



## TWO CHEERS FOR *TRINITY WALL STREET V. WAL-MART*: THE AWKWARD NEW TEST FOR ORDINARY BUSINESS EXCLUSION

by Professor 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.

This allocation of authority is essential to run the corporation efficiently. Just as a large city cannot be run as a New England town meeting, so too a large corporation is a poor candidate for direct democracy. There are simply too many shareholders who are dispersed too widely, 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. Accordingly, state corporate law traditionally has given primary decision-making authority to the board and the managers to whom the board properly delegates authority.<sup>1</sup> As the Delaware General Corporation Law puts it, for example, the “business and affairs” of a corporation “shall be managed by or under the direction of a board of directors.”<sup>2</sup>

In recent years, however, shareholders have increasingly made use of a provision of the federal proxy rules known as the shareholder proposal rule—*i.e.*, Securities and Exchange Commission (SEC) Rule 14a-8—to 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. To be sure, for reasons beyond the scope of this LEGAL BACKGROUNDER, most of these proposals are phrased as recommendations,<sup>3</sup> but they nevertheless have become a powerful tool for influencing corporate decision making.<sup>4</sup>

Three basic categories of investors currently make active use of shareholder proposals in this area. The first is comprised of corporate social responsibility activists seeking to redirect corporate behavior in ways the activists believe will be more ethical. The second consists of union and state and local government pension funds, whose activism is often directed at achieving not greater investment returns but “progress on labor rights desired by union fund managers and enhanced political reputations for public pension fund managers.”<sup>5</sup> Finally, activist hedge funds are increasingly seeking to effect changes in how portfolio companies run their businesses.<sup>6</sup> Although their motives differ, each category increasingly seeks to micromanage the firms in which they invest.

### The Ordinary Business Operations Exclusion

In theory, Rule 14a-8 contains limits on shareholder micro-management. The rule permits management to exclude proposals on a number of both technical and substantive bases, of which the exclusion in Rule 14a-8(i)(7) for proposals relating to ordinary business operations 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.”<sup>7</sup>

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Unfortunately, court decisions have largely eviscerated the ordinary business operations exclusion. Corporate decisions involving “matters which have significant policy, economic or other implications inherent in them” may not be excluded as ordinary business matters,<sup>8</sup> for example, which creates a gap through which countless proposals have slipped onto corporate proxy statements.

*Trinity Wall St. v. Wal-Mart Stores, Inc.*<sup>9</sup> recently tested whether Rule 14a-8(i)(7) was to be rendered entirely toothless. Trinity timely submitted a proposal for inclusion in Wal-Mart’s 2014 proxy statement that, if adopted, would broadly request Wal-Mart’s board of directors

to develop and implement standards for management to use in deciding 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.’<sup>10</sup>

Despite that breadth Trinity’s proposal was closely linked to Wal-Mart’s sale of rifles with high capacity magazines.<sup>11</sup>

After Wal-Mart refused to include the proposal in its proxy statement, Trinity sought an injunction from the U.S. District Court for the District of Delaware ordering Wal-Mart to do so. The court granted the injunction on the grounds that the proposal was focused (a) on the duties of the board of directors rather than of management and (b) on corporate policies rather than decisions about specific products.<sup>12</sup> Accordingly, the proposal could not be excluded as relating to “ordinary business operations.” The Third Circuit reversed. In doing so, the court reached the right result—ensuring that Rule 14a-8(i)(7) retains some teeth as a deterrent to shareholder micromanagement—but by way of a test that lacks administrability, predictability, and, in spots, basic common sense.

### The Third Circuit’s Awkward New Test

Although the court stated that it was employing “a two-part analysis,” its test actually has three prongs. First, the court must determine “the ‘subject matter’ of the proposal.”<sup>13</sup> Anticipating the possibility that Wal-Mart would try to exclude the proposal under Rule 14a-8(i)(7), Trinity had carefully worded its proposal so it could claim that the proposal transcended ordinary business matters. It 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. The Third Circuit, however, refused to “allow drafters to evade Rule 14a-8(i)(7)’s reach by styling their proposals as requesting board oversight or review.”<sup>14</sup> Instead, the court held that it must identify the intended “ultimate consequence” of the proposal, which in this case was to pressure Wal-Mart to stop selling high-capacity firearms.

In so holding, the court wisely rejected the lower court’s ruling that a proposal falls outside Rule 14a-8(i)(7)’s exclusion if it merely asks the board to develop a policy or review the application of extant policies to various products.<sup>15</sup> 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. Indeed, despite the court’s repeated condemnation of “clever drafting,” the holding may simply encourage proposal proponents to engage in increasingly clever efforts to obfuscate their intentions, while making it harder for firms to determine *ex ante* if a proposal will be excludable.

In the second step, the test asks whether the subject matter identified in the first step “relates” to ordinary business operations. 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.”<sup>16</sup> A proposal related to the decision of which products the company should sell is thus excludable “even though the proposal doesn’t demand any specific changes to the make-up of [a company’s] product offerings.”<sup>17</sup> This step prevents proponents from evading the ordinary business exclusion by wording proposals to avoid suggesting specific changes or recommending particular outcomes.

The court split the 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.<sup>18</sup>

The court quickly disposed of 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."<sup>19</sup> Perhaps so, but it is not obvious that social significance should mandate inclusion of a proposal that otherwise implicates a matter of ordinary business. Query whether we want federal bureaucrats or federal judges deciding whether a politically charged proposal has enough ethical or social significance to justify its inclusion in the proxy statement.

In the first place, such an inquiry inevitably lacks certainty and predictability, as "significant" is hardly a bright-line test. Consider, for example, the SEC's treatment of proposals relating to manufacture of tobacco products by cigarette makers:

In February, 1990, the staff reversed, and the Commission upheld the reversal of, its long-held position that registrants could omit shareholder proposals dealing with tobacco and tobacco products. In a number of letters dated February 22, 1990, the SEC staff found that its "prior letters failed to reflect adequately the growing significance of the social and public policy issues attendant to operations involving the manufacture of tobacco related products." As one commentator put it, "Since when?"<sup>20</sup>

Second, the inquiry invites judges to apply their own views of what makes a policy significant or not,<sup>21</sup> which is inconsistent with the rule of law. Finally, it allows inclusion of many proposals that have less to do with a company's economic performance than with providing a soapbox for the proponent's pet political cause.

Turning to prong 3.B, the court unnecessarily created a twisted maze of logic to avoid requiring Wal-Mart to include Trinity's proposal. It explained that "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."<sup>22</sup> This "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.'<sup>23</sup> Once again, the court's requirement fails to draw a bright line between what proposals may be excluded and which may not.

Worse yet, in seeking to explicate how the standard would work, the court observed 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."<sup>24</sup> If selling higher-capacity rifles 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 on which shareholders normally have a voice.<sup>25</sup>

## Conclusion

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 and predictability. Interestingly, the court itself signaled awareness 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.<sup>26</sup>

The court's unwillingness to undertake the task of developing such a superior standard apparently stemmed from its belief that the SEC is entitled to *Chevron* deference in this area.<sup>27</sup> With the erosion of the *Chevron* doctrine in the last Supreme Court term, however, future courts may be willing to tread where the Third Circuit feared to go.<sup>28</sup>

## Endnotes

<sup>1</sup> See, e.g., Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 N.W. U. L. REV. 547 (2003).

<sup>2</sup> DEL. CODE ANN., tit. 8, § 141(a) (2015).

<sup>3</sup> For an overview of Rule 14a-8, see Stephen M. Bainbridge, *CORPORATE LAW* 264-71 (2d ed. 2009).

<sup>4</sup> See, e.g., 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”).

<sup>5</sup> Roberta Romano, *Less Is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174, 231-32 (2001).

<sup>6</sup> See, e.g., 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”).

<sup>7</sup> *Apache Corp. v. New York City Employees' Ret. Sys.*, 621 F. Supp. 2d 444, 451 (S.D. Tex. 2008) (quoting Amendments to Rules on Shareholder Proposals, 63 Fed. Reg. 29106, 29108 (May 28, 1998)).

<sup>8</sup> *Austin v. Consol. Edison Co. of New York*, 788 F. Supp. 192, 194 (S.D.N.Y. 1992).

<sup>9</sup> 2015 WL 4069291 (3d Cir. July 6, 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.*

<sup>10</sup> *Id.* at \*1.

<sup>11</sup> James H. Cooper, *Why Trinity Church and Wal-Mart Went to Federal Court* (Dec. 2, 2014), <https://www.trinitywallstreet.org/blogs/news/why-trinity-church-and-wal-mart-went-federal-court>.

<sup>12</sup> *Trinity Wall St. v. Wal-Mart Stores, Inc.*, No. CV 14-405-LPS, 2014 WL 6790928, at \*9-10 (D. Del. Nov. 26, 2014) (noting that “Trinity's Proposal leaves development of policy to the Board Committee” and that it did “not dictate what products should be sold or how the policies regarding sales of certain types of products should be formulated or implemented”), rev'd, 2015 WL 1905766 (3d Cir. Apr. 14, 2015).

<sup>13</sup> *Trinity*, 2015 WL 4069291 at \*14.

<sup>14</sup> *Id.* at \*16.

<sup>15</sup> The court thus agreed with Washington Legal Foundation, whose *amicus* brief in the case argued that “it is the underlying subject matter of a proposal, not the form of the action requested, that determines whether a proposal is excludable.” Brief for Washington Legal Foundation as *Amicus Curiae*, *Trinity Wall St. v. Wal-Mart Stores, Inc.*, 2015 WL 416657 (C.A.3), at \*11-12 (available at [http://www.wlf.org/upload/litigation/briefs/WLFAmicusBrief\(TrinityWallStreetvWalmartStores\)3rdCircuit.pdf](http://www.wlf.org/upload/litigation/briefs/WLFAmicusBrief(TrinityWallStreetvWalmartStores)3rdCircuit.pdf)).

<sup>16</sup> *Trinity*, 2015 WL 4069291 at \*17 (emphasis in original).

<sup>17</sup> *Ibid.*

<sup>18</sup> *Id.* at \*18.

<sup>19</sup> *Id.* at \*19.

<sup>20</sup> Kevin W. Waite, *The Ordinary Business Operations Exception to the Shareholder Proposal Rule: A Return to Predictability*, 64 FORDHAM L. REV. 1253, 1268 (1995)

<sup>21</sup> Indeed, the court frankly acknowledged that the test it purportedly borrowed from SEC guidance embraced “what can only be described as a ‘we-know-it-when-we-see-it’ approach.” *Trinity*, 2015 WL 4069291 at \*19.

<sup>22</sup> *Ibid.*

<sup>23</sup> *Ibid.* (quoting *Apache Corp. v. New York City Emps.' Ret. Sys.*, 621 F.Supp.2d 444, 451 n. 7 (S.D.Tex.2008)).

<sup>24</sup> *Id.* at \*22.

<sup>25</sup> 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”). As 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, *supra* note 15, at \*13. This is true even when assessing the risks and benefits of continuing to make a single product.

<sup>26</sup> *Trinity*, 2015 WL 4069291 at \*24.

<sup>27</sup> See *id.* at \*10 n.9 (“Each of the SEC's interpretive releases was adopted after notice and comment and thus merits our deference.”).

<sup>28</sup> See Charles T. Wehland, *After Michigan v. EPA, High Court Less Swayed By Chevron*, Law360.com (July 10, 2015), <http://www.law360.com/articles/677500/after-michigan-v-epa-high-court-less-swayed-by-chevron> (noting “a trend away from Supreme Court deference to executive agency interpretations of statutory authority”).