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Comment on the Proposed Definition of “Eligible Organization” for Purposes of Coverage of Certain Preventative Services Under the Affordable Care Act

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Re: Comment on the proposed definition of “eligible organization” for purposes of Coverage of Certain Preventative Services Under the Affordable Care Act [File Code CMS-9940-P]

Date: October 20, 2014

Dear Sir or Madam:

We write to provide comments on the matter referenced above. We are law professors who for many years have taught, written about, and spoken on corporate law subjects. All institutional affiliation information is provided solely for identification purposes, and no implication that any of our universities approve or agree with these comments is intended. Many of the points set forth in this letter are elaborated on in a forthcoming article titled “Corporate Law after *Hobby Lobby*,” co-authored by Lyman Johnson and Professor David Millon, to be published in the November 2014 issue of *The Business Lawyer*, the flagship journal of the American Bar Association’s Section on Business Law. It can be accessed on SSRN at: <http://ssrn.com/abstract=2507406>.

In Part I below we provide comments on your proposed rules. In Part II, because your proposal invites suggestions, we comment on approaches that, if suggested by other commenters,

should be avoided in the rule-making process because they are not consistent with the Supreme Court’s reasoning in *Hobby Lobby* and are not consonant with generally applicable precepts of state corporate law or principles of federalism.

I. Comments on Proposed Rules

A. In several places (*see, e.g.*, pp. 3, 11, 13-14, 32), the background explanation and the proposed rules themselves misdescribe the *Hobby Lobby* ruling. First, although the three companies in that litigation were “closely-held,” the Court’s reasoning decidedly was not limited to such companies. Justice Alito’s opinion acknowledged that the cases before the Court did “not involve publicly traded corporations” and “we have no occasion in these cases to consider RFRA’s applicability to such companies.”¹ But Justice Alito did not in principle exclude public companies as being able to assert RFRA claims, stating instead only that it was “unlikely” due to “numerous practical restraints,” and that, for factual reasons of share ownership patterns, it was “improbable.”² Nowhere did the Court exclude public corporations from the universe of companies that could assert RFRA claims and this is because the state corporate law principles drawn on in *Hobby Lobby* permit all corporations – whether private or public – to exercise religion. State law makes no distinction among corporations in that regard. Whether a particular corporation does in fact exercise religion is a distinct matter, addressed below, but all corporations, as a matter of state corporate law, are legally empowered to do so.

¹ *Hobby Lobby*, 2014 WL 2921709 at *18.

² *Id.*

The corporate treatises and corporate statutes cited by Justice Alito with respect to a corporation’s freedom to act in a non-profit-maximizing manner, and thereby exercise religion, are not limited in application to “closely-held” corporations,³ nor do those generally applicable corporation statutes even refer to or somehow distinguish “closely-held” corporations.⁴ The relevant statutory provisions appear in state general incorporation statutes that apply to all corporations organized under their provisions, public as well as privately-held. Federal “exercise of religion” claims under RFRA, as a practical matter and as Justice Alito noted, likely will be made by close corporations, but the Court’s *reasoning* on the permissibility of pursuing broad, non-commercial purposes under state corporate law, such as the exercise of religion, applies to all companies. This necessarily is the case because under state corporate law there simply is no basis for contending that general state incorporation statutes – and judicial interpretations of them – do not apply categorically to all corporations, except where the statute itself provides otherwise.⁵ Thus, there is no principled basis for construing the *Hobby Lobby* Court’s views on corporate freedom to exercise religion as limited to “closely-held” corporations. In ruling that the three closely-held corporations before it had the legal power to exercise religion, the Court looked to state law sources equally applicable to public companies.

Second, throughout the proposed rules – and in the background material preceding it – the term “for-profit” is used. The Court and Justice Ginsburg in *Hobby Lobby* also used that term for ease of reference and to distinguish “non-profit” corporations. In fact, the Oklahoma

³ *Id.* at *15-16.

⁴ As addressed later in this letter, some states do have special “close corporation” statutory provisions, but those were not involved in *Hobby Lobby* and are only very infrequently even used.

⁵ *See, e.g.*, Mod. Bus. Corp. Act §8.01 (referring to §7.32).

corporation statute involved in the *Hobby Lobby* case does not use that term; nor does the Delaware corporate statute or the widely adopted Model Business Corporation Act. The standard terminology is “business corporation.” This term better captures the related statutory fact that state corporate codes do not require that business corporations pursue profits at the expense of competing considerations, a point explicitly noted by the Court and central to its reasoning.⁶

Third, throughout the proposed rules – and in the background material preceding it – the *Hobby Lobby* opinion is misdescribed as grounded on the “owners” religious beliefs. The Court, of course, held that the *corporations* themselves had a free exercise right. Prior to even addressing the issue of whether a business corporation could “exercise religion,” the Court had to decide – which it did – that such a corporation was, in its own right, a “person” under RFRA. As a matter of state corporate law, moreover, “owners” or “shareholders” (in corporate businesses) are not legally identical to the corporation itself and they neither formulate a corporation’s business policies nor direct the business and affairs of a corporation.⁷ That function belongs to the board of directors in all states. *See* Del. Code tit 8 §141(a); Model Business Corporation Act §8.01(a). Thus the question of whether a business corporation will or will not “exercise religion” is a question to be resolved by the board of directors under state law, not shareholders. A board of directors acts in only one of two ways: either at a meeting where, if a quorum is present, decisions are made by a majority vote – unanimity is not required – or alternatively, a board may

⁶ 2014 WL 2921709 at *15. *See* Ronald J. Colombo, THE FIRST AMENDMENT AND THE BUSINESS CORPORATION (Oxford University Press, forthcoming 2015); Ronald J. Colombo, *The Naked Private Square*, 51 HOUSTON L. REV. 1 (2013).

⁷ Shareholders are not “owners” of the corporation. The corporation holds legal title to and owns its own assets, and shareholders own only the corporation’s stock. The distinction is important because ownership of the corporation could imply stronger control and financial rights than state corporation law actually provides to shareholders.

act without meeting if all directors sign an appropriate written consent. No shareholder involvement is necessary or required when a board so acts. Few indeed are the matters on which shareholders are permitted to vote or consent under state corporate law: electing and removing directors, amending the articles of incorporation and bylaws, and voting on mergers, sales, and so on. Beyond that, shareholders have no role in directing a corporation's business and affairs.

The persons involved in the Hobby Lobby Stores corporation in the *Hobby Lobby* case made this clear in arguing that they “cannot in good conscience *direct* their corporations to provide insurance coverage for the four drugs,...” (emphasis added). That directors, not shareholders, are the key decision-makers in business corporations is a basic and uniform state corporate law principle of the type relied on by the Court in *Hobby Lobby* and in numerous cases prior to that. *See CTS Corp. v. Dynamics Corp. of Am.*, 481 U. S. 69, 91 (1987) (“the corporation...owes its existence and attributes to state law”); *Burks v. Lasker*, 441 U. S. 471, 478 (1979). A federal administrative agency has no legal authority to somehow engraft onto state corporate law the requirement of shareholder consent (unanimous or otherwise) to corporate action when underlying state law imposes no such obligation. The cases cited above, including *Hobby Lobby* itself, recognize that state law alone determines the core features of business corporations.

B. Because, as a matter of state law and the reasoning of the Supreme Court in *Hobby Lobby*, any business corporation may exercise religion in its business operations if the board of directors elects and follows through on that course of action,⁸ the proposed rules should

⁸ That policy decision might be set forth in a board-adopted “Vision Statement,” “Statement of Values,” or it could be expressed in the corporation's articles of incorporation or bylaws. If a majority of shareholders acts, they

not categorically exclude certain types of corporations from the definition of “eligible organizations.” The rules might, of course, create a “safe harbor” – one, however, that should give wide berth – for certain types of corporations, but they should still permit other corporations (and entities) to obtain an exemption. If a numerical limit on the number of shareholders is chosen as one factor for the safe harbor it should be a large number, such as the threshold for reporting obligations under the federal securities laws – i.e., 2,000 shareholders. Thus, the safe harbor could and should, with respect to that specific factor, define “eligible organization” as any corporation that is not a publicly reporting company under federal securities laws, the board of directors of which has determined will exercise religion in its business affairs.

II. Approaches to Avoid in Rulemaking

A. Although the three companies in the *Hobby Lobby* litigation were “family owned” (indirectly), there is no principled basis for limiting “eligible organization” to such types of companies. That descriptor – “family owned” – is unknown to state business law and is irrelevant to it. To provide an example, a company the stock of which is owned and the affairs of which are directed by ten Olson family members is not any more able to “exercise religion” in its business affairs than a company the stock of which is owned and the affairs of which are directed by one Olson family member and one Steinheimer family member.

This comment is an extension of the view set forth in Part I above. Just as general state corporation laws apply equally to public and private corporations so too they apply equally to “family owned” and non family-owned companies.

too can employ bylaw amendments to cause the corporation to exercise religion – or to influence how it does so – if the board does not do so. See Alan J. Meese and Nathan B. Oman, *Hobby Lobby, Corporate Law, and the Theory of the Firm: Why For-Profit Corporations are RFRA Persons*, 127 HARV. L. REV. FOR. 273, 281-83 (2014).

B. There is no principled basis for limiting “eligible organizations” to corporations organized as “benefit corporations” or as statutory close corporations. None of the three corporations involved in *Hobby Lobby* was organized as a benefit corporation (a form of organization available only since 2010) or under a special close corporation statute. Pennsylvania, the state of incorporation of Conestoga Wood Specialties, Inc., a party in *Hobby Lobby*, has such a statute (19 Pa. Code ch. 27), but Conestoga Wood was not organized under it. The Court in *Hobby Lobby* in no way required such a limitation because it is simply an option under state law, not a requirement. In fact, close corporation statutory elections are so infrequently made that several years ago the American Bar Association’s Section on Business Law withdrew such a supplement from its Model Business Corporation Act. On principles of federalism and the Supreme Court’s reasoning in *Hobby Lobby*, there is no legal warrant for the proposed rules to so radically limit eligibility. Such an approach would simply be a back door ex post way to try to avoid the full reach of the binding Supreme Court ruling in *Hobby Lobby*.⁹ The same is true for any approach seeking to tie the definition of “eligible organization” to the rules or statutes of any particular state, whether Delaware or any other state. Each state has the undoubted legal authority to specify the attributes of corporateness for companies organized under its laws. No single state’s corporate laws directly or indirectly (via HHS rules) should become the federal law for all others on this important issue, especially since Congress itself has steadfastly refused to adopt a federal corporation statute.

C. Any approach to rulemaking that is grounded on supposed concerns about director or officer fiduciary duties is irrelevant to sound rules. It is not within HHS authority to

⁹ For critiques of a failed pre-*Hobby Lobby* effort to deny that business corporations have RFRA rights, see Stephen M. Bainbridge, *A Critique of the Corporate Law Professors’ Amicus Brief in Hobby Lobby and Conestoga Wood*, 100 Virginia Law Review Online 1 (2014); Meese and Oman, *supra* note 8.

address fiduciary duty issues, a matter of state law and one that necessarily is fact-sensitive and thus one uniquely suited for judicial resolution. Moreover, boards of directors have enormous discretion in making decisions and, among other matters, need not heed or follow the recommendations of shareholders. They are free to – indeed they must – exercise their own independent business judgment. Shareholder votes or consents standing alone are, as noted in Part I, of no legal force under general corporate statutes that uniformly place plenary decision-making power in the board of directors.

D. The proposed rules should not require unanimous shareholder (or other owner) consent because neither *Hobby Lobby* nor state corporate law principles require such a highly unusual requirement. The Supreme Court stated that business corporations, “with ownership approval, support a wide variety of charitable causes.”¹⁰ And the Court also said, “So long as its owners agree,”¹¹ a corporation may deviate from profit maximization.¹² One might be tempted to construe the words “with ownership approval” and “so long as owners agree” as implying that *all* must so agree. But that simply is not what those passages say or mean. Nowhere does the Court use the words “all” or “unanimous” or anything like them. Justice Alito, in this portion of the opinion, is not addressing the nuances of the voting rules for shareholders under state corporate law, which, in any event, are governed by a majoritarian principle, not rules of unanimity.

¹⁰ 2014 WL 2921709 at *15.

¹¹ *Id.*

¹² Of course, under state law a corporation can make charitable contributions without any shareholder involvement; that too is a matter for the board of directors. This and numerous other points emphasizing board of director authority in the post-*Hobby Lobby* context are elaborated by Professor Brett McDonnell. Brett McDonnell, *The Liberal Case for Hobby Lobby*, forthcoming on SSRN.

Moreover, in responding to Justice Ginsberg’s dissent, Justice Alito explicitly takes up the question of “disputes among the owners of corporations.”¹³ He acknowledges that “the owners of a company might well have a dispute relating to religion.”¹⁴ If so, then necessarily all shareholders do not agree on business policy and unanimity thereby is lacking. But that does not mean that, lacking unanimous agreement, the business cannot exercise religion. It means precisely what Justice Alito then notes: “State corporate law provides a ready means for resolving any conflicts by, for example, dictating how a corporation can establish its governing structure.... Courts will turn to that structure and the underlying state law in resolving disputes.”¹⁵ And as noted, the default voting rule in corporate governance is a lower threshold than unanimity. The treatise to which Alito cites at this point in his opinion refers, quite conventionally, to “simple majority vote.”¹⁶

Further, as noted in Part I above, on questions of business policy, including charitable contributions and strategic and operational decisions that sacrifice profits for other considerations – whether to exercise religion or otherwise – shareholders ordinarily have no voting rights at all. It is for the board of directors to decide such questions, and even in the boardroom unanimity is not required. If the shareholders disagree with a board-level decision, their primary recourse will be to act to remove directors at the annual election of directors or at a special meeting held for that purpose. Absent an unusual charter or by-law provision, directors

¹³ 2014 WL 2921709 at *19.

¹⁴ *Id.* Justice Alito cites as an example some stockholders wishing to remain open on the Sabbath to make more money while other stockholders might want to close for religious reasons. *Id.*

¹⁵ *Id.*

¹⁶ *Id.* See Alan Meese, *Hobby Lobby, Shareholder Primacy and Profit Maximization*, www.theconglomerate.org, July 17, 2014 (unanimity by shareholders is not necessary).

are the key decision-makers in corporations and neither they nor shareholders (where they do get to vote) must act with unanimity.

In short, by acting appropriately through the legally mandated corporate governance structure, a majority of directors will chart business policy.¹⁷ One aspect of this is deciding how, if at all, religious or other philosophical or social policy beliefs will play a role in shaping that strategy. As the key decisionmakers address that question, the usual default governance and majoritarian voting rules will apply, not a highly-unusual unanimity rule that would obtain only if specifically agreed ex ante. The decision to engage in – or refrain from – non-maximizing of profits behavior of all sorts, including the exercise of religion through business affairs, will thus be decided in the customary way under standard corporate law rules.

Very truly yours,

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¹⁷ See generally, Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2002).

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