14a-8(i)(7). *See, e.g.*, Anchor Bancorp, Inc., SEC No-Action Letter, 2013 WL 3535159, at *1 (July 11, 2013) (issuing a no-action letter where the issuer proposed to exclude a proposal to "maximize shareholder value, including, but not limited to a sale of the Company as a whole, merger or other transaction for all or substantially all of the assets of the Company"); Sears, Roebuck & Co., SEC No-Action Letter, 2000 WL 34223845, at *1 (Feb. 7, 2000) (issuing a no-action letter where the issuer proposed to exclude a proposal asking that the board retain an investment bank to "arrange for the sale of all or parts of the Company" because the proposal related to the company's ordinary business operations); The Reader's Digest Ass'n, Inc., SEC No-Action Letter, 1998 WL 488472, at *1 (Aug. 18, 1998) (issuing a no-action letter where the issuer proposed to exclude a proposal asking that the board retain an investment bank to "evaluate the options for reorganization or divestment of any or all company assets as well as any strategic acquisitions").

164. To be excludable, a proposal "need not dictate any particular outcome." *Trinity*, 792 F.3d at 344. To drive the point home, the *Trinity* Court considered a hypothetical proposal that "merely asked Wal-Mart's Board to *reconsider* whether to continue selling a given product." *Id*. Although a request so phrased "doesn't dictate a particular outcome," the court had "no doubt it would be excludable . . . even though it doesn't suggest any changes." *Id.*

3. Evaluating the Proposal's Social Significance

As noted above,[165] the *Trinity* Court split its third prong into two parts:

> The first is whether the proposal focuses on a significant policy (be it social or, as noted below, corporate). If it doesn't, the proposal fails to fit within the social-policy exception to Rule 14a-8(i)(7)'s exclusion. If it does, we reach the second step and ask whether the significant policy issue transcends the company's ordinary business operations.[166]

The court quickly disposed of the first step—which we might call prong 3.A—noting that "it is hard to counter that Trinity's proposal doesn't touch the bases of what are significant concerns in our society and corporations in that society."[167] Accordingly, the court held that the proposal raised a matter of sufficiently significant social and public policy concern to require that the court move on to the second step, which we might call prong 3.B.[168] Frustratingly, however, the relevant portion of the opinion contains no discussion of the policy issues raised by the proposal, let alone any explanation of why those concerns rose to the requisite level. Although the court criticized the SEC for adopting "what can only be described as a 'we-know-it-when-we-see-it' approach,"[169] the court's approach is no better. Instead, it simply asserted the proposal's social significance by judicial fiat.

The opinion thus provides future courts with no meaningful guidance on a critical but also highly opaque part of the analysis. What metric should courts use to determine a proposal's significance? How does one determine whether the proposal's significance is sufficient? Put another way, assuming the court intended a baseball analogy, how many bases must the proposal touch? The lack of guidance on these issues deprives the *Trinity* decision of much of its potential precedential value.

Turning to prong 3.B, the court's analysis is complex, convoluted, unhelpful, and unpersuasive. First, as Judge Patty Shwartz's concurring opinion cogently argued, the better view is that the social significance test is not a two-part test.[170] Instead, a proposal becomes nonexcludable where its significance transcends the level of an ordinary business matter.[171] Put

165. *See supra* text accompanying note 146 (discussing the third prong's two-step standard).

166. *Trinity*, 792 F.3d at 345.

167. *Id.* at 346.

168. *See id.* (holding that "its proposal raises a matter of sufficiently significant policy").

169. *Id.*

170. *See id.* at 353 (Shwartz, J., concurring) (arguing that "whether a proposal focuses on an issue of social policy that is sufficiently significant is not separate and distinct from whether the proposal transcends a company's ordinary business"). In a staff legal bulletin issued in response to the *Trinity* decision, the SEC's Division of Corporate Finance stated that "the concurring judge analyzed Rule 14a-8(i)(7) in a manner consistent with the approach articulated by the Commission and applied by the Division." SEC Staff Legal Bulletin No. 14H (CF), *supra* note 47, at *5. The staff specifically rejected the majority's holding that "a proposal's focus [is] separate and distinct from whether a proposal transcends a company's ordinary business." *Id.* at *6.

171. *See* SEC Staff Legal Bulletin No. 14(H) (CF), *supra* note 47, at *6 (arguing that "a proposal is sufficiently significant 'because' it transcends day-to-day business matters" (quoting *Trinity*, 792 F.3d at 353 (Shwartz, J., concurring))).

another way, transcendence is the metric—albeit a highly opaque one—by which the significance of the proposal is to be measured.

Second, the court's analysis wholly failed to draw a bright line between which proposals may be excluded and which may not. According to the court, "a shareholder must do more than focus its proposal on a significant policy issue; the subject matter of its proposal must 'transcend' the company's ordinary business."[172] This is so, the court explained, because the "transcendence requirement plays a pivotal role in the social-policy exception calculus. Without it shareholders would be free to submit 'proposals dealing with ordinary business matters yet cabined in social policy concern.'"[173]

Perhaps so, but this is analysis by epithet and reasoning by pejorative, rather than coherent legal argument. "Transcend" is undefined in the opinion.[174] Instead, the court contrasts a proposal that is not excludable because it transcends the company's ordinary business with one that is excludable because it is "enmeshed with the way it runs its business and the retailer-consumer interaction."[175] Unfortunately, the court also failed to define "enmeshed." The mental images invoked by the dictionary definition—"[t]o mesh; to tangle or interweave in such a manner as not to be easily separated, particularly in a mesh or net like manner"—are singularly unhelpful.[176] The same is true of the dictionary definition of transcend, which is "to pass beyond the limits of something."[177]

Instead of stating a rule or defining a standard, the court simply offers up labels with no guidance as to when and how they should be applied in specific future cases. This is problematic because, as scholars have observed of the use of analysis by epithet in the context of contract interpretation, "[a] court's focus on labels rather than on reasoning not only impedes law students' understanding of what the law is and how to answer questions on an exam, but also lawyers' understanding of how to advise clients and how to present arguments to arbitrators and judges."[178]

To be sure, the court offered up several examples of hypothetical proposals that either transcend or are enmeshed with the hypothesized companies' businesses.[179] But these too are unhelpful. For example, the court stated:

172. *Trinity*, 792 F.3d at 346–47.

173. *Id.* at 347 (quoting Apache Corp. v. N.Y.C. Emps. Ret. Sys., 621 F. Supp. 2d 444, 451 n.7 (S.D. Tex. 2008)).

174. A words and phrases search for the term in Westlaw's main case database proved unavailing, as did a search of *Black's Law Dictionary*.

175. *Trinity*, 792 F.3d at 350.

176. *Enmesh*, WIKTIONARY, https://en.wiktionary.org/w/index.php?title=enmesh&oldid=35612368 (last visited Oct. 16, 2016) [https://perma.cc/H9T6-3RDW].

177. *Transcend*, WIKTIONARY, https://en.wiktionary.org/w/index.php?title=transcend&oldid=33848621 (last visited Oct. 16, 2016) [https://perma.cc/SPX8-A9BY].

178. David G. Epstein et al., *Extrinsic Evidence, Parol Evidence, and the Parol Evidence Rule: A Call for Courts to Use the Reasoning of the Restatements Rather Than the Rhetoric of Common Law*, 44 N.M. L. REV. 49, 86 (2014).

179. *See Trinity*, 792 F.3d at 347–50 (offering illustrations of its argument).

> To illustrate the distinction, a proposal that asks a supermarket chain to evaluate its sale of sugary sodas because of the effect on childhood obesity should be excludable because, although the proposal raises a significant social policy issue, the request is too entwined with the fundamentals of the daily activities of a supermarket running its business: deciding which food products will occupy its shelves. So too would a proposal that, out of concern for animal welfare, aims to limit which food items a grocer sells.[180]

The court's example is flawed for a number of reasons. First, the reference to a proposal motivated by concern for animal welfare is inconsistent with the leading precedent of *Lovenheim v. Iroquois Brands, Ltd.*,[181] which held that a proposal asking a food importer to "to study the methods by which its French supplier produces pâté de foie gras," had ethical and social significance.[182] This inconsistency further undermines *Trinity*'s utility as precedent.

Second, consider a variation on the court's main hypothetical in which a similar proposal is submitted to a manufacturer of "sugary sodas." Would such a proposal also be excludable? The court implied that it would not allow the latter proposal to be excluded, observing that "[a] policy matter relating to a product is far more likely to transcend a company's ordinary business operations when the product is that of a manufacturer with a narrow line."[183] But if *selling* sugary sodas is ordinary business, should *not making* them be so as well? Indeed, the case for exclusion would seem stronger as the company's line of business narrows. After all, choosing a company's principal line of business is a core responsibility of the board of directors and not something in which shareholders normally have a voice.[184]

In sum, the Third Circuit reached the right result. It also properly condemned efforts like Trinity's to end-run the ordinary business exclusion

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180. *Id.* at 347.

181. 618 F. Supp. 554 (D.D.C. 1985).

182. *Id.* at 556. Although *Lovenheim* was decided under the exemption for economically insignificant proposals now recognized as Rule 14a-8(i)(5), there is substantial overlap between the standards under that exception and the exclusion for ordinary business matters. *See* 3E HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, *Shareholder Proposals Raising Social, Ethical or Policy Issues—Medical Committee Legacy*, *in* SECURITIES & FEDERAL CORPORATE LAW § 24:86 (2d ed. 2016) ("The Rule 14a-8(i)(5) exclusion for proposals not significantly related to registrant's business and the Rule 14a-8(i)(7) exclusion for proposals relating to 'ordinary business operations' are inextricably bound together . . . .").

183. *Trinity*, 792 F.3d at 349.

184. *See* Troy A. Paredes, *The Firm and the Nature of Control: Toward a Theory of Takeover Law*, 29 J. CORP. L. 103, 162 (2003) (noting that an "ordinary business decision, such as whether or not to build a new factory or enter into a new line of business, . . . falls squarely within the board's control"). Moreover, as the Washington Legal Foundation's amicus brief argued, "proposals concerning a company's assessment of the risks and benefits of aspects of its business operations do not raise significant policy issues . . . but instead delve into the ordinary conduct of business." Brief of Washington Legal Foundation as Amicus Curiae in Support of Defendant-Appellant, Urging Reversal at 7–8, *Trinity*, 792 F.3d 323 (No. 14-4764). This is true even when assessing the risks and benefits of continuing to make a single product.

via clever wording. In getting there, however, the court announced a test that lacks administrability, predictability, and certainty.

III. A BETTER TEST

The *Trinity* Court was aware that a better test is needed:

> Although a core business of courts is to interpret statutes and rules, our job is made difficult where agencies, after notice and comment, have hard-to-define exclusions to their rules and exceptions to those exclusions. For those who labor with the ordinary business exclusion and a social-policy exception that requires not only significance but "transcendence," we empathize. Despite the substantial uptick in proposals attempting to raise social policy issues that bat down the business operations bar, the SEC's last word on the subject came in the 1990s, and we have no hint that any change from it or Congress is forthcoming. . . .
>
> . . . We thus suggest that [the SEC] consider revising its regulation of proxy contests and issue fresh interpretive guidance.[185]

The court's unwillingness to undertake the task of developing a better standard apparently stemmed from its belief that the SEC is entitled to *Chevron* deference in this area.[186] Before setting out an alternative proposal, it is worth briefly addressing the question of whether the SEC is in fact deserving of deference in this area.

A. Chevron

In *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*,[187] the U.S. Supreme Court held that, where congressional intent is unclear, a reviewing court should defer to an agency's interpretation of a statute so long as it constitutes a permissible construction of the statute.[188] In light of the remarkably limited and unhelpful legislative history of section 14(a) of the Securities Exchange Act of 1934,[189] SEC actions in this area would seem plausible candidates for *Chevron* deference. In fact, however, courts have frequently declined to defer to SEC interpretations of Rule 14a-8, especially with respect to the ordinary business exclusion.[190]

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185. *Trinity*, 792 F.3d at 351.

186. *See id.* at 337 n.9 ("Each of the SEC's interpretive releases was adopted after notice and comment and thus merits our deference.").

187. 467 U.S. 837 (1984).

188. *Id.* at 842–43.

189. *See* Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19C-4*, 69 WASH. U. L.Q. 565, 607–08 (1991) ("The legislative history of section 14(a) is relatively sparse, in large part because the controversy over federal proxy regulation was resolved early in the legislative process.").

190. *See* Nagy, *supra* note 89, at 980 (citing opinions in which courts declined to give *Chevron* deference "where the regulatory ambiguity at issue involved SEC Rule 14a-8"); *see also supra* notes 111–15 and accompanying text (noting cases in which courts declined to defer to the SEC on Rule 14a-8 issues).

The basic problem is that the SEC and its staff have consistently failed to apply the ordinary business exclusion consistently.[191] Worse yet, the SEC often has failed to justify its interpretative flip-flops.[192] As the Supreme Court has recognized, albeit in a different context, this sort of unexplained inconsistency renders *Chevron* deference inappropriate.[193]

B. Substance over Form

As with the *Trinity* decision, my proposal is premised on the notion that substance should prevail over form.[194] In particular, I endorse the court's refusal to allow shareholders to evade the ordinary business exclusion by requesting a report on a subject or asking the issuer's board of directors to review the subject.[195] Put another way, the mere fact that a proposal asks the board for a report on, or a review of, some matter should not prevent the proposal from being excluded if the subject matter of the report remains one of ordinary business.[196]

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191. *See* Amalgamated Clothing & Textile Workers Union v. Wal-Mart Stores, Inc., 821 F. Supp. 877, 886 (S.D.N.Y. 1993) (recognizing that the SEC's "treatment of these proposals has changed over time"); *see also* Palmiter, *supra* note 19, at 882 (observing that "the agency's interpretive flip-flops in no-action letters have become legion"); Waite, *supra* note 133, at 1265 ("The SEC and its staff, while attempting to apply the two-part test, has many times reversed its position on a given issue . . . .").

192. *See* Palmiter, *supra* note 19, at 909 ("Why matters once improper for shareholder dialogue became proper overnight, or once proper became improper, the SEC and its staff have failed to explain."); Waite, *supra* note 133, at 1265 (noting that the SEC has often switched positions "without giving any strong support for its choice to do so").

193. *See* Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs., 545 U.S. 967, 981 (2005) (holding that an "unexplained inconsistency is . . . a reason for holding an interpretation to be an arbitrary and capricious change from agency practice"). Although the issue is beyond the scope of this Article, I also note in passing that the Supreme Court appears to be gradually abandoning—or at least undermining—*Chevron*. *See, e.g.*, Michael Herz, Chevron *Is Dead; Long Live* Chevron, 115 COLUM. L. REV. 1867, 1868 (2015) (observing that "reports of *Chevron*'s death seemed to get significant confirmation at the end of the Supreme Court's 2014–2015 Term, when the Court decided three important cases that suggested that *Chevron*'s condition was, if not terminal, at least serious"); Caroline E. Keen, *Clarifying What Is "Clear": Reconsidering Whistleblower Protections Under Dodd-Frank*, 19 N.C. BANKING INST. 215, 230 (2015) ("An emerging trend in regulatory interpretation involves the courts willingness to abandon the key principles of *Chevron*, thereby shifting the focus from a search for congressional intent to one of textual clarity.").

194. *See supra* text accompanying note 154 (noting the *Trinity* Court's discussion of the substance versus form issue).

195. *See* Trinity Wall St. v. Wal-Mart Stores, Inc., 792 F.3d 323, 342 (3d Cir.) (noting that "under Trinity's position, the subject matter of a proposal that calls for a report on how a restaurant chain's menu promotes sound dietary habits would be corporate governance as opposed to important matters involving the promotion of public health"), *cert. dismissed*, 136 S. Ct. 499 (2015).

196. As the D.C. Circuit has observed:

> For a time, the Commission staff "ha[d] taken the position that proposals requesting issuers to prepare reports on specific aspects of their business or to form [study committees] would not be excludable under Rule 14a-8(c)(7)." The Commission has changed that position. Pointing out that the staff's interpretation "raise[d] form over substance," the Commission instructed the staff to "consider whether the subject matter of the [requested] report or [study] committee involves a matter of ordinary business: where it does, the proposal [is] excludable under Rule 14a-8(c)(7)."

To be sure, although allowing exclusion of proposals requesting a review or report captures much of the low hanging fruit, in some cases the task of discerning the proposal's true goals will introduce an element of uncertainty to the administration of the exclusion.[197] Yet, doing so is critical if the exclusion is to have real teeth. Otherwise, proponents could avoid it simply by clever drafting. Courts therefore must look beyond the wording of the proposal—and, in appropriate cases, the four corners thereof—to determine whether the intent of the proposal is to affect the way in which the company conducts matters of ordinary business.

C. Modifying the Social and Policy Significance Carve Out

The exemption for matters of social and ethical significance from the exclusionary provisions of Rules 14a-8(i)(5) and 14a-8(i)(7) has long been controversial. For one thing, "shareholders' social policy proposals [occasionally] require a company to include speech in its proxy statements that appears directly adverse to the company's interests."[198] Setting aside the issue of whether it is sound securities regulation policy to require a corporation to include statements adverse to its interests in its disclosure documents, forcing the corporation to do so implicates the First Amendment rights of both the corporation and its shareholders.[199] In effect, the Rule forces shareholders to subsidize speech that may reduce the value of their investments.[200] This remains true despite the shift toward hedge fund activism, as I have observed elsewhere:

> [W]hile there is considerable evidence for the proposition that activist shareholders can profit through private rent-seeking, there is little evidence that activism has benefits for investors as a class. Navigant Consulting recently undertook a review of the most basic form of shareholder activism—Rule 14a-8 proposals—and found no evidence that

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> We need not linger over the report issue. The staff's no-action letters in this respect are unremarkable and entirely in keeping with current practice.

Roosevelt v. E.I. du Pont de Nemours & Co., 958 F.2d 416, 428 (D.C. Cir. 1992) (alterations in original) (citations omitted) (quoting Amendments to Rule 14a-8 Under the Securities Exchange Act of 1934 Relating to Proposals by Security Holders, Exchange Act Release No. 20,091, 48 Fed. Reg. 38,218, 38,221 (Aug. 23, 1983)).

197. *See supra* note 160 and accompanying text (discussing the lack of guidance on this point provided by the opinion).

198. Antony Page, *Taking Stock of the First Amendment's Application to Securities Regulation*, 58 S.C. L. REV. 789, 804 (2007).

199. *Cf.* Lucian A. Bebchuk & Robert J. Jackson, Jr., *Corporate Political Speech: Who Decides?*, 124 HARV. L. REV. 83, 113 (2010) (arguing that shareholders have a "First Amendment interest in not being forced to be associated with political speech that they do not support").

200. *See* Patrick J. Ryan, *Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy*, 23 GA. L. REV. 97, 121 (1988) (observing that "corporate assets are being spent to subsidize corporate internal debate on proposals that never will be adopted").

> it resulted in either short or long-term increases in market value. This was true of both social and governance proposals.[201]

Courts therefore should ask whether a reasonable shareholder of an issuer would regard a proposal as having material economic importance for the value of his shares. This standard is based on the well-established securities law principle of materiality.[202] It is intended to exclude proposals made primarily for the purpose of promoting general social and political causes, while requiring inclusion of proposals a reasonable investor would believe are relevant to the value of his investment. Such a test seems desirable to ensure that an adopted proposal redounds to the benefit of all shareholders, not just those who share the political and social views of the proponent. Absent such a standard, as we have seen, the Shareholder Proposal Rule becomes nothing less than a species of private eminent domain by which the federal government allows a small minority to appropriate someone else's property. The company is a legal person,[203] after all, and it is the company's proxy statement at issue, which the minority is attempting to use as a soapbox to disseminate its views. Because the shareholders hold the residual claim,[204] and all corporate expenditures thus come out of their pocket, it is not entirely clear why other shareholders should have to subsidize speech by a small minority.[205]

D. Two-Prong Proposal

Both the SEC and the courts have rarely looked to state law to determine what constitutes ordinary business, instead developing what amounts to a federal common law standard.[206] By failing to do so, however, they have fundamentally departed from the basic principles that animate Rule 14a-8. As adopted, Rule 14a-8 was not intended to create any new substantive rights, but only to make effective a right to ballot access that the SEC believed existed under state law.[207] This is equally true of the ordinary

201. STEPHEN M. BAINBRIDGE, CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS 252 (2012).

202. *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) ("An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.").

203. *See* Metro. Life Ins. v. Ward, 470 U.S. 869, 881 n.9 (1985) ("It is well established that a corporation is a 'person' within the meaning of the Fourteenth Amendment.").

204. *See* Ashby, *supra* note 59, at 535 (observing that "shareholders own the residual claim to the company's earnings and assets").

205. *See* Palmiter, *supra* note 19, at 886 ("By shifting the proposing shareholder's solicitation costs to the company, the rule compels the body of shareholders to subsidize self-appointed corporate reformers.").

206. *See* Brown, *supra* note 46, at 510 ("Disconnected from state law and devoid of any real standards, application of the 'ordinary business' exclusion developed in an ad hoc and inconsistent fashion that could result in tenuous determinations."); Uhlenbrock, *supra* note 45, at 307 (positing that "the SEC will continue to formulate its 'common law' definition of the scope of the ordinary business operations exception through no-action letters").

207. *See* Fisch, *supra* note 13, at 1144 (explaining that "state law rather than the federal proxy rules was to define the substantive relationship between shareholder and management in governing the corporation"); Milton V. Freeman, *An Estimate of the Practical*

business exclusion itself, which follows directly from the limits on shareholder power imposed by state law.[208]

Drawing on state law to determine what constitutes ordinary business for purposes of Rule 14a-8 is consistent with—if not mandated by—the line between federal and state law drawn by *Business Roundtable v. SEC*,[209] the leading case on federalism in corporate law.[210] In that case, the D.C. Circuit drew a distinction between full disclosure and fair solicitation procedures, and substantive shareholder rights.[211] Because the SEC rule in question in that case "directly interfere[d] with the substance of what the shareholders may enact," the D.C. Circuit held the rule was invalid as beyond the SEC's authority to adopt.[212]

As I have recognized elsewhere, Rule 14a-8 in general is likely a valid exercise of SEC authority, because "absent the rule, shareholders have no practical means of holding management accountable through the voting process or even affecting the agenda. As such, it too may be supportable 'as a control over management's power to set the voting agenda.'"[213] The ordinary business exclusion, however, goes neither to substance or procedure. Instead, it speaks to "the distribution of powers among the various players in the process of corporate governance," which *Business Roundtable* teaches is properly the subject of state rather than federal law.[214] Accordingly, the validity of subsection 14a-8(i)(7) depends on using state law to define the meaning and scope of ordinary business.

State law provides two standards by which to determine which proposals impinge on ordinary business matters. First, state law draws a distinction

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Consequences of the Stockholder's Proposal Rule, 34 U. DET. L.J. 549, 549 (1957) (stating that the rule "is merely a recognition of rights granted by state law").

208. *See* Amalgamated Clothing & Textile Workers Union v. Wal-Mart Stores, Inc., 821 F. Supp. 877, 882–83 (S.D.N.Y. 1993) ("A shareholder proposal pertaining to 'ordinary business operations' would be improper if raised at an annual meeting, because the law of most states (including Delaware) leaves the conduct of ordinary business operations to corporate directors and officers rather than the shareholders.").

209. 905 F.2d 406 (D.C. Cir. 1990).

210. *See, e.g.*, Philip C. Berg, *The Limits of SEC Authority Under Section 14(a) of the Exchange Act: Where Federal Disclosure Ends and State Corporate Governance Begins*, 17 J. CORP. L. 311, 329 (1992) ("Until *Business Roundtable* . . . it had remained unclear whether this federalism had any teeth. The D.C. Circuit makes clear that it does, and that the SEC's statutory mandate does not allow it to regulate corporate governance absent specific authorization from Congress to that effect."); Roberta S. Karmel, *The Securities and Exchange Commission Goes Abroad to Regulate Corporate Governance*, 33 STETSON L. REV. 849, 852 (2004).

> In another important precedent concerning the SEC's power to regulate corporate governance, the United States Court of Appeals for the District of Columbia, in *Business Roundtable v. SEC*, invalidated a voting-rights rule adopted by the SEC on the ground that 'the rule directly [controlled] the substantive allocation of powers among classes of shareholders,' and therefore, 'it [was] in excess of the [SEC's] authority under [Section] 19 of the [Exchange Act].

Id. at 852 (alterations in original).

211. *See Business Roundtable*, 905 F.2d at 411 (describing the "murky area between substance and procedure").

212. *Id.*

213. Bainbridge, *supra* note 189, at 622.

214. *Business Roundtable*, 905 F.2d at 412.

between those matters that are the proper subject of shareholder amendments to the corporation's bylaws and those that are beyond the shareholders' power to adopt. As an important doctrinal line of separation between what is in the power of the board of directors and that of the shareholders, this body of law is relevant by way of analogy. In addition, however, shareholder proposals under Rule 14a-8 increasingly take the form of proposed amendments to the bylaws. As such, this body of law is directly relevant to the problem at hand. Second, state law draws a distinction between ordinary and extraordinary actions for purposes of determining what actions must be taken by the board of directors rather than corporate managers. While not precisely on point, this distinction provides a logical analogy for this purpose.

1. The Bylaw Analogy

In *CA, Inc. v. AFSCME Employees Pension Plan*,[215] AFSCME's pension plan put forward a shareholder proposal to amend CA's bylaws to provide that the corporation would be obliged to reimburse the reasonable expenses of a shareholder who successfully conducted a short slate proxy contest.[216] CA notified the SEC of its intention to omit the proposal from its proxy statement and requested an SEC no-action letter supporting exclusion.[217]

In response, the SEC invoked a unique Delaware constitutional provision that authorizes the SEC to certify questions of law to the Delaware Supreme Court.[218] The SEC certified two questions: (1) was AFSCME's proposal a proper subject for shareholder action under Delaware law and (2) would the proposal, if adopted, cause CA to violate any Delaware law?[219]

In answering the first of those questions, the court stated it was unable to draw a bright line of general applicability between permissible and impermissible bylaws.[220] In analyzing the specific bylaw in question, however, the court stressed the broad statutory grant of managerial power to the board of directors and the absence of any such power on the part of shareholders:

> *8 Del. C.* § 141(a) . . . pertinently provides that:

215. 953 A.2d 227 (Del. 2008).

216. *See id.* at 229–30 (setting out the text of the proposal).

217. *See id.* at 230.

218. *See id.* at 229 ("This proceeding arises from a certification by the United States Securities and Exchange Commission (the 'SEC'), to this Court, of two questions of law pursuant to Article IV, Section 11(8) of the Delaware Constitution and Supreme Court Rule 41." (footnote omitted)); *see also* Junis L. Baldon, *Taking a Backseat: How Delaware Can Alter the Role of the SEC in Evaluating Shareholder Proposals*, 4 ENTREPRENEURIAL BUS. L.J. 101 (2009) (discussing the Delaware provision allowing certification by the SEC of questions to the Delaware Supreme Court).

219. *See CA, Inc.*, 953 A.2d at 231 (setting out the text of the certified questions).

220. *See id.* at 234 (stating that Delaware precedents did not permit the court to "articulate with doctrinal exactitude a bright-line that divides those bylaws that shareholders may unilaterally adopt under Section 109(b) from those which they may not under Section 141(a)").

> The 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.
>
> No such broad management power is statutorily allocated to the shareholders. Indeed, it is well-established that stockholders of a corporation subject to the DGCL may not directly manage the business and affairs of the corporation, at least without specific authorization in either the statute or the certificate of incorporation.[221]

Accordingly, the court limited shareholder power over bylaws by holding that the "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."[222]

As I have noted elsewhere:

> This distinction between substance (disallowed) and process (allowed) captures an appropriate balance between authority and accountability. If shareholder interventions directed at substantive decisions can be discouraged, the board's decision-making authority is respected. Indeed, if it is the case—as seems likely—that private rent seeking most often will take the form of substantive interventions, discouraging that category of interventions provides a useful prophylactic solution to the rent-seeking problem. Conversely, process and procedural interventions do not deprive the board of its authority but rather can be used to ensure that that authority is used accountably.[223]

Incorporating the state test for valid bylaws into the ordinary business exclusion thus advances a core policy goal of drawing the appropriate balance between shareholder and director power. In addition, by incorporating the state standard, federal courts would also limit the ability of shareholders to end-run the other restrictions on micromanagement by using shareholder proposals to advance amendments to the bylaws. Only bylaws valid under state law would be exempt from exclusion as ordinary business matters, thereby reinforcing the ability of Rule 14a-8(i)(1) to keep such bylaw amendments off the proxy statement. Finally, the substance/procedure dichotomy echoes the *Business Roundtable* holding that the substance of shareholder rights is left to state law and the procedures by which they vote is determined by federal law.

2. The Ordinary Versus Extraordinary Matter Analogy

The disconnect between the current judicial definition of ordinary business under Rule 14a-8(i)(7) and state law is sometimes justified on grounds that state law fails to define the term.[224] Yet, in fact, there is a

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221. *Id.* at 232 (footnotes omitted).
222. *Id.* at 234–35.
223. Bainbridge, *supra* note 97, at 245.
224. *See, e.g.*, 1982 Proposing Release, *supra* note 102, at 47,429 ("State law precedent . . . is rarely conclusive as to what is or is not ordinary business, and the staff

well-established body of state law precedents that offer guidance on which the SEC and courts easily could rely. Specifically, I propose that the Rule 14a-8(i)(7) definition of ordinary business incorporate the extensive body of state law dealing with the distinction between ordinary and extraordinary actions for purposes of determining the scope of the apparent authority of corporate officers.

As agents of the corporation, senior managers have broad authority—both actual and apparent—to act on behalf of the corporation.[225] A well-established line of cases, however, limits the implied and apparent authority of corporate officers to matters arising in the ordinary course of business. In the leading decision of *Lee v. Jenkins Bros.*,[226] the Second Circuit held "that the president [of a corporation] only has authority to bind his company by acts arising in the usual and regular course of business but not for contracts of an 'extraordinary' nature."[227]

In general, acts consigned by statute to the board of directors will be deemed extraordinary.[228] Likewise, acts that boards as a whole may not delegate to board committees "would normally not be within the authority of the president or other senior executives."[229] So are acts that would require shareholder approval.[230] In addition, many specific actions that by statute require neither board nor shareholder action have been identified as extraordinary.[231] Conversely, there is a substantial number of precedents

generally has had to make its own determination as to whether a proposal involves an activity relating to the issuer's ordinary business.").

225. *See* RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. c (AM. LAW INST. 2006) ("The elements of common-law agency are present in the relationships between . . . corporation and officer . . . .").

226. 268 F.2d 357 (2d Cir. 1959).

227. *Id.* at 365; *see also In re* Mulco Prods., Inc., 123 A.2d 95, 104 (Del. Super. Ct. 1956) (stating that "it is held generally that the General Manager of a corporation entrusted with the entire management and control of its business has implied power to borrow money for the legitimate purpose of the corporation in its current and usual business"); RESTATEMENT (THIRD) OF AGENCY § 3.03 cmt. e(3) ("The apparent authority of a president or chief executive officer encompasses transactions falling within the ordinary course of the corporation's business.").

228. *See, e.g.*, Plant v. White River Lumber Co., 76 F.2d 155 (8th Cir. 1935) (deeming the sale of all or substantially all corporate assets extraordinary).

229. AM. LAW INST., PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3.01 (1994).

230. *See* RESTATEMENT (THIRD) OF AGENCY § 3.03 cmt. e(3).

231. *See, e.g.*, *In re* Lee Ready Mix & Supply Co., 437 F.2d 497 (6th Cir. 1971) (mortgaging assets); Maple Island Farm, Inc. v. Bitterling, 209 F.2d 867 (8th Cir. 1954) (lifetime employment contract); Abraham Lincoln Life Ins. v. Hopwood, 81 F.2d 284 (6th Cir. 1936) (contract to effectuate a merger); Comput. Maint. Corp. v. Tilley, 322 S.E.2d 533 (Ga. Ct. App. 1984) (shareholder buy-sell agreement); First Nat'l Bank v. Cement Prods. Co., 227 N.W. 908 (Iowa 1929) (guaranteeing debt of another firm); Ney v. E. Iowa Tel. Co., 144 N.W. 383 (Iowa 1913) (initiating a lawsuit against the corporation's largest shareholder); Chesapeake & Potomac Tel. Co. v. Murray, 84 A.2d 870 (Md. 1951) (lifetime employment contract); Burlington Indus., Inc. v. Foil, 202 S.E.2d 591 (N.C. 1974) (guaranteeing another firm's debts); Daniel Webster Council, Inc. v. St. James Ass'n, 533 A.2d 329 (N.H. 1987) (land sales contract); Myrtle Ave. Corp. v. Mt. Prospect Bldg. & Loan Ass'n, 169 A. 707 (N.J. 1934) (postponing mortgage foreclosure); Brown v. Grayson Enters., Inc., 401 S.W.2d 653 (Tex. Civ. App. 1966) (making a lifetime employment

deeming specific actions to be within the ordinary business of the corporation.[232] Taken together, these lines of cases provide a database on which Rule 14a-8(i)(7) issues could be resolved.

In addition, state law provides guidance for resolving issues as to which there is no binding precedent:

> [A]mong the elements to be taken into account for purposes of determining what constitutes an "extraordinary" action, which would normally be outside the apparent authority of senior executives, are the economic magnitude of the action in relation to corporate assets and earnings, the extent of risk involved, the time span of the action's effect, and the cost of reversing the action. Examples of the kinds of actions that would normally be "extraordinary" include the creation or retirement of long-term or other significant debt, the reacquisition of significant amounts of equity, significant capital investments, business combinations including those effected for cash, the disposition of significant businesses, entry into important new lines of business, significant acquisitions of stock in other corporations, and actions that would foreseeably expose the corporation to significant litigation or significant new regulatory problems. A useful generalization is that decisions that would make a significant change in the structure of the business enterprise, or the structure of control over the enterprise, are extraordinary corporate actions, and therefore are normally outside the apparent authority of senior executives.[233]

Admittedly, I am proposing a standard rather than a bright-line rule, so the SEC staff still would be required to make determinations in specific cases. Moreover, there is an unfortunate degree of inconsistency from state to state as to which actions are deemed extraordinary and which are deemed ordinary. States are divided, for example, as to whether such basic matters as filing a lawsuit[234] or executing a guarantee of another corporation's debts are ordinary or extraordinary.[235]

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contract); Lloydona Peters Enters., Inc. v. Dorius, 658 P.2d 1209 (Utah 1983) (initiating litigation).

232. *See, e.g.*, *Lee*, 268 F.2d 357 (hiring or firing employees and fixing their compensation and benefits); United Producers and Consumers Coop. v. Held, 225 F.2d 615 (9th Cir. 1955) (discussing the same); Custer Channel Wing Corp. v. Frazer, 181 F. Supp. 197 (S.D.N.Y. 1959) (initiating a lawsuit); Mem'l Hosp. Ass'n of Stanislaus Cty. v. Pac. Grape Prods. Co., 290 P.2d 481 (Cal. 1955) (making a charitable pledge); *In re Mulco Prod., Inc.*, 123 A.2d 95 (executing a promissory note); Quigley v. W.N. MacQueen & Co., 321 Ill. 124 (1926) (corporation would repurchase stock from shareholder at latter's option); Sperti Prods., Inc. v. Container Corp. of Am., 481 S.W.2d 43 (Ky. Ct. App. 1972) (executing a guarantee of another firm's debts); Emperee v. Meyers, 269 A.2d 731 (Pa. 1970) (executing a note for benefit of prospective employee).

233. AM. LAW. INST., *supra* note 229, § 3.01 reporter's note.

234. *Compare Custer*, 181 F. Supp. 197 (holding that the corporation's president had authority to do so), *with Lloydona*, 658 P.2d 1209 (holding that the corporation's president had no authority to do so).

235. *Compare Sperti Prods.*, 481 S.W.2d 43 (holding that the corporation's president had authority to do so), *with First Nat'l Bank*, 227 N.W. 908 (holding that the corporation's president had no authority to do so).

Yet, as we have seen,[236] the SEC staff in some cases already must make what it calls "reasoned distinctions" that even the SEC admits are "somewhat tenuous."[237] Unlike my proposal, moreover, the staff currently makes those distinctions in an inconsistent manner that is divorced from the state law principles that are supposed to undergird the shareholder proposal regime.[238] My proposal provides both specific precedents and a state-law-based standard for resolving cases where there are no binding state law precedents.

As for the problem of state-to-state inconsistency, there is a solution at hand; namely, the internal affairs doctrine, which "is a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation's internal affairs—matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders."[239] Accordingly, when presented with a no-action letter relying on Rule 14a-8(i)(7), the SEC staff should simply look to the law of the state of incorporation. The SEC staff's interpretative burden is further alleviated because over half of all public corporations are incorporated in Delaware.[240] Delaware law permits the SEC to certify questions of law to the Delaware Supreme Court for determination.[241] Finally, express adoption of this standard by the SEC might encourage states to develop a more consistent application of the ordinary business question.

To be sure, my proposal is similar to one previously rejected by the SEC. As the *Trinity* court observed, "the SEC in its 1976 Adopting Release rejected the proposed bright line whereby shareholder proposals involving 'matters that would be handled by management personnel without referral to the board . . . generally would be excludable,' but those involving 'matters that would require action by the board would not be.'"[242] As we have seen, however, the SEC's rejection of such a proposal should not receive *Chevron* deference.[243] In addition, the SEC rejected the 1976 proposal on grounds that it was administratively infeasible because state law purportedly does not provide adequate guidance as to which matters are limited to the board.[244] As discussed above, however, I believe state law in fact does provide relevant guidance.

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236. *See supra* notes 206–08 and accompanying text (discussing the SEC staff's development of a federal common law definition of ordinary business).

237. *See* Trinity Wall St. v. Wal-Mart Stores, Inc., 792 F.3d 323, 340 (3d Cir.) (quoting 1998 Adopting Release, *supra* note 116), *cert. dismissed*, 136 S. Ct. 499 (2015).

238. *See supra* notes 46, 206–08 and accompanying text (discussing the staff's inconsistency in applying the ordinary business exclusion and the staff's failure to rely on state law, respectively).

239. Edgar v. MITE Corp., 457 U.S. 624, 645 (1982).

240. *See* Omari Scott Simmons, *Delaware's Global Threat*, 41 J. CORP. L. 217, 264 (2015).

241. *See* CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 229 n.1 (Del. 2008).

242. *Trinity*, 792 F.3d at 342.

243. *See supra* Part III.A (discussing application of *Chevron* to SEC actions in this context).

244. *See* Waite, *supra* note 133, at 1263 (discussing the 1976 proposal).

3. Application

State law provides workable standards by which to determine what constitutes ordinary business matters for purposes of Rule 14a-8(i)(7). Either standard, standing alone, would be a significant improvement on current law in terms of fidelity to core federalism principles and administrability. In my view, however, the two standards would work well in concert. Courts should determine whether a proposal goes to substance or procedure, because that distinction goes to the core division between the powers of the board and those of the shareholders. This is not enough, however, because proposals cast as procedural initiatives could still impinge on how decisions relating to ordinary substantive matters are made. Accordingly, courts should also assess whether the subject matter of the proposal falls within the relevant state law definition of an ordinary business matter.

CONCLUSION

In *Trinity*, the Third Circuit reached the right result. It also properly condemned efforts like Trinity's to end-run the ordinary business exclusion via clever wording. In getting there, however, the court announced a test that lacks administrability, predictability, and certainty. The court's test is further problematic because it is inconsistent with the relevant federalism principles that allocate authority to the states over the substance of what shareholders may decide. In contrast, my proposal is squarely rooted in the relevant principles of state corporate law, while providing a test that—albeit still consisting of standards rather than a bright-line rule—provides greater certainty and administrability.