

2010

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Recommended Citation

Matthew T. Bodie, *The Case for Employee Referenda on Transformative Transactions As Shareholder Proposals*, 87 WASH. U. L. REV. 897 (2010).

Available at: http://openscholarship.wustl.edu/law_lawreview/vol87/iss4/6

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THE CASE FOR EMPLOYEE REFERENDA ON TRANSFORMATIVE TRANSACTIONS AS SHAREHOLDER PROPOSALS

MATTHEW T. BODIE*

In an earlier article in the *Washington University Law Review*,¹ I made the case for a unique addition to the corporate law framework. I proposed that employees at a company involved in a corporate combination, such as a merger or sale of substantially all assets, would be entitled to vote in a nonbinding referendum about the transaction whenever shareholders were also voting. The structure was fairly straightforward. The employees—defined by tax law or some other bright-line test—would vote up or down on the proposed merger in a firm-wide election. The corporation would conduct the balloting after the combination’s announcement but before the shareholders’ vote, and the company would be required to inform shareholders of the election results. Since the vote would have no binding effect on the combination or the company, its primary purpose would be to provide information about the employees’ views on the proposed transaction.

The original article proposed that the referendum would be most appropriately situated as part of the state corporate law firmament.² Although Congress could implement the proposal, states made more sense.³ State law controls not only the basic structure of the corporation, but also the approval process for mergers and other transformative transactions. Moreover, many prominent corporate law theorists have celebrated the competition between states to achieve the “best” corporate law.⁴ If implemented through state law, the referenda could be treated as experiments and tinkered with over time to achieve the most efficient design.⁵

* Associate Professor, Saint Louis University School of Law. I am deeply indebted to Lyman Johnson for the idea behind this Comment.

1. Matthew T. Bodie, *Workers, Information, and Corporate Combinations: The Case for Nonbinding Employee Referenda for Transformative Transactions*, 85 WASH. U. L. REV. 871 (2007).

2. *Id.* at 926.

3. *See id.* Some commentators on the piece raised concerns that the National Labor Relations Act might preempt the referenda if they became part of state law. However, given the traditional deference given to state corporate law, as well as the referenda’s noninterference with collective rights, I argued that preemption would be unlikely. *See id.* at 926 n.282.

4. *See, e.g.*, ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 5 (1993).

5. Bodie, *supra* note 1, at 926 (“States could implement the referenda in a variety of ways and determine, by looking at others, which practices work best.”).

As it turns out, however, I neglected to suggest a third possibility for the implementation of these nonbinding employee referenda—namely, shareholder proposals.⁶ These proposals, which are made through SEC Rule 14a-8,⁷ have become an increasingly important part of the corporate governance landscape. Under Rule 14a-8, shareholders can use the company's proxy materials to propose a "recommendation or requirement that the company and/or its board of directors take action."⁸ Any shareholder who meets the holding requirements⁹ can submit a proposal of no more than 500 words to be included on the annual proxy materials. A "yes" or "no" vote on the proposal is then included on the proxy ballot. Because the company pays for and distributes the proxy materials, Rule 14a-8 makes it much easier for shareholders to raise governance issues. Without that process, shareholders would be left to distribute the proxy materials on their own dime.¹⁰

Although shareholder proposals often concern broader social issues, they have increasingly been used to promote corporate governance reforms. Many of these proposals endeavor, in a variety of ways, to restrict the board's ability to mount takeover defenses against hostile bidders.¹¹ Other proposals seek to make it easier for non-incumbents to run for seats on the board by providing either access to the corporate proxy¹² or reimbursement of proxy expenses.¹³ Yet another set of corporate governance proposals seeks to facilitate direct shareholder participation by making it easier to amend bylaws or to submit additional proposals down the road.¹⁴ Rule 14a-8 proposals have become the new front in the battle between corporate boards and shareholder activists.¹⁵

6. I am much obliged to Lyman Johnson for this idea.

7. Securities Exchange Act of 1934, 17 C.F.R. § 240.14a-8 (2009).

8. 17 C.F.R. § 240.14a-8(a).

9. See 17 C.F.R. § 240.14a-8(b)(1) (requiring inter alia that the shareholder have continuously held at least \$2000 in market value or 1% of the company's securities for at least one year).

10. See D. GORDON SMITH & CYNTHIA A. WILLIAMS, BUSINESS ORGANIZATIONS: CASES, PROBLEMS, AND CASE STUDIES 473 (2d ed. 2008) ("As a practical matter, therefore, proposals that are not embraced by incumbent managers must pass through Rule 14a-8 to have any chance of success.").

11. See, e.g., *Bebchuk v. CA, Inc.*, 902 A.2d 737 (Del. Ch. 2006) (case regarding proposed bylaw limiting the authority of a board of directors to enact a stockholder rights plan of unlimited duration).

12. See, e.g., *Am. Fed'n of State, County & Mun. Employees v. Am. Int'l Group, Inc.*, 462 F.3d 121 (2d Cir. 2006).

13. See, e.g., *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008).

14. See, e.g., *Bebchuk v. Elec. Arts Inc.*, No. 08-cv-3716 (S.D.N.Y. Nov. 13, 2008).

15. For discussions of the role of Professor Lucian Bebchuk in many of these proposal battles, see *The Bebchuk Bylaw*, M&A J., Vol. 6, No. 10, 2006, 1; Lucian Bebchuk, *Key Ways to Reform Corporate Elections*, WALL ST. J., May 27, 2009, available at <http://online.wsj.com/article/SB124337825782056121.html>.

Many of these proposals have failed to ever reach a proxy ballot, however, because companies have legally excluded them. Rule 14a-8 provides thirteen substantive reasons for excluding proposals from the ballot.¹⁶ A board may exclude the proposal based on one of these reasons after informing the proposing shareholder and providing its justification to the SEC.¹⁷ The SEC then provides an action letter on the company's decision, either agreeing that it will take no action against the exclusion or refusing to so agree. If the shareholder disagrees with the company's exclusion, the shareholder can bring suit against the company to require that it be included.¹⁸

The nonbinding employee referendum would be an ideal candidate for a shareholder proposal.¹⁹ The referendum is useful as a check against CEO and board overreaching in the context of transformative transactions.²⁰ The CEO and other top officers are generally responsible for negotiations regarding such transactions. Once negotiations are complete, management then must sell the idea to the board. After the board announces the combination, it believes in the merger and is primarily interested in selling it to shareholders. Employees, however, may disagree with the board's decision. An employee "no" vote may provide shareholders with a reason to go beyond the board's optimism to a more realistic assessment.²¹ However, it is important to keep in mind that the referendum vote would have no binding effect. It would simply allow employees to communicate with both the board and the shareholders about their perspectives on this significant event in the corporation's life. This information would come at a relatively low price, as an employee poll could be conducted at a manageable cost.²²

A shareholder interested in implementing the referendum could frame the proposal either as a recommendation to the board of directors or as a change to the bylaws. Framed in a precatory fashion, the "softer" version of the proposal would almost certainly meet the requirements of Rule 14a-8, as it would only require the board to investigate the pros and cons of the

16. 17 C.F.R. § 240.14a-8(i)(1)–(13) (2009).

17. *Id.* § 240.14a-8(j).

18. *Roosevelt v. E.I. Du Pont de Nemours & Co.*, 958 F.2d 416, 425 (D.C. Cir. 1992).

19. Of course, if management were willing, the referendum could simply be instituted by the company itself.

20. Bodie, *supra* note 1, at 883–913.

21. In the article, I discuss three types of reasons why employees might vote against a proposed combination: business-judgment concerns, employee-related concerns, and managerial-opportunism concerns. *Id.* at 902–13.

22. *Id.* at 925.

referendum.²³ The more complicated question—and the one to which I turn for the rest of this Comment—is whether the referendum could be proposed directly as a bylaw.

In the Appendix, I have drafted a shareholder proposal that would implement the referendum as an amendment to the company's bylaws (hereinafter the "referendum-bylaw proposal"). A Rule 14a-8 proposal can amend a corporation's bylaws directly. Section 109 of the Delaware General Corporation Law (DGCL) states that "the power to adopt, amend or repeal bylaws shall be in the stockholders entitled to vote."²⁴ However, the board may exclude a proposal under any of the thirteen substantive exclusions listed in the rule. The two pertaining most directly to the referendum-bylaw proposal would be the "improper under state law" and "violation of the law" exclusions.²⁵

Companies may object to the referendum-bylaw proposal on the grounds that the referendum is an improper subject for a bylaw. The language of § 109(b) would appear to allow almost any bylaw, as it states: "[t]he bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees."²⁶ However, the language of § 109(b) can be read to conflict with the requirements of

23. In discussing the grounds for excluding shareholder proposals, Rule 14a-8 states that "we will assume that a proposal drafted as a recommendation or suggestion is proper unless the company demonstrates otherwise." 17 C.F.R. § 240.14a-8(i)(1) (2009). However, such precatory proposals have been criticized as "generally only a weak tool" with a "shadowy presence in state law." Brett H. McDonnell, *Shareholder Bylaws, Shareholder Nominations, and Poison Pills*, 3 BERKELEY BUS. L.J. 205, 254 (2005).

24. DEL. CODE ANN. tit. 8, § 109(a) (2009). I have chosen Delaware law because that state has the lion's share of publicly traded companies, as well as a robust public discussion of the propriety of bylaw amendments through shareholder proposals.

25. Although these two exclusions appear similar in their wording, the Delaware Supreme Court treated them as separate inquiries in *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008). The court considered whether the proposal was improper by examining whether the shareholders had the power to implement the proposal under state law. *Id.* at 231–38. It then considered whether there were any potential circumstances under which the proposal could lead the directors to violate their fiduciary duties under its "violation of state law" inquiry. *Id.* at 238–40.

As for the other eleven grounds for exclusion, the "management functions" exclusion in Rule 14a-8(i)(7) would not apply, as the referendum relates to the procedures regarding transformative transactions, not "ordinary business operations." The proposal does not "relate[] to an election" because that exclusion only concerns "election[s] for membership on the company's board of directors or analogous governing body." 17 C.F.R. § 240.14a-8(i)(8) (2009). The referendum does not provide a special benefit or further a personal interest, which are grounds for exclusion under Rule 14a-8(i)(4), and the proposal is "significantly related to the company's business" and therefore a relevant concern according to Rule 14a-8(i)(5).

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

§ 141(a), which states: “[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.”²⁷ Delaware has interpreted § 141(a) to limit the scope of § 109(b).²⁸ Thus, a bylaw cannot intrude too far into the board’s managerial authority.

The exact lines of demarcation between § 141(a) and § 109(b) have been the subject of considerable and heated discussion.²⁹ Some commentators have argued that § 109(b) be given a limited role, handling primarily the convocation of shareholder meetings, director qualifications, and other fairly narrow procedural matters.³⁰ Others have argued for a more expansive role—one that would allow shareholders to participate more actively in the management of outside takeover bids and other sources of board-shareholder conflict.³¹ However, the “general consensus” appears to be that “bylaws that regulate the process by which the board acts are statutorily authorized.”³² In *CA, Inc. v. AFSCME Employees Pension Plan*, the Delaware Supreme Court articulated the test for determining whether a shareholder-proposed bylaw unlawfully impeded upon the board’s discretion. The Court framed the issue as “whether the Bylaw is one that establishes or regulates a process for substantive director decision-making, or one that mandates the decision itself.”³³ The former is

27. *Id.* § 141(a). See also *id.* § 102(b)(1) (requiring that “any provision creating, defining, limiting, and regulating the powers of the corporation, the directors and the stockholders” be placed in the certificate of incorporation).

28. *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227, 232 n.7 (Del. 2008) (stating that “the board’s managerial authority under Section 141(a) is a cardinal precept of the DGCL” and that § 109(b) is not an exception to § 141(a)). The *CA* case seems to have solved the “recursive loop” issue by giving primacy to § 141(a). See Jeffrey N. Gordon, “Just Say Never?” *Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett*, 19 CARDOZO L. REV. 511, 546–47 (1997) (identifying and explaining the loop).

29. Compare John C. Coates IV & Bradley C. Faris, *Second-Generation Shareholder Bylaws: Post-Quickturn Alternatives*, 56 BUS. LAW. 1323, 1353 (2001) (“A bylaw is impermissible if its primary purpose is to prevent or interfere with the board’s discretion under section 141(a) to manage the business and affairs of the corporation . . .”), and Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?*, 73 TUL. L. REV. 409, 428–44 (1998) (concluding that Delaware law provides for a very limited role for shareholder-proposed bylaws), with Gordon, *supra* note 28, at 547–48 (arguing that there is “no easy statutory resolution” to the conflict between §§ 109 and 141(a)), and McDonnell, *supra* note 23, at 235 (determining that “legislative and judicial history do not clearly resolve the general tension between sections 141(a) and 109(b)”).

30. Hamermesh, *supra* note 29, at 479–86. But see McDonnell, *supra* note 23, at 207 n.4 (arguing that Hamermesh takes an “overly narrow view of the bylaw power”).

31. McDonnell, *supra* note 23, at 208 (advocating for a default rule of broad shareholder power to enact bylaws concerning corporate governance).

32. *Hollinger Int’l, Inc. v. Black*, 844 A.2d 1022, 1079 (Del. Ch. 2004).

33. *CA, Inc.*, 953 A.2d at 235.

permissible under Delaware law, while the latter is not. The Court held that a bylaw requiring reimbursement of expenses for outside director candidates was aimed at “regulating the process for electing directors,” even though it mandated reimbursement, and was therefore permissible under § 141(a).³⁴

At its core, the referendum bylaw follows the requirement that a bylaw “establishes or regulates a process for substantive director decision-making.”³⁵ It simply requires that directors hold a nonbinding election amongst employees prior to a shareholders’ vote for a merger or other transformative transaction. That vote does not compel the directors’ decision one way or the other; they retain their managerial freedom to pursue the merger regardless of the employee vote.³⁶ However, the board must at least hold the election before the transaction can be approved. It is appropriate that shareholders initiate this amendment to the bylaws, as they would benefit from the additional information that the referendum provides.³⁷

The Court ultimately found that the bylaw in *CA, Inc.* could potentially violate state law, because it could require directors to reimburse a candidate who was motivated by personal concerns or who had interests that were adverse to the corporation.³⁸ In the case of the referendum, however, it is difficult to envision a scenario in which the holding of the referendum itself would be a violation of the directors’ fiduciary duties. A company might claim that it would be too costly or difficult to arrange an employee election before the requisite shareholders’ election. In such a case, it could arguably be detrimental to the company to postpone the shareholder vote to allow for an employee vote. However, given the ease of access to employees, it is hard to envision that a corporation could not come up with any reasonable method of polling its employees prior to the shareholders’ vote. In my proposed referendum, the board has the authority to manage the referendum. The only requirements are that it shall be held no sooner than two weeks following the agreement, no later than two weeks prior to the shareholder vote, and by secret ballot. Given the flexibility to manage the election as it so desires, the board could use a

34. *Id.* at 235–36.

35. *Id.* at 235.

36. The fact that the referendum would cost some money to run does not render it improper. *See CA, Inc.*, 953 A.2d at 236 (“[A] bylaw that requires the expenditure of corporate funds does not, for that reason alone, become automatically deprived of its process-related character.”).

37. A merger or asset sale that requires shareholder approval is uniquely situated outside of managerial authority, as shareholders must agree to the combination.

38. *Id.* at 238–40.

variety of different methods to conduct the balloting within these parameters.³⁹ Since the referendum would not interfere with the board's management prerogatives, and would therefore not cause the board to violate state law, a company would have no grounds for excluding the referendum-bylaw proposal under Rule 14a-8.

There is much more that could be said about this issue that goes beyond the space of this brief Comment. But I hope that enough has been said to interest shareholders in pursuing this avenue. The employee referendum would be a simple way of generating more information at relatively little cost to the company and shareholders. In this era of proposal experimentation, the referendum could be yet another opportunity for shareholders to work with management in improving our system of corporate governance.

39. In the alternative, the bylaw could provide directors with broader authority to amend or repeal the bylaw in keeping with their duties and responsibilities as directors. The second alternative is also provided in the Appendix.

APPENDIX

Proposal Example 1: Bylaw Amendment in Delaware

RESOLVED, pursuant to Section ____ of the Bylaws of Company X and section 109 of the Delaware General Corporation Law, the stockholders hereby amend the Bylaws by adding Section ____ as follows:

Section ____ (a):

After the board of directors adopts an agreement concerning a merger or sale of substantially all assets or other corporate combination upon which the shareholders must vote to approve, the board shall direct the Company to hold a nonbinding Referendum in which all employees (as defined by the company) shall vote “yes” or “no” on the agreement.

Section ____ (b):

The board shall set the time and date of the Referendum. The Referendum shall be held no sooner than two weeks following the agreement, and no later than two weeks prior to the shareholder vote.

Section ____ (c):

The board has the authority to manage the Referendum. It may delegate this authority. The Referendum shall be conducted by secret ballot.

Section ____ (d):

The results of this Referendum shall be disclosed to shareholders prior to the shareholder vote.

OPTIONAL:

Section ____ (e):

Notwithstanding anything else in these bylaws to the contrary, a decision by the Board of Directors to amend or repeal this Section shall require the affirmative vote of all of the members of the Board of Directors.

OR

Section ____ (e):

The Board of Directors shall have the authority to amend or repeal this Section in keeping with their duties and responsibilities as Directors.

SUPPORTING STATEMENT:

This proposal would amend the bylaws to provide for a nonbinding employee vote on any merger, acquisition, or other corporate combination on which the shareholders are also entitled to vote. The purpose of the referendum is to provide shareholders with information regarding the employees' views on the transaction. Employees are in the midst of the day-to-day business of the company. Their repository of knowledge is a resource to be tapped, especially during the course of a transformative transaction. The referendum would provide a formal mechanism through which all employees could make their voices heard. It is hoped that the referendum would then spur increased interactions among the shareholders, the board, management, and employees on the wisdom of the transaction as well as the best ways to manage the company going forward.