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SHAREHOLDER BYLAWS AND THE DELAWARE CORPORATION

CHRISTOPHER M. BRUNER*

Much like hostile tender offers in the 1980s and 1990s, shareholder bylaws purporting to limit board authority in key areas of corporate governance are, once again, forcing Delaware's courts to grapple with the fundamental nature of the corporate form. Who ultimately calls the shots in corporate governance? And for whose benefit? The shareholders' statutory authority to enact bylaws has become a pivotal issue in the on-going battle for corporate governance supremacy.

In its 2008 opinion in *CA, Inc. v. AFSCME Employees Pension Plan*,¹ the Delaware Supreme Court began to define the nature and scope of the shareholders' bylaw authority. No doubt to activist shareholders' delight, the court held that a proposed bylaw requiring reimbursement of shareholders' proxy expenses under specified circumstances was "a proper subject for shareholder action" under the Delaware General Corporation Law ("DGCL"). This victory was essentially pyrrhic, however, because the court went on to hold that such a mandatory bylaw would nevertheless violate Delaware common law by forcing the board to breach its fiduciary duties if it concluded that reimbursement would not promote the company's interests.²

Commentators have criticized the court's fiduciary duty-based analysis as excessively vague and indeterminate. I argue here that the court's reliance on fiduciary duties in this context reflects not a failed attempt at clarity so much as a decided effort to maintain ambiguity. Just like in hostile takeover cases, which forced the court to address the scope of the shareholders' unilateral power to sell the company, one cannot meaningfully analyze the scope of the shareholders' unilateral power to write the rules of corporate governance without defining the nature and purpose of the corporation itself. However, given the lack of statutory guidance on the core questions of corporate power and purpose, Delaware judges have consistently – and understandably – remained reluctant to grapple with these issues in a clear and decisive way.

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¹ 953 A.2d 227 (Del. 2008).

² See *infra* part II.

As in the takeover context, the court has fallen back on a fiduciary duty-based analysis precisely because it permits evasion of what is truly at stake. Through such analysis, the court has avoided the policy issue of who should possess a given form of power by transforming it into the doctrinal issue of whether the board's fiduciary duties permit that power to be exercised by shareholders. Absent legislative intervention, we can expect a bylaw jurisprudence exhibiting a theoretical obscurity and hands-off posture reminiscent of Delaware's takeover jurisprudence – a trend already evidenced by the holding in *CA, Inc.*³

I. THE SHAREHOLDERS' BYLAW AUTHORITY

Beyond the power to elect and remove directors, bylaw authority represents essentially the only statutory mechanism through which shareholders can bring their will to bear on the governance of a Delaware corporation.⁴ DGCL § 109 provides that “the power to adopt, amend or repeal bylaws shall be in the stockholders entitled to vote,” and that “bylaws may contain any provision, not inconsistent with law or with the [charter], 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.”⁵ This statute would appear to confer substantial authority upon the shareholders. However, two elements of the statute substantially qualify it. First, concurrent bylaw authority may be, and typically is, given to the board through the company's charter,⁶ raising the complex issue of whether shareholder bylaws may be amended or repealed later by the board. Second, bylaws cannot be “inconsistent with law,”⁷ raising the issue of the extent to which shareholders can utilize their power over bylaws to constrain the board's own statutory governance authority. Indeed, board authority under DGCL § 141(a) is similarly sweeping: “[t]he business and affairs of every corporation . . . 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 [charter].”⁸

³ See *infra* part III.

⁴ See DEL. CODE ANN. tit. 8, §§ 211(b), 141(k) (2009). Shareholders can also dissolve the corporation unilaterally, but only by unanimous written consent. See DEL. CODE ANN. tit. 8, § 275(c) (2009).

⁵ DEL. CODE ANN. tit. 8, § 109(a)-(b) (2009).

⁶ See DEL. CODE ANN. tit. 8, § 109(a). See also DAVID A. DREXLER, LEWIS S. BLACK, JR. & A. GILCHRIST SPARKS, III, *DELAWARE CORPORATION LAW AND PRACTICE* § 9.02 (2008); Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?*, 73 TUL. L. REV. 409, 470 (1998).

⁷ DEL. CODE ANN. tit. 8, § 109(b).

⁸ DEL. CODE ANN. tit. 8, § 141(a) (2009).

It is widely recognized that these statutes provide no meaningful guidance regarding how these grants of authority relate to each other.⁹ In fact, they appear to create a circularity that Jeffrey Gordon has termed the “recursive loop” – under § 109 bylaws cannot be “inconsistent with law,” including § 141; however, under § 141 the board’s authority is limited as “provided in this chapter,” which includes § 109.¹⁰ Not surprisingly, scholars have advanced sharply conflicting views on the interaction of these provisions. Lawrence Hamermesh has argued that no limits on board authority should be permitted through bylaws except where a provision other than § 109 explicitly envisions it.¹¹ Others, however, have observed that this reading renders the expansive language of § 109 pointless.¹² Perhaps the most influential effort to reconcile these provisions has been offered by John Coffee, who argues that shareholder bylaws are more likely to pass muster if they relate to “fundamental” matters (as opposed to “ordinary” matters), “negative” constraints on action (as opposed to “affirmative” instructions), “procedural” matters (as opposed to “substantive” business decisions), and matters of general “governance” (as opposed to specific matters).¹³ Coffee’s approach has garnered both adherents and detractors.¹⁴

Meanwhile, the stakes grow ever higher as activist shareholders continue to advance bylaw proposals that implicate core governance matters such as takeover defenses, proxy access, and board elections.¹⁵ This, once again, raises the issue of who ultimately controls the corporation. In 2006, Lucian Bebchuk, as a shareholder of CA, Inc., sought a declaratory judgment on the validity of a proposed bylaw that required adoption or extension of a poison pill to be approved either by shareholders

⁹ See, e.g., Christopher M. Bruner, *The Enduring Ambivalence of Corporate Law*, 59 ALA. L. REV. 1385, 1423-24, 1444-47 (2008); John C. Coffee, Jr., *The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?*, 51 U. MIAMI L. REV. 605, 606-08 (1997); Jeffrey N. Gordon, *“Just Say Never?” Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett*, 19 CARDOZO L. REV. 511, 544-47 (1997); Brett H. McDonnell, *Bylaw Reforms for Delaware’s Corporation Law*, 33 DEL. J. CORP. L. 651, 659-60 (2008); Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: “Sacred Space” in Corporate Takeovers*, 80 TEX. L. REV. 261, 319-20 (2001).

¹⁰ See Gordon, *supra* note 9, at 546-47.

¹¹ See Hamermesh, *supra* note 6, at 430-44.

¹² See, e.g., Brett H. McDonnell, *Shareholder Bylaws, Shareholder Nominations, and Poison Pills*, 3 BERKELEY BUS. L.J. 205, 213-15 (2005); Thompson & Smith, *supra* note 9, at 321.

¹³ See Coffee, *supra* note 9, at 613-15.

¹⁴ Compare McDonnell, *supra* note 9, at 660-61 (endorsing Coffee’s latter two factors), with Hamermesh, *supra* note 6, at 432-44 (rejecting Coffee’s factors as “fail[ing] to afford either predictability or even compelling logic.”).

¹⁵ See, e.g., McDonnell, *supra* note 9, at 651-52.

or by unanimous vote of the board on an annual basis.¹⁶ Although Vice Chancellor Lamb indicated that such a bylaw could potentially be found valid,¹⁷ he ultimately refused to provide declaratory relief on ripeness grounds, leaving the question unanswered.¹⁸

Due to the unsettled state of Delaware law, “federal law has been the realm within which most of the debate has taken place,” as boards and shareholders have sought to persuade the Securities and Exchange Commission (“SEC”) that various proposed bylaws could or could not be excluded from public company proxy statements under Securities Exchange Act Rule 14a-8.¹⁹ Such guidance has inevitably been limited, however, by the fact that the pertinent bases for exclusion hinge on state law – notably whether the proposed bylaw is “a proper subject for action by shareholders” in the jurisdiction of incorporation and whether the bylaw “would, if implemented, cause the company to violate any state, federal, or foreign law to which it is subject.”²⁰

II. THE EMERGING ANALYTICAL FRAMEWORK

CA, Inc. v. AFSCME Employees Pension Plan reflects the confluence of these state and federal dynamics. In June 2008 the SEC, taking advantage of a recent amendment to the Delaware Constitution, certified to the Delaware Supreme Court two questions regarding a proposed bylaw that AFSCME sought to include in *CA, Inc.*’s proxy statement.²¹ The proposed bylaw would have required the board to reimburse proxy expenses of shareholders nominating a short slate of board candidates where certain requirements were met.²² The SEC wanted to know whether the bylaw would run afoul of the Rule 14a-8 exclusions cited above, which turned on (1) whether it was “a proper subject for action by [Delaware]

¹⁶ See *Bebchuk v. CA, Inc.*, 902 A.2d 737, 738-39 (Del. Ch. 2006). Amendment or repeal would likewise require unanimous board approval. *Id.*

¹⁷ See *id.* at 742-43. See also Lucian A. Bebchuk et al., *On the Validity of Poison Pill By-Laws* (June 2006), available at <http://ssrn.com/abstract=928674> (providing Bebchuk’s brief from the case).

¹⁸ See *Bebchuk*, 902 A.2d at 740-42. The bylaw ultimately failed, receiving 41 percent of the vote. See WILLIAM T. ALLEN, REINIER KRAAKMAN & GUHAN SUBRAMANIAN, *COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION* 624 (2d ed. 2007).

¹⁹ See Robert B. Thompson, *Defining the Shareholder’s Role, Defining a Role for State Law: Folk at 40*, 33 DEL. J. CORP. L. 771, 778-82 (2008).

²⁰ See 17 CFR 240.14a-8(i)(1)-(2) (2009).

²¹ *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227, 229 (Del. 2008).

²² *Id.* at 229-30.

shareholders,” and (2) whether it would otherwise cause the company to violate Delaware law.²³

The court’s “proper subject” analysis focused on whether unilateral enactment of such a bylaw would “facially violate any provision of the DGCL,”²⁴ which brought the court to the recursive loop. Justice Jacobs resolved this issue in the board’s favor, reasoning that because the board’s management authority is “a cardinal precept of the DGCL,” § 141’s exception could not be construed as including § 109.²⁵ Consequently, the issue became whether the proposed bylaw would be “inconsistent with law” under § 109 itself, which Justice Jacobs clarified would include § 141’s grant of board authority.²⁶ He rejected CA’s argument, however, that board authority may not be limited through bylaws, recognizing that this would gut § 109 of any significance.²⁷ Noting that §§ 109 and 141 are “only marginally helpful” in ascertaining the scope of the shareholders’ bylaw authority, Justice Jacobs declined to adopt a single “bright line,” but did effectively endorse one of the factors advocated by Coffee – the distinction between “procedures” and “specific substantive business decisions.”²⁸ In this light, the “context and purpose” of the bylaw – facilitating shareholder participation in the board nomination process – supported the conclusion that the bylaw was indeed a proper subject for shareholder action.²⁹

The analysis of whether the bylaw would otherwise violate Delaware law, however, focused on common law. The court ultimately found that such a mandatory bylaw would force the board to breach its fiduciary duties if the board concluded that reimbursement of proxy expenses was not consistent with the company’s interests.³⁰ Citing to cases involving board action that hindered the board’s own ability to discharge its fiduciary duties (“no-shop” provisions and “delayed redemption” poison pills), Justice Jacobs rejected AFSCME’s argument that a shareholder-imposed constraint is a different matter.³¹ AFSCME took the view “that it is unfair to claim that the Bylaw prevents the CA board from discharging its fiduciary duty where the effect of the Bylaw is to relieve the board entirely of those

²³ *Id.* at 229-31.

²⁴ *Id.* at 231, 238.

²⁵ *Id.* at 232 n.7.

²⁶ *Id.*

²⁷ *Id.* at 234.

²⁸ *Id.* at 234-36.

²⁹ *Id.* at 235-37.

³⁰ *Id.* at 238.

³¹ *Id.* at 238-39.

duties in this specific area.”³² Characterizing this argument as “more semantical than substantive,” Justice Jacobs insisted that AFSCME’s bylaw “mandates reimbursement of election expenses in circumstances that a proper application of fiduciary principles could preclude.”³³ Those believing that such a shareholder bylaw should be permissible were urged to pursue a charter amendment, requiring board approval, or to “seek recourse from the Delaware General Assembly.”³⁴

III. FIDUCIARY DUTIES AND CORPORATE PURPOSE IN THE BYLAW DEBATE

The procedure/substance distinction applied in the court’s “proper subject” analysis has been relatively uncontroversial.³⁵ However, the application of fiduciary duties to assess whether the bylaw would otherwise violate Delaware law has given rise to sharp disagreement. Naturally, those favoring less shareholder action herald this approach, while those favoring more disparage it.³⁶ Virtually all seem to agree, however, that such bylaw proposals implicate core questions of corporate law and theory,³⁷ and it is through this lens that the court’s fiduciary duty-based approach comes into focus.

As Brett McDonnell observes, the court’s rejection of AFSCME’s argument as “more semantical than substantive” is itself less than compelling,³⁸ though perhaps not for the reason that McDonnell suggests. McDonnell endorses AFSCME’s argument on the logic that “where the beneficiaries of [the board’s fiduciary] duty, the shareholders, have decided to limit the board’s discretion because they do not trust the board on a particular matter, the need for a fiduciary duty limitation on the board ceases.”³⁹ This conclusion reflects McDonnell’s acceptance of economically-oriented arguments favoring shareholder power. Such arguments emphasize the value of experimentation through default governance rules and

³² *Id.* at 239.

³³ *Id.* at 239-40.

³⁴ *Id.* at 240. *See also* DEL. CODE ANN. tit. 8, § 242(b) (2009) (requiring board approval of charter amendments).

³⁵ *See* Frederick H. Alexander & James D. Honaker, *Power to the Franchise or the Fiduciaries?: An Analysis of the Limits on Stockholder Activist Bylaws*, 33 DEL. J. CORP. L. 749, 750-58 (2008); McDonnell, *supra* note 9, at 661-63.

³⁶ *Compare* Alexander & Honaker, *supra* note 35, at 764-66 (endorsing this approach) *with* McDonnell, *supra* note 9, at 664-69 (criticizing it as “unclear and ominous” for shareholders).

³⁷ *See, e.g.*, Alexander & Honaker, *supra* note 35, at 769; Gordon, *supra* note 9, at 547; Thompson & Smith, *supra* note 9, at 319-20.

³⁸ McDonnell, *supra* note 9, at 669.

³⁹ *Id.*

minimization of agency costs.⁴⁰ This leads McDonnell to assume that the shareholders can be treated as the singular beneficiaries of the board's fiduciary duties. This is not fully consistent with Delaware case law, however, which has long described fiduciary duties as being owed simultaneously to both "the corporation and its stockholders."⁴¹ This is precisely why the *CA, Inc.* court framed the issue of the proposed bylaw's legality by referring to the board's fiduciary duties.

I have argued elsewhere that Delaware corporate law is deeply ambivalent regarding the corporate governance role of shareholders, due principally to misgivings regarding the consistency of their interests and incentives with those of the larger public.⁴² This dynamic figures most prominently in the hostile takeover context, where shareholder interests directly conflict with those of other stakeholders, but shareholder bylaws are fundamentally similar in that they implicate the defining issues of corporate law.⁴³ In both contexts, shareholders deploy a generally accepted right (selling stock, enacting bylaws) in an arguably novel and creative manner with the purpose and effect of challenging the board's governance authority. In both types of cases, courts directly confront the core issue of corporate power, which necessarily implicates corporate purpose – that is, the aims and intended beneficiaries of corporate activity.⁴⁴

In each instance, then, we find the court evading these defining issues by the same means – reliance on an ambivalent formulation of fiduciary duties. In takeovers, the core issue of who should control whether a hostile tender offer succeeds is reframed as whether the board's fiduciary duties permit such a decision to be made by the shareholders themselves (or narrowly in their interests).⁴⁵ In *CA*,

⁴⁰ *Id.* at 654-57.

⁴¹ See, e.g., *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939); *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 99 (Del. 2007) (reiterating this formulation).

⁴² See Bruner, *supra* note 9, at 1449 ("Corporate law's ambivalence regarding power constituencies, regarding beneficiaries, and regarding the achievement of the social good, each reflect larger misgivings about the consistency of shareholders' interests and incentives with those of society at large."); Christopher M. Bruner, *Power and Purpose in the "Anglo-American" Corporation*, 50 VA. J. INT'L L. (forthcoming 2010), available at <http://ssrn.com/abstract=1431952> (contrasting this ambivalence with the stark shareholder-centrism of U.K. corporate governance and arguing that the degree of shareholder orientation in each system reflects the degree of stakeholder protection provided outside corporate governance).

⁴³ See, e.g., Bruner, *supra* note 9, at 1408-32.

⁴⁴ See generally Gordon, *supra* note 9 (discussing the effects of shareholder bylaws and takeover defenses on "the distribution of power between shareholders and the board of directors"); Lyman Johnson, *The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law*, 68 TEX. L. REV. 865 (1990) (discussing how hostile takeovers have forced courts to confront issues of corporate purpose).

⁴⁵ See, e.g., *Paramount Commc'n, Inc. v. Time, Inc.*, 571 A.2d 1140, 1154 (1990) (characterizing "selection of a time frame for achievement of corporate goals" as an element of fiduciary duty that

Inc. the court repeats this maneuver in the bylaw context. The core issue of who should control whether shareholder proxy expenses are reimbursed is reframed as whether the board's fiduciary duties permit such a decision to be made by the shareholders themselves (or narrowly in their interests).⁴⁶ In each case, the distinction is subtle but important – policy is restyled as doctrine, obscuring the fundamental nature of the issue, and preservation of board power is restyled as non-abdication of a broadly phrased preexisting duty.⁴⁷

It is telling that the *CA, Inc.* court more than once observes the lack of legislative action to clarify what the scope of the shareholders' bylaw authority ought to be.⁴⁸ This too resembles the takeover context, where the Delaware legislature has remained conspicuously absent while the courts have labored to delineate the scope of the shareholders' capacity to accept hostile tender offers.⁴⁹ I suggest that, if left to the courts, we can expect a Delaware bylaw jurisprudence exhibiting a theoretical obscurity strongly reminiscent of that characterizing its takeover jurisprudence,⁵⁰ an outcome reflecting the fact that Delaware's judges have again been placed in the awkward position of answering the core policy questions of corporate law.⁵¹ Federal pressure may, to be sure, force the Delaware legislature to address various bylaw-related issues in a piecemeal fashion.⁵² In the meantime, *CA, Inc.* shows the Delaware Supreme Court to be well along a familiar path.

“may not be delegated to the stockholders”); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (1985) (permitting boards to consider “constituencies” other than shareholders” in assessing proportionality of defensive measures).

⁴⁶ See *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 239-40 (Del. 2008).

⁴⁷ Cf. William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U. CHI. L. REV. 1067, 1070-71 (2002) (observing the tendency “to write judicial opinions in a way that obscures policy choices,” including in Delaware's takeover jurisprudence).

⁴⁸ See *CA, Inc.*, 953 A.2d at 234-35, 240.

⁴⁹ See Allen, Jacobs & Strine, *supra* note 47, at 1068 (describing this “legislative vacuum”).

⁵⁰ See, e.g., Gordon, *supra* note 9, at 515 (describing Delaware takeover opinions as “delphic”); Johnson, *supra* note 44, at 902 (arguing that Delaware's takeover jurisprudence aims to “harmonize management discretion with shareholder primacy while, in fact, sweeping the whole thing under the rug”).

⁵¹ See, e.g., Allen, Jacobs & Strine, *supra* note 44, at 1067-71.

⁵² See generally Thompson, *supra* note 19. J. Robert Brown speculates that the new DGCL § 112 permitting proxy access bylaws represents an attempt “to cut off the anticipated federal right.” See J. Robert Brown, *The SEC, Access and the Need to Preempt Delaware Law*, Apr. 23, 2009, available at <http://www.theracetothetbottom.org/preemption-of-delaware-law/the-sec-access-and-the-need-to-preempt-delaware-law.html>; see also DEL. CODE ANN. tit. 8, § 112 (2009); Facilitating Shareholder Director Nominations, 74 Fed. Reg. 29024 (proposed June 10, 2009); Press Release, U.S. Sec. & Exch. Comm'n, SEC Votes to Propose Rule Amendments to Facilitate Rights of Shareholders to Nominate

Directors (May 20, 2009), available at <http://www.sec.gov/news/press/2009/2009-116.htm>. The new § 113 similarly permits proxy expense reimbursement bylaws, though its list of potential “procedures or conditions” makes no mention of the board’s fiduciary duties. See DEL. CODE ANN. tit. 8, § 113 (2009). Practitioners express uncertainty as to whether this statutory provision “overrides” the court’s holding in *CA, Inc.* that Delaware law requires board discretion to deny reimbursement. See Sullivan & Cromwell LLP, *Corporate Governance of Delaware Corporations: Delaware Adopts Amendments to the Delaware General Corporation Law Relating to Corporate Governance*, at 4, Apr. 28, 2009, <http://www.sullcrom.com> (follow “Site Map” hyperlink; then follow “Publications” hyperlink; then type “Corporate Governance of Delaware” in search box). See also Eric S. Wilensky & Angela L. Priest, *Corporate Governance Developments in a Recessionary Environment*, 41 Sec. Reg. & L. Rep. (BNA) 921 (May 18, 2009) (observing that as “an opt-in statute,” the board could repeal a § 113 shareholder bylaw).