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Third Circuit Opinion Raises Uncertainty for the Ordinary Business Exclusion in Shareholder Proposals

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On July 6, 2015, the U.S. Court of Appeals for the Third Circuit issued its opinion[1] in *Trinity Wall Street v. Wal-Mart Stores, Inc.*[2] The holding permitted Wal-Mart Stores, Inc. ("Wal-Mart") to exclude a shareholder proposal submitted by Trinity Wall Street ("Trinity") from the company's proxy statement for its 2015 annual meeting of shareholders. The opinion was long-awaited by the corporate governance community because the main issue on appeal was whether Wal-Mart could exclude the proposal based on the often-asserted ordinary business exclusion of Rule 14a-8(i)(7) under the Securities Exchange Act of 1934 (the "Exchange Act"). The lower court, the U.S. District Court for the District of Delaware, had disagreed with the recommendation of the staff of the Division of Corporation Finance (the "Staff") of the Securities and Exchange Commission (the "Commission") and required Wal-Mart to include Trinity's shareholder proposal. Accordingly, prior to the Court of Appeals' ruling, it was unclear whether the long-standing interpretations of the exclusion applied by the Commission and the Staff would withstand judicial scrutiny.

Although the Court of Appeals ultimately reversed the District Court's ruling and agreed with the earlier recommendation of the Staff, the differing analyses for evaluating Rule 14a-8(i)(7) utilized by the majority (Judges Thomas Ambro and Thomas Vanaskie) and by Judge Patty Shwartz, who concurred only in judgment, may have created more questions than answers. The decision likely will require the Commission to issue additional guidance on Rule 14a-8(i)(7) prior to the 2016 proxy season, so that both proponents and companies will have some certainty on the application of the ordinary business exclusion.

Background

Prior to the 2014 proxy season, Trinity submitted a shareholder proposal to Wal-Mart requesting that Wal-Mart's board of directors amend its Compensation, Nominating and Governance Committee charter to provide for "oversight concerning the formulation and implementation of, policies and standards that determine whether or not [Wal-Mart] should sell a product that (1) especially endangers public safety and well-being; (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 [Wal-Mart]'s promotion of its brand." Although the proposed charter amendment did not mention a specific product, it was clear from the proposal and its supporting statement that the proposal was inspired, at least in part, by Wal-Mart's sale of guns with high-capacity magazines.

The Staff, which provides informal, nonbinding recommendations on a company's ability to exclude a shareholder proposal,[3] found that there was "some basis" for Wal-Mart to rely on Rule 14a-8(i)(7) to exclude Trinity's proposal from the company's 2014 proxy statement.[4] Following its customary practice, the Staff did not elaborate in any detail on its analysis for permitting Wal-Mart to exclude Trinity's proposal. However, the Staff stated that it thought the proposal related to "products and services offered for sale" by a company and, following its historical practice, concluded that such proposals are "generally excludable under rule 14a-8(i)(7)."[5]

Following the Staff's decision, Trinity filed suit against Wal-Mart in the U.S. District for the District of Delaware to seek, among other things, (i) declaratory judgment that Wal-Mart's omission of Trinity's proposal from its 2014 proxy statement would violate Section 14(a) of the Exchange Act and Rule 14a-8 thereunder and (ii) injunctive relief preventing Wal-Mart from excluding the proposal from its 2015 proxy statement on the basis of Rule 14a-8(i)(7). The District Court granted summary judgment for Trinity on these two issues, [6] and Wal-Mart appealed the decision to the U.S. Court of Appeals for the Third Circuit.

Court of Appeals Opinion

The Court of Appeals reversed the District Court's ruling and wrote an in-depth opinion analyzing the shareholder proposal process and guidance from the Commission and the Staff on Rule 14a-8(i)(7). However, the majority opinion's discussion on how to analyze significant social policies in the context of Rule 14a-8(i)(7) likely created even more uncertainty as to the application of the exclusion.

By its terms, Rule 14a-8(i)(7) allows a company to exclude a shareholder proposal that "deals with a matter relating to the company's ordinary business operations." In the adopting release to the 1998 amendments to Rule 14a-8 (the "1998 Release"),[7] the Commission explained its two considerations for the ordinary business exclusion.[8] First, even if the proposal's subject matter related to the company's ordinary business, a company could not rely on Rule 14a-8(i)(7) to exclude it if the proposal "focuses" on a significant social policy issue. Second, a company could rely on Rule 14a-8(i)(7) to exclude a proposal if the proposal sought to "micro-manage" the company. Following the Commission's guidance, in denying relief under Rule 14a-8(i)(7), the Staff frequently cites to the proposal's focus on a significant policy issue[9] and, where the company makes a micro-management argument, that the proposal does not seek to micro-manage the company.[10]

In the first part of its analysis, the Court of Appeals concluded that the subject matter of Trinity's proposal was Wal-Mart's approach to merchandising decisions for certain products and held that such subject matter related to Wal-Mart's ordinary business. The Court of Appeals next analyzed whether the exceptions to Rule 14a-8(i)(7) would prevent exclusion of the proposal, despite the proposal's relation to Wal-Mart's ordinary business.

While the majority opinion concluded that Trinity's proposal focuses on a significant social policy issue – the sale of guns with high-capacity magazines – it did not analyze the Commission's second consideration – whether the proposal would micro-manage Wal-Mart – and instead substituted a different consideration in its analysis. According to the majority opinion, a shareholder proposal survives a challenge under Rule 14a-8(i)(7) only if (i) the proposal focuses on a significant policy issue[11] and (ii) its underlying subject matter transcends the day-to-day business matters of the company.

For support of its conjunctive approach to the analysis, the majority opinion cites to guidance from the Staff set forth in Staff Legal Bulletin No. 14E ("SLB 14E"). In SLB 14E, the Staff stated the following (emphasis added):

In those cases in which a proposal's underlying subject matter transcends the day-to-day business matters of the company and raises policy issues so significant that it would be appropriate for a shareholder vote, the proposal generally will not be excludable under Rule 14a-8(i)(7) as long as a sufficient nexus exists between the nature of the proposal and the company.

While a literal reading of SLB 14E could suggest that whether a proposal focuses on a significant policy issue is only one part of a two-part test, separate and distinct from whether a proposal transcends the company's day-to-day business, it is questionable whether such a reading is supported by the Commission's guidance. Judge Patty Shwartz makes this argument in her concurring opinion, which concurred in the Court of Appeals' judgment but disagreed with the majority opinion's analysis.[12] For support, Judge Shwartz cites to the following language from the 1998 Release:

[P]roposals relating to [ordinary business] matters but focusing on sufficiently significant social policy issues (e.g., significant discrimination matters) generally would not be considered to be excludable, because the proposals would transcend the day-to-day business matters and raise policy issues so significant that it would be appropriate for a shareholder vote.

The above passage, as well as the history of the 1998 Release,[13] seems to support Judge Shwartz's position that "the significance and transcendence concepts [are] interrelated, rather than independent."

Interestingly, while the majority opinion cited to SLB 14E for its two-part conjunctive test, it did not acknowledge a potential third requirement contained in the guidance. As suggested by the following language (emphasis added), which is the same passage cited to by the majority opinion to support its two-part test, a proposal also must have a "nexus" with the company to survive a challenge under Rule 14a-8(i)(7):

In those cases in which a proposal's underlying subject matter transcends the day-to-day business matters of the company and raises policy issues so significant that it would be appropriate for a shareholder vote, the proposal generally will not be excludable under Rule 14a-8(i)(7) as long as a sufficient nexus exists between the nature of the proposal and the company.

Because the majority opinion concluded that Trinity's proposal did not transcend Wal-Mart's ordinary business, it did not necessarily need to reach the issue of whether the proposal had a sufficient nexus to Wal-Mart. However, the fact that the majority opinion did not even mention SLB 14E's nexus requirement, in an otherwise thorough analysis of Rule 14a-8(i)(7), raises questions about whether the requirement should be a consideration, separate and distinct from the other considerations raised by the Commission and the majority opinion.[14]

In the end, the majority opinion, Judge Shwartz's concurring opinion and the Staff all reached the same conclusion – Wal-Mart could exclude Trinity's proposal based on Rule 14a-8(i)(7). However, the different analysis undertaken by the majority opinion – seemingly supported by a literal reading of the Staff's SLB 14E – and Judge Shwartz's concurring opinion – seemingly supported by the Commission's 1998 Release – to reach that conclusion raises more questions for the 2016 proxy season.

Looking Ahead

Following the Court of Appeals' decision, there exists potentially three sets of guidance on considerations to analyze for Rule 14a-8(i)(7). First, the Court of Appeals, through the majority opinion, sets forth a two-part test based on whether the proposal focuses on a significant policy issue and whether it transcends the company's day-to-day business operations. Next, the Commission, through the 1998 Release, appears to consider significance and transcendence as different terms that refer to the same factor but also requires that the proposal not micro-manage the company. Finally, the Staff, through SLB 14E, appears to have emphasized the requirement that there be a nexus between the proposal and the company.

While the Court of Appeals might have established a competing line of analysis from that set forth by the Commission or the Staff, it also recognized the need for interpretative guidance in the shareholder proposal arena. For the application of Rule 14a-8(i)(7), that interpretative guidance, whether from the Commission or the Staff, is more important than ever because the uncertainty created by the majority opinion's two-part conjunctive test will make it more difficult for companies, shareholders and their respective counsel to analyze the potential application of the ordinary business exclusion in the next proxy season.

[1] The opinion is available here.

[2] The Court of Appeals previously had issued its order on the case in April 2015 but delayed the issuance of its opinion.

[3] A court has ultimate authority on whether a company must include a shareholder proposal in its proxy statement. See Division of Corporation Finance, Informal Procedures Regarding Shareholder Proposals (November 2, 2011), available here.

[4] *Wal-Mart Stores, Inc.* (March 20, 2014).

[5] Other examples of when the Staff permitted companies to rely on Rule 14a-8(i)(7) to exclude proposals that relate to products and services include: *Dominion Resources, Inc.* (February 19, 2014); *JPMorgan Chase & Co.* (March 7, 2013); *Regions Financial Corporation* (January 28, 2013); and *Wells Fargo & Company* (January 28, 2013).

[6] *Trinity Wall Street v. Wal-Mart Stores, Inc.*, 2014 WL 6790928 (D. Del. November 26, 2014).

[7] Release 34-40018 (May 21, 1998).

[8] The Commission stated the following in the 1998 Release:

"The policy underlying the ordinary business exclusion rests on two central considerations. The first relates to the subject matter of the proposal. Certain tasks are so fundamental to management's ability to run a company on a day-to-day basis that they could not, as a practical matter, be subject to direct shareholder oversight. Examples include the management of the workforce, such as the hiring, promotion, and termination of employees, decisions on production quality and quantity, and the retention of suppliers. However, proposals relating to such matters but focusing on sufficiently significant social policy issues (e.g., significant discrimination matters) generally would not be considered to be excludable, because the proposals would transcend the day-to-day business matters and raise policy issues so significant that it would be appropriate for a shareholder vote.

The second consideration relates to the degree to which the proposal 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. This consideration may come into play in a number of circumstances, such as where the proposal involves intricate detail, or seeks to impose specific time-frames or methods for implementing complex policies."

[9] See, e.g., *Amazon.com, Inc.* (March 25, 2015); *Revlon, Inc.* (March 18, 2014); *Lowe's Companies, Inc.* (March 17, 2014); and *Kohl's Corporation* (January 28, 2014).

[10] See, e.g., *Devon Energy Corporation* (March 19, 2014); *Rayonier Inc.* (March 11, 2014); *Spectra Energy Corp* (January 14, 2014); and *Franklin Resources, Inc.* (December 30, 2013).

[11] The majority opinion also implies that the significant policy issue can be social or corporate for the first prong of its test to be met.

[12] While Judge Shwartz stated that Trinity's proposal may have raised the significant social policy issue of sale of guns with high-capacity magazines, she did not believe that the proposal focused on such issue. Accordingly, Judge Shwartz concurred with the Court of Appeals' judgment that Wal-Mart could exclude Trinity's proposal under Rule 14a-8(i)(7).

[13] In the proposing release to the 1998 Release, the above quoted phrase read as follows (emphasis added): "[P]roposals relating to such matters but focusing on significant social policy issues generally would not be considered to be excludable, because such issues typically fall outside the scope of management's prerogative." Release 34-39093 (September 18, 1997). Accordingly, the Commission changed its rationale for why a proposal focusing on a significant social policy issue would not be excludable from (i) the issue falling outside of the scope of management's prerogative to (ii) the issue transcending day-to-day business matters. While it is unclear why the Commission changed the language, it appears that these two reasons are synonymous with each other and the Commission did not intend for transcending day-to-day business matters to be a new substantive requirement.

[14] It is unlikely that the Court of Appeals was unaware of the potential argument for SLB 14E's nexus requirement, as Wal-Mart advanced the argument in its brief to the Court of Appeals.

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