POWER TO THE FRANCHISE OR THE FIDUCIARIES?: AN ANALYSIS OF THE LIMITS ON STOCKHOLDER ACTIVIST BYLAWS

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ABSTRACT

This article questions the validity of stockholder-proposed bylaws that attempt to limit the managerial power of boards of directors of Delaware corporations. The authors conclude that certain bylaw proposals violate both the letter and spirit of Delaware corporation law because they would allow a faction of stockholders (who do not owe fiduciary duties to advance the interests of their fellow stockholders) to prevent director-fiduciaries from managing the corporation for the benefit of all stockholders. To support their conclusion, the authors discuss their concerns with three types of bylaw proposals urged by stockholder activists: bylaws that limit a board's power to adopt or continue a stockholder rights plan, bylaws that require a board to reimburse a stockholder for expenses incurred in conducting a proxy contest for director elections, and bylaws that require the board to include stockholder nominees on a corporation's proxy materials.

I. INTRODUCTION

Stockholder activism has changed the way many practitioners view corporate bylaws. In addition to serving as a repository of internal corporate housekeeping rules, bylaws have become a battleground for some stockholders to exercise greater control over the management of public companies.[1] Although the Delaware courts have not provided definitive guidance as to the validity of many bylaws that have been proposed by stockholder activists, Delaware's existing statutory and common law suggest that the corporate form's underlying structure is inconsistent with the use of mandatory bylaws to

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[1]Bylaws have become such a battleground because, under Delaware law, bylaws (unlike provisions of the certificate of incorporation) can be unilaterally adopted by stockholders. DEL. CODE ANN. tit. 8, § 109(a) (2001).

control corporate activity and curtail board authority. This structure allows assets held on behalf of a heterogeneous class of owners (stockholders) to be managed by fiduciaries (directors) who owe duties to the corporate enterprise and all of its stockholders. Thus, in the classic model, stockholders select directors, and directors oversee the management of the assets. This structure allows owners with very different profiles to pool their assets with confidence that no single group of dominating owners can "hijack" the corporate assets for its own purposes.[2]

A bylaw that effectively allows stockholders to make decisions as to the management of corporate assets runs counter to this principle and, accordingly, likely violates the Delaware statutory or common law. This article illustrates this point by discussing several specific bylaws proposed by stockholder activists.

II. REFORM IN THE RIGHT DIRECTION: STOCKHOLDER ACTIVIST BYLAWS THAT ARE VALID UNDER DELAWARE LAW

Although the debate about stockholder activist measures often centers on bylaws of doubtful validity, any attempt to sketch the outer limits of what a bylaw can provide should start by highlighting the considerable amount of private ordering that stockholders can achieve through the bylaws. Consistent with the dichotomy between the roles of stockholders and directors, bylaws that regulate how directors make decisions and how stockholders exercise their franchise are, for the most part, appropriate to the extent they operate in a manner that prevents directors from invading the stockholders' territory and prevents stockholders from usurping board authority. Section 109(b) of the Delaware General Corporation Law (DGCL), the provision that addresses the appropriate content of bylaws, authorizes the adoption of "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

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[2]This model is not the only way to manage pooled capital. The Delaware General Corporation Law (DGCL) provides stockholders the opportunity to opt into "close corporation" status, where the stockholders can directly manage the corporation. *See* DEL. CODE ANN. tit. 8, §§ 341-356 (2001). Similarly, "private equity" participants in the capital markets are likely to be heavily involved in the management of their investments. These other "stockholder-oriented" models, of course, do not work for the small diversified investor, who is unlikely to possess either the time or expertise to actively participate in the management of corporate assets. The authors believe that, in an era where an increasing percentage of Americans are being asked to fund their retirements through individual savings and investments, the needs of these small, diversified, long-term investors must not be ignored.

or the rights or powers of its stockholders, directors, officers or employees."[3] The DGCL also contains several other provisions that specifically permit the stockholders (or the board, if the charter authorizes the board to adopt bylaw amendments) to enact bylaw provisions relating to a wide variety of topics. Stockholder activists can (and in many instances do) take advantage of these DGCL provisions to effect significant changes in corporate governance. For example:

- Section 216 permits bylaws specifying the vote required for director elections.[4] In recent years, public corporations have taken advantage of section 216 to adopt bylaws that opt out of the plurality voting default rule set forth in that statute and instead require majority voting for uncontested director elections.[5] Stockholder activists assert that the adoption of majority voting permits stockholders to register a more meaningful dissent against current management by essentially authorizing a vote of "no confidence" in uncontested director elections.[6]

- Section 211(d) permits bylaws specifying who, other than the board of directors, may call special meetings of the stockholders.[7] In recent years, stockholder activists have urged the adoption of bylaws that permit stockholders to call special meetings.[8]

- Section 141(d) permits stockholders to adopt bylaws creating a staggered board of directors, in which directors are elected to serve three-year terms in one of three classes, with only one class facing election each year.[9] Staggered boards have fallen out of favor with

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[3] *Id.* § 109(b). Unless otherwise noted, all section references herein refer to the DGCL. In addition, references to the "certificate of incorporation" and the "charter" are used interchangeably to refer to the same governing document of the corporation.

[4] *Id.* § 216.

[5] *See* CLAUDIA H. ALLEN, STUDY OF MAJORITY VOTING IN DIRECTOR ELECTIONS 1 (2007), http://www.ngelaw.com/news/pubs_detail.aspx?ID=777 (noting that "66% of the companies in the S&P 500 and over 57% of the companies in the Fortune 500 have adopted a form of majority voting" for director elections).

[6] A. Gilchrist Sparks, III & James D. Honaker, *The Battle Over the Election Ballot: A Survey of the Movement to Reform the Director Election System for U.S. Corporations*, *in* SECURITIES REGULATION INSTITUTE 603, 609 (PLI Corp. Law & Practice Course, Handbook Series No. 11518, 2007), WL 1634 PLI/Corp 603.

[7] DEL. CODE ANN. tit. 8, § 211(d) (2001).

[8] *See* Lucian Ayre Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 871 (2005).

[9] DEL. CODE ANN. tit. 8, § 141(d) (2001).

many public investors recently, but they can serve to strengthen director independence and enhance the protection of small stockholders by essentially preventing a simple majority of stockholders from effecting drastic changes in board membership at a single annual meeting.

- Section 141(b) permits bylaws that govern certain aspects of board procedure, such as specifying the minimum number of directors necessary for a quorum, and the minimum vote required to take certain actions.[10]

- Section 141(b) permits bylaws establishing qualifications that a nominee must satisfy to be eligible for director election.[11]

- Section 141(h) permits bylaws that place restrictions on the board's power to fix its own compensation.[12]

- Section 145(f) permits bylaws that confer on directors or officers the right to indemnification or advancement of expenses.[13]

Even a brief survey of the DGCL demonstrates that stockholders are offered wide latitude in adopting bylaw measures that affect corporate governance. Procedural bylaws that establish rules as to how stockholders elect the fiduciaries and how those fiduciaries make decisions promote the fiduciary-centered model of corporate governance reflected in Delaware law.

III. LIMITATIONS ON BYLAW PROVISIONS: DECISIONS THAT ARE RESERVED FOR FIDUCIARY DECISION MAKERS

Despite the wide latitude for private ordering, it is also important to note that the list of items that may appear in the bylaws does not cover substantive decisions about corporate management. For example, the bylaws can specify the quorum and minimum vote requirements for board action, who is qualified to serve as a director, and even how long directors serve once they

[10] *Id.* § 141(b).
[11] *Id.*
[12] *Id.* § 141(h).
[13] DEL. CODE ANN. tit. 8, § 145(f) (2001).

are elected, but the DGCL stops short of authorizing bylaws that place restrictions on the actual decisions that a board can make.[14]

This distinction between regulating procedural aspects of the board's decision-making process and the selection of directors, on the one hand, and the actual decisions made by directors, on the other hand, is no accident. Indeed, other provisions of the DGCL—which may not be modified in a corporation's bylaws—specify that directors are vested with the ultimate power to manage the business and affairs of the corporation. Section 141(a) of the DGCL states, "The 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."[15] A plain reading of the statute would suggest that the bylaws cannot impose limits on the board's power to manage the corporation because section 141(a) permits variation from that rule in the charter, but not the bylaws.

Some commentators, however, posited a tension between sections 141(a) and 109(b), suggesting that the provisions of the DGCL, standing alone, would not resolve the question whether the bylaws may place limits on the board's power to manage the corporation. This perceived tension in the statute arose because section 141(a) permits alternative arrangements for managing the corporation "as may be otherwise provided" in the DGCL,[16] and,

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[14]The distinction between the process by which a decision is made and limitations on the substance of a board's decision is reflected in section 109(b) itself. Section 109(b) authorizes only bylaws "relating to" the business and affairs of the corporation and the rights or powers of the directors. *Id.* § 109(b). This language is more limiting than the parallel provision in section 102(b)(1), which authorizes provisions in the charter "creating, defining, limiting and regulating" the powers of the corporation and the directors. *Id.* § 102(b)(1). *See* CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227, 234-35 (Del. 2008) ("It is well-established Delaware law that a proper function of bylaws is not to mandate how the board should decide specific substantive business decisions, but rather, to define the process and procedures by which those decisions are made."); Lawrence Hamermesh, *The Shareholder Rights By-Law: Doubts from Delaware*, 20 CORP. GOV. ADVISOR, Jan./Feb. 1997, at 14 n.20 ("A by-law removing an entire category of business decisions from board authority . . . is quite distinct from a by-law that merely governs how board decisions are to be made . . . ."). *See also id.* at 10 ("By-laws of Delaware corporations do not customarily prescribe or limit the substantive content of business decisions.").

Indeed, the only "substantive" rights or restrictions that may expressly be placed in the bylaws involve placing restrictions on directors setting their own compensation and bylaws that confer on directors, officers, and agents of the corporation the right to be indemnified and advanced expenses for lawsuits. DEL. CODE ANN. tit. 8, §§ 141(h), 145(f) (2001). However, not even these decisions pertain to the management of the corporation, but only to certain aspects of how the managers and decision makers are compensated and shielded from liability in performance of those managerial duties.

[15]DEL. CODE ANN. tit. 8, § 141(a) (2001).

[16]*Id.*

in turn, section 109(b) (i.e., another "provision" of the DGCL) permits stockholders to adopt bylaws that "contain any provision, not inconsistent with law or with the certificate of incorporation."[17] Commentators suggested that the language in sections 141(a) and 109(b) creates a "recursive loop"[18] in which it is impossible to determine whether a bylaw that seeks to limit the board's power is invalid because it is contrary to section 141(a) and therefore "inconsistent with law," or whether it is consistent with law because the enabling provisions of section 109(b) are essentially incorporated by reference into the proviso "except as may be otherwise provided in this chapter," which appears in section 141(a).

Despite this posited tension, section 141(a)'s explicit reference to the certificate of incorporation suggests it is quite unlikely that the drafters of the provision intended that board action could be regulated in the bylaws. Indeed, practitioners and commentators who have studied this issue pointed out that the statute can be harmonized and the "loop" can in fact be "cut" by reading section 141(a) in a manner that does not permit bylaw provisions that limit the board's managerial power.[19] In a recent decision, the Delaware Supreme Court

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[17]*Id*. § 109(b).

[18]*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).

[19]As one commentator noted, under a more "natural[]" reading of this language, the reference to other DGCL provisions relates only to statutes that expressly provide for management of a corporation by persons other than directors, such as the DGCL provisions that permit court-appointed trustees, custodians, or receivers to manage the corporation in place of a board of directors. *See* Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?*, 73 TUL. L. REV. 409, 430-31 (1998) (citing DGCL section 226(b) as specifying the powers of court-appointed custodians; section 291 as specifying the powers of court-appointed receivers; and section 351 as providing for the management of statutorily defined "close corporations" by stockholders). This interpretation is also supported by the second sentence of section 141(a), which provides that when a charter (i.e., not the bylaws) delegates managerial power to persons other than directors, those persons must undertake the directors' duties, which further suggests that only the charter may vary the directors' managerial authority and by section 102(b)(7), which provides that the limited exculpation for breach of duty available to directors is also available to such persons. *See* DEL. CODE ANN. tit. 8, § 141(a) (2001) ("The 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. *If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation*.") (emphasis added); *id.* § 102(b)(7) ("A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director [for certain items set forth in the statute] . . . . All references in this paragraph to a director shall also be deemed to refer (x) to a member of the governing body of a corporation

expressly rejected the recursive loop argument and stated that "the shareholders' statutory power to adopt, amend or repeal bylaws is . . . limited by the board's management prerogatives under Section 141(a)."[20]

The Delaware Supreme Court's interpretation of sections 141(a) and 109(b) is consistent with the critical policies that underpin those provisions. One specific policy rationale stands out as an important reason to conclude that stockholders cannot adopt bylaws that limit or interfere with the board's managerial power: the stockholders cannot impose substantive limits on board decisions and cannot use the bylaws to make decisions for the board, because the stockholders do not generally owe the corporation and their fellow stockholders fiduciary duties. Under Delaware common law, the board's statutory authority to manage the corporation is accompanied by "concomitant" fiduciary duties to exercise that authority in the stockholders' best interests.[21] Thus, the directors owe duties of care, good faith, and loyalty to reach an informed decision on all matters that come before the board, and to reach that decision based on the best interests of the corporation and its stockholders. In contrast, stockholders have no such duties.[22]

In light of the common law, it is easy to understand why the Delaware Supreme Court held that the stockholders cannot use their statutory power to adopt bylaws to make management decisions: because stockholders do not owe fiduciary duties to the other stockholders. Moreover, this policy concern (i.e., that managerial power must be accompanied by fiduciary responsibility) is not addressed by pointing to the simple fact that the stockholders who have adopted the bylaw at issue are the "owners" of the corporate assets. As discussed above, Delaware's corporate law provides for the management of

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which is not authorized to issue capital stock, and (y) to such other person or persons, if any, who, pursuant to a provision of the certificate of incorporation in accordance with § 141(a) of this title, exercise or perform any of the powers or duties otherwise conferred or imposed upon the board of directors by this title.").

[20]CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227, 232 (Del. 2008). The court further explains that:

> [b]ecause the board's managerial authority under Section 141(a) is a cardinal precept of the DGCL, we do not construe Section 109 as an 'except[ion] . . . otherwise specified in th[e] [DGCL]' to Section 141(a). Rather, the shareholders' statutory power to adopt, amend or repeal bylaws under Section 109 cannot be 'inconsistent with law,' including Section 141(a).

Id. at 232 n.7.

[21]*See* Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281, 1292-93 (Del. 1998) (noting that directors owe fiduciary duties that are "concomitant" to their managerial authority under section 141(a) of the DGCL).

[22]*See* Bershad v. Curtiss-Wright Corp., 535 A.2d 840, 845 (Del. 1987) (noting that, except in limited circumstances, Delaware law does not impose fiduciary duties on stockholders and further noting that stockholders may make their decisions based on "personal profit" or even based on "whim or caprice").

pooled assets, and requires that fiduciaries manage the corporation in the best interests of the enterprise and its stockholders, and not simply take a direction from a stockholder majority.[23] Accordingly, stockholder activists cannot justify bylaw provisions that tread on the authority of corporate fiduciaries by relying solely on the fact that a majority of the stockholders support the substance of the provision embodied in the bylaw.[24]

There is a myriad of reasons that corporations are not run directly by stockholder vote. Stockholders cannot make fully informed decisions about management matters because they do not possess all of the information that directors have. Nor would it necessarily be in the corporation's best interests to disseminate such information publicly in order to seek stockholders' approval for management actions. Even if they could make informed decisions, not all stockholders would take action to maximize the net present value of the corporation. Some stockholders have investment horizons that are not consistent with maximizing a corporation's potential value on a risk-adjusted basis.[25] Stock may also be held by investors that are managed by agents who are not always economically incentivized to act in the best interests of the investor in its capacity as a stockholder, much less the interests of other stockholders of the corporation.[26] Moreover, recent scholarship has also demonstrated that

[23] *Cf.* Paramount Commc'ns Inc. v. Time Inc., Nos. 10,866, 10,670 & 10,935, 1989 Del. Ch. LEXIS 77, at *89 (Del. Ch. July 14, 1989), *reprinted in* 15 DEL. J. CORP. L. 700, 749-50 (1990) ("The corporation law does not operate on the theory that directors, in exercising their powers to manage the firm, are obligated to follow the wishes of a majority of shares. In fact, directors, not shareholders, are charged with the duty to manage the firm."), *aff'd*, 571 A.2d 1140 (Del. 1989).

[24] The Delaware courts sometimes use rhetoric evoking the "will of the stockholders" in a way that might suggest that the board must follow the wishes of a stockholder majority, even with respect to managerial decisions. *See* UniSuper Ltd. v. News Corp., No. 1699-N, 2005 Del. Ch. LEXIS 205, at *32 (Del. Ch. Dec. 20, 2005), *reprinted in* 31 DEL. J. CORP. L. 1186, 1199 (2006) (comparing, in dicta, the director-stockholder relationship to that of agent and principal). These broad pronouncements about following stockholder wishes, however, should be properly understood to apply only to those actions for which the DGCL requires stockholder approval. UniSuper Ltd. v. News Corp., No. 1699-N, 2006 Del. Ch. LEXIS 11, at *11-13 (Del. Ch. Jan. 19, 2006) (revised Jan. 20, 2006) (clarifying its prior opinion to note that the agent-principal analogy was intended only to illustrate that the directors could not use their fiduciary duties as an excuse to refrain from putting a charter amendment to a stockholder vote where, the court assumed, the board had contractually obligated itself to submit the amendment to stockholders).

[25] For example, many hedge funds and mutual funds have a short-term investment focus compared to index funds, pension funds, and individual investors. *See, e.g.*, Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1290-91 (2008).

[26] For example, a stockholder that is a pension fund for a labor union may use its influence as a stockholder to attempt to unseat directors in order to benefit the labor union rather than the pensioners. *See id.* at 1286; Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 795-96 (1993). A hedge fund manager also may have an incentive to push for risky management strategies for companies in which the hedge

instances may arise where voting power is vastly different from the economic interest of a given stockholder. The use of derivative contracts can enable a stockholder to exercise considerable voting power while having a significantly smaller economic interest in the corporation—or even an economic interest that is contrary to the best interests of the corporation.[27]

Clearly, stockholders do not speak with one voice and do not have a single, unified economic interest in a corporation. This fact, in itself, is not troubling. Delaware law permits stockholders to exercise their rights as stockholders in their own self-interest, absent special circumstances. This very freedom to take self-interested action, however, is mitigated by the presence of fiduciaries, who must take action in the interest of the enterprise. Only this fiduciary filter has the ability to protect minority investors from the "tyranny of the majority."[28] Without this filter, the small, long-term investor would have little assurance that it could safely participate in the equity markets alongside a professional investment class.[29]

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fund invests because the manager receives only the upside of the stock's performance (in the form of fees to manage the hedge fund) and does not share equivalent downside risk of a loss of equity value in the stock. Of course, there is nothing inherently wrong with these relationships. They simply gainsay the notion that polling stockholders is necessarily the best manner to make decisions that maximize a corporation's value.

[27]For example, an investor may enter into a hedge transaction so that its economic stake is not as great as its voting interest or, alternatively, so that its economic interest is adverse to the corporation. An investor may also enter into a "record date capture" strategy in which a stockholder borrows a large amount of stock as of the record date for a corporate action and either simply returns the shares after the record date or engages in a short sale transaction (i.e., to sell the borrowed stock and later purchase stock at an anticipated lower price to satisfy the obligations to the lender). In either event, the stockholder entitled to voting power through ownership on the record date may hold a far smaller economic position as of the meeting (because it has since sold the shares), and, in a short sale transaction, may possess an economic interest adverse to the corporation's interests. *See generally* Henry T.C. Hu & Bernard Black, *Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms*, 61 BUS. LAW. 1011, 1014-15 (2006). In addition, investors who are fully diversified with respect to a synergistic transaction between two corporations may support a deal at any price because they will share the benefits of the synergy and are indifferent to the allocation of value between two sets of stockholders.

[28]Of course, this system is imperfect, and sometimes fiduciaries fail. However, the important point is that, conceptually, the model is centered around a fiduciary concept, so that failures are recognized as such. Thus, if executives are overcompensated, we can name the issue: the directors, who owe fiduciary duties to stockholders to maximize value, are failing to do so by allocating assets unnecessarily to managers. If managers are overcompensated in a model centered on collective decision making by majority vote, then minority stockholders could not register a coherent objection if a majority of stockholders approved wildly inappropriate executive compensation because there would be no accountable fiduciary.

[29]There are instances where fiduciary or other equitable duties will be placed on a stockholder, or group of stockholders, who controls a majority of the corporation's voting power or who otherwise has the power to control the day-to-day affairs of the corporation. *See* Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1115 (Del. 1994). This case law, however, does not apply to unaffiliated stockholders who, constituting a majority, are each acting in their own interests.

To see how the DGCL and the common law overlay of fiduciary duties interact with respect to specific bylaws proposed by stockholder activists, the next three sections of this article explain how three types of bylaw proposals that stockholder activists have presented in recent proxy seasons either are, or should be, invalid as a matter of Delaware law: (1) bylaws limiting the board's power to adopt or continue a stockholder rights plan; (2) bylaws that purport to require the corporation to reimburse a stockholder for the expenses it incurs in a proxy contest for director elections; and (3) bylaws that purport to require the corporation to include a stockholder proposal (or nomination) in the corporation's proxy materials even though inclusion is not required by federal securities laws.[30]

IV. BYLAWS THAT PURPORT TO LIMIT A BOARD'S POWER TO ADOPT OR CONTINUE A STOCKHOLDER RIGHTS PLAN

Rights plan bylaw proposals have become a popular topic among practitioners and academics, and are also a favorite of many stockholder activists. These proposals relate to the board's adoption or continuance of stockholder rights plans. A rights plan is a corporate instrument that effectively dilutes the economic and voting interest of a would-be acquiror who buys a threshold amount of stock (typically fifteen or twenty percent of the outstanding stock) without prior board approval.[31] A rights plan can prevent a would-be acquiror from buying a corporation for less than fair value by forcing the acquiror to negotiate with the board. Because a rights plan can effectively block a hostile acquisition of shares of the corporation, many stockholder activists have

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[30]Although outside the scope of this article, there may also be reasons why even a charter cannot provide for provisions that limit the board's managerial power. Section 141(a) of the DGCL permits charter provisions that delegate the board's power to persons other than directors. DEL. CODE ANN. tit. 8, § 141(a) (2001). Yet, one can argue that such a charter-imposed delegation of authority must be accompanied by corresponding fiduciary duties. *See id.* § 102(b)(7) (specifying that persons delegated director power pursuant to section 141(a) may also be exculpated by charter provision from liability for certain breaches of fiduciary duty, which suggests that persons delegated director power will owe fiduciary duties to the corporation and its stockholders); *see also id.* § 351 (permitting charters of statutory closely held corporations to vest managerial power in the stockholders, but when such a provision is effective "stockholders . . . shall be subject to all liabilities of directors"). Accordingly, it appears that while the charter can limit board power, it can do so only by taking managerial power from the directors and delegating it to substitute fiduciaries who accept the fiduciary responsibilities that accompany that power. *But cf.* Jones Apparel Group, Inc. v. Maxwell Shoe Co., Inc., 883 A.2d 837, 838 (Del. Ch. 2004) (upholding as valid a charter provision that prevented the board from fixing a record date for written consent actions, even though section 213(b) expressly vests the board with the power to fix a record date).

[31]A rights plan accomplishes this result by allowing all stockholders, except the person who has acquired the threshold stock amount, to buy additional stock at half price.

attempted to use the bylaws as a means to limit the board's power with respect to rights plans. Early iterations of these proposals purported to flatly prohibit the board from adopting a rights plan without prior stockholder approval and to require the board to redeem any existing rights plan.[32] Professor Lucian Bebchuk recently developed a more nuanced proposal, which requires that a stockholder rights plan either be approved by the stockholders or renewed for successive one-year terms by a supermajority vote of the board.[33] This more nuanced proposal is still a limitation on the board's power, i.e., the proposal would preclude the board from adopting a multi-year rights plan without stockholder approval.

As noted in the prior section, the validity of these bylaws should be tested against both the statutory provisions of the DGCL and the common law concepts of fiduciary duty. The specific question whether the bylaws may limit the board's power to adopt or maintain a rights plan can be answered definitively by reference to the DGCL. Section 157 vests the board with the exclusive power to issue rights to buy stock.[34] That same statute also specifies that the terms of such rights "shall be such as shall be stated in the certificate of incorporation, or in a resolution adopted by the board of directors providing for the creation and issue of such rights."[35] Moreover, rights plans are

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[32] *See, e.g.*, Novell, Inc., SEC No-Action Letter, 2000 SEC No-Act. LEXIS 212 (Feb. 14, 2000) (determining that the SEC would not recommend enforcement action if the company excluded the rights plan proposal in question).

[33] Bebchuk v. CA, Inc., 902 A.2d 737, 739 (Del. Ch. 2006). Professor Bebchuk presented one such proposal to the stockholders of CA, Inc., which provided:

> Section 1. . . . [R]ights agreement, or any other form of "poison pill" which is designed to or has the effect of making an acquisition of large holdings of the Company's shares of stock more difficult or expensive ("Stockholder Rights Plan") or the amendment of any such Stockholder Rights Plan which has the effect of extending the term of the Stockholder Rights Plan or any rights or options provided thereunder, shall require the affirmative vote of all the members of the Board of Directors, and any Stockholder Rights Plan so adopted or amended and any rights or options provided thereunder shall expire no later than one year following the later of the date of its adoption and the date of its last such amendment.
>
> Section 2. Section 1 of this article shall not apply to any Stockholder Rights Plan ratified by the stockholders.
>
> Section 3. Notwithstanding anything in these By-laws to the contrary, a decision by the Board of Directors to amend or repeal this Article shall require the affirmative vote of all the members of the Board of Directors.

Id. In that case, the Delaware Court of Chancery declined to rule on the validity of the bylaw because the matter was not ripe for judicial determination, but noted that the validity of the bylaw would require the court to answer some difficult issues of Delaware law. *Id.* at 742-43.

[34] DEL. CODE ANN. tit. 8, § 157(a) (2001).

[35] *See id.* § 157(b) ("The terms upon which, including the time or times which may be limited or unlimited in duration, at or within which, and the consideration (including a formula by

generally initiated by distributing the rights to stockholders through a dividend, an action that is also reserved to the board, subject only to restrictions included in the charter.[36]

Using the Bebchuk bylaw as an example, it should be clear that sections 157 and 170 prohibit the adoption of a bylaw that purports to limit the term of rights plans to successive, renewable one-year terms. Section 157 of the DGCL specifies that the terms and conditions of a right to buy stock, including "the time or times which may be limited or unlimited in duration" in which the right may be exercised, must be set forth in either the charter or in a resolution adopted by the board.[37] This means that the board controls the process for issuing rights to buy stock: the board can either unilaterally adopt a resolution creating the rights or adopt, and recommend for stockholder approval, a charter amendment to create such rights. The Delaware Supreme Court has stated that section 157, along with certain other provisions in the DGCL (such as section 141(a)), "confirm the board's exclusive authority to issue stock and regulate a corporation's capital structure."[38] Indeed, the Delaware courts have interpreted the provisions of section 157 literally to mean that *only* the board, and no one else, may specify the terms and conditions of rights to buy stock.[39] The Bebchuk proposal would violate section 157 because it attempts to usurp for the stockholders the power to determine that certain rights to buy stock must expire within one year unless they are approved by stockholders or

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which such consideration may be determined) for which any such shares may be acquired from the corporation upon the exercise of any such right or option, shall be such as shall be stated in the certificate of incorporation, or in a resolution adopted by the board of directors providing for the creation and issue of such rights or options, and, in every case, shall be set forth or incorporated by reference in the instrument or instruments evidencing such rights or options. In the absence of actual fraud in the transaction, the judgment of the directors as to the consideration for the issuance of such rights or options and the sufficiency thereof shall be conclusive.").

[36] *Id.* § 170(a) ("The directors of every corporation, subject to any restrictions contained in its certificate of incorporation, may declare and pay dividends upon the shares of its capital stock . . . .").

[37] *Id.* § 157(b).

[38] Grimes v. Alteon Inc., 804 A.2d 256, 261 (Del. 2002).

[39] *See id.* at 262 (invalidating a right to buy stock because, among other reasons, the CEO of the corporation rather than its board approved the right at issue); James v. Furman, No. 597-N, 2004 Del. Ch. LEXIS 181 (Del. Ch. Nov. 29, 2004) (holding that a stockholder stated an actionable claim that the directors violated section 157 by allegedly delegating to officers the power to make changes to certain terms in a rights plan).

The DGCL provides only one exception to the prohibition on directors delegating their power under section 157 to others: section 157(c) permits the board to delegate to an officer the power to allocate rights among employees of the corporation, provided that the board sets a ceiling on the number of rights that may be issued. DEL. CODE ANN. tit. 8, § 157(c) (2001). As one group of commentators has noted, other than this single, express exception, "directors have the exclusive right and duty to control and implement all aspects of the creation and issuance of options and rights." DAVID A. DREXLER ET AL., DELAWARE CORPORATION LAW AND PRACTICE § 17.06, at 17-30 (2007).

renewed by the board. The bylaw would inject into every stockholder rights plan a new term that would dictate when the rights expire. Under the express terms of section 157, such a bylaw is invalid because this global expiration provision would appear in neither the charter nor a board-adopted resolution. In other words, the bylaw is "inconsistent with law" and, therefore, falls outside of the scope of section 109(b) of the DGCL.

Moving from the express provisions of the DGCL to common law policy considerations, it is also clear that a rights plan bylaw, including a Bebchuk bylaw, should be invalid as a matter of Delaware law. The courts have recognized that rights plans enable the board to fend off hostile acquirors, either to buy time so that the board can auction the corporation to the highest bidder,[40] or, in certain circumstances, to allow the board to prevent an acquisition that it believes would not provide the stockholders full value for their stock.[41] The Delaware courts have recognized that there is a potential for conflicts of interest in that it may be difficult to determine whether the board is thwarting a hostile offer out of a desire to protect the stockholders or for a self-interested motivation to maintain their offices as directors. In response to this "omnipresent specter" of self-interest,[42] the Delaware courts carefully monitor a board's use of rights plans and can order a board to redeem a rights plan if its continued use is unreasonable under the circumstances.[43] In other words, the

[40] *See* CRTF Corp. v. Federated Dep't Stores, 683 F. Supp. 422, 439 (S.D.N.Y. 1988) (explaining that a rights plan "provides the directors with a shield to fend off coercive offers, and with a gavel to run an auction"); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 181 (Del. 1986) (noting that a rights plan "spurred the bidding to new heights, a proper result of its implementation").

[41] *See, e.g.*, Moore Corp. v. Wallace Computer Servs., Inc., 907 F. Supp. 1545, 1563-64 (D. Del. 1995) (applying Delaware law and finding that directors acted reasonably in maintaining a rights plan to deter a hostile acquiror because the board was in the process of enacting technological advances in the corporation that, in the board's view, would significantly increase the corporation's value once fully implemented); Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 278, 289-91 (Del. Ch. 1989) (finding that directors acted reasonably when they took action to deter a hostile acquiror because the corporation was about to begin trial on a potentially lucrative claim against a third party and the directors were in the best position to assess the value of that claim).

[42] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985).

[43] *See In re* Pure Res., Inc., S'holders Litig., 808 A.2d 421, 440, 446 n.49 (Del. Ch. 2002) (expressing, in dicta, a similar sentiment to that expressed in *Chesapeake Corp. v. Shore*, 771 A.2d 293, 324-29 (Del. Ch. 2000) (expressing some skepticism about the extent to which a board can reasonably take action to block a hostile offer in response to the threat that stockholders would accept an inadequate price because they are not informed of the corporation's real value)); *see also* Grand Metro. Pub. Ltd. v. Pillsbury Co., 558 A.2d 1049, 1060 (Del. Ch. 1988) (ordering redemption of rights so that stockholders could choose between an all-cash acquisition offer and a rival restructuring plan proposed by the board); City Capital Assocs. Ltd. P'ship v. Interco Inc., 551 A.2d 787, 803-04 (Del. Ch. 1988) (ordering directors to redeem rights where the board had concluded an auction to sell the corporation and where the results of the auction were so close that one bid could not reasonably be said to be superior to the other bid), *interlocutory appeal*

board's exclusive power to adopt and maintain a rights plan is accompanied by concomitant fiduciary duties to use the rights plan only in a manner that benefits the stockholders.

Permitting nonfiduciary stockholders to deprive the board of its authority to adopt rights plans would upset this carefully crafted balance of director power tested against the law of fiduciary duties. If stockholders could tie the board's hands and prevent the adoption or continuation of a rights plan through a stockholder-adopted bylaw to that effect, the bylaw could leave the corporation vulnerable to low-ball acquisitions that do not offer stockholders the best value for their shares. Moreover, there is no reason to assume that such a bylaw will be adopted out of an attempt to enhance stockholder value. The bylaw could be approved by stockholders who have a short-term interest in the corporation, stockholders who have a long-term interest in a hostile acquiror or stockholders who are fully diversified and may rationally support a deal at any price, even a price that is not favorable from the perspective of a stockholder of the corporation wishing to maximize the value of its stock in the corporation over the long term. The Delaware Supreme Court has referred to the decision whether to terminate a rights plan as one of the "fundamental management duties" that directors owe the corporation.[44] In fact, the Delaware Supreme Court has held that not even the board can tie its own hands by precluding itself from redeeming or terminating a rights plan for a specified

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dismissed, 556 A.2d 1070 (Del. 1988) (order issued without opinion); Mills Acquisition Co. v. Macmillan, Inc., No. 10,168, 1988 Del. Ch. LEXIS 138, at *56 (Del. Ch. Oct. 18, 1988) (holding that rights plan should not remain in effect following an auction to sell the corporation because the bids were so close in price and structure that there was no justification for precluding the stockholders from choosing between them), *rev'd on other grounds*, 559 A.2d 1261 (Del. 1989).

[44]Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281, 1291 (Del. 1998). In the *Quickturn* decision, the Delaware Supreme Court noted that:

> [t]he Delayed Redemption Provision [which provided that if a majority of the directors were replaced by stockholder action, the newly elected board could not redeem the rights for six months for the purpose of facilitating a transaction with an "Interested Person"] . . . would prevent a newly elected board of directors from *completely* discharging its fundamental management duties to the corporation and its stockholders for six months. While the Delayed Redemption Provision limits the board of directors' authority in only one respect, the suspension of the Rights Plan, it nonetheless restricts the board's power in an area of fundamental importance to the shareholders—negotiating a possible sale of the corporation.

Id. at 1291-92. *See also* MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc., 501 A.2d 1239, 1247 (Del. Ch. 1985) (stating that, when faced with an acquisition offer, "the directors have the right, even the duty, to adopt defensive measures to defeat a takeover attempt which is perceived as being contrary to the best interests of the corporation and its shareholders") (citation omitted), *aff'd*, 506 A.2d 173 (Del. 1986); *Unocal*, 493 A.2d at 955 & n.10 (stating that the directors' "duty of care extends to protecting the corporation and its owners from perceived harm whether a threat originates from third parties or other shareholders" and rejecting the proposition that "a board's response to a takeover threat should be a passive one").

period of time, unless such a limitation is approved by the board and the stockholders in a charter amendment.[45] There is no reason to believe that the result should be any different simply because stockholders, who owe no duties to the corporation or the other stockholders, and who may have quite divergent economic interests, wish to tie the board's hands to prevent or limit the board's power to use a rights plan either to fend off acquirors long enough to run an orderly auction of the corporation or to prohibit consummation of an offer that is not in the best interests of the corporation or its stockholders qua stockholders. In fact, in *CA, Inc. v. AFSCME Employees Pension Plan*, the Delaware Supreme Court recently held that the validity of a limitation on the directors' fiduciary duties does not turn on whether the limitation is imposed by the stockholders or directors.[46] In the context of determining that a bylaw requiring directors to reimburse stockholders for proxy expenses would have been invalid if adopted by the stockholders, the court compared the proposed stockholder limitation on director power to instances in prior case law where the board improperly limited its own authority.[47] The court noted that stockholder-imposed bylaw limitations and director-imposed limitations on board power should be treated the same.[48]

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[45] *Quickturn*, 721 A.2d at 1291-92.

[46] CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227, 239 (Del. 2008).

[47] *Id.* at 238-39. Specifically, the Delaware Supreme Court discussed two of its prior decisions. In the first decision, *Paramount Communications Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1994), the Delaware Supreme Court held that the board of Paramount Communications Inc. breached its fiduciary duties by deciding to enter into an agreement to be acquired by Viacom Inc., where the agreement prevented the Paramount board from entertaining a rival acquisition offer from QVC Network, Inc., because the Paramount board was aware of QVC's offer and the Paramount board acted unreasonably by refusing to consider that rival offer. *Id.* at 49. In the second decision, *Quickturn Design Systems, Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998), the Delaware Supreme Court invalidated a stockholder rights plan provision that, under certain circumstances, would have prevented the newly elected directors from redeeming the rights provided for in that plan, and therefore would have prevented them from pursuing a proposal to acquire the company, for a six-month period following their election to the board. *Id.* at 1291.

[48] *CA, Inc.*, 953 A.2d at 239 (noting that the bylaw at issue would "prevent the directors from exercising their full managerial power in circumstances where their fiduciary duties would otherwise require," and concluding that it does not "legally matter" for purposes of analyzing the bylaw's validity whether it is adopted by the board or the stockholders).

Of course, we do not believe this authority means that a board cannot limit the exercise of its fiduciary duties to the extent it enters into binding contracts, in which the board contractually limits its range of actions in exchange for bargained-for consideration. Such a contract can be entered into with a stranger to the corporation, or even with a stockholder, if the agreement involves a bargained for exchange of benefits. *See In re* infoUSA, Inc. S'holders Litig., 953 A.2d 963, 999 (Del. Ch. 2007) ("Every contract approved by a board of directors, after all, limits the discretion of the board in future transactions, but a board is empowered to make agreements with *other actors in commerce*, including its own shareholders.") (emphasis added). Thus, the board can agree not to issue stock for a specified period of time without obtaining the consent of a stockholder, where that

V. BYLAWS THAT PURPORT TO REQUIRE THE CORPORATION TO REIMBURSE A STOCKHOLDER FOR PROXY CONTEST EXPENSES

In an effort to encourage proxy contests, stockholder activists have also attempted to use bylaw proposals to usurp the board's managerial power to decide how to use funds from the corporate treasury by proposing bylaws that would require a stockholder to reimburse an insurgent stockholder for its proxy expenses if the stockholder is successful in electing director candidates, or if the stockholder manages to garner some specified percentage of the votes cast in a director election.[49] In the recent *CA, Inc.* decision, the Delaware Supreme Court held that such a bylaw would violate Delaware law if adopted by the stockholders.[50]

The statutory issue presented by a reimbursement proposal, whether to spend money from the corporation's treasury to reimburse a proxy contestant,

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stockholder has purchased stock for a price that includes the value of the board's promise not to issue additional equity without such approval. *See* Sample v. Morgan, 914 A.2d 647, 671-72 (Del. Ch. 2007). A board can also agree to exempt a stockholder from the terms of a stockholder rights plan in exchange for the exempted stockholder's agreement to enter into a "standstill" agreement that restricts its right to buy additional stock. *See infoUSA*, 953 A.2d at 998-99.

In our view, such commercial contracts differ from bylaw provisions that do not involve bargained-for consideration but instead are intended solely to alter the statutorily-mandated allocation of authority between current and future boards and between a board and the stockholders. *See CA, Inc.*, 953 A.2d at 239 (referring to the bylaw at issue as an "internal governance contract," i.e., not a commercial contract, that impermissibly limited the board's authority to deny a stockholder proxy contestant reimbursement of expenses).

[49]*See* Citigroup Inc., SEC No-Action Letter, 2006 SEC No-Act. LEXIS 300 (Mar. 2, 2006) (denying request for no-action with respect to a reimbursement proposal).

[50]For purposes of this article, we limit our discussion to the type of reimbursement bylaw proposal at issue in the *CA, Inc.* decision, which provided:

> RESOLVED, that pursuant to section 109 of the Delaware General Corporation Law and Article IX of the bylaws of CA, Inc., stockholders of CA hereby amend the bylaws to add the following Section 14 to Article II:
>
> The board of directors shall cause the corporation to reimburse a stockholder or group of stockholders (together, the "Nominator") for reasonable expenses ("Expenses") incurred in connection with nominating one or more candidates in a contested election of directors to the corporation's board of directors, including, without limitation, printing, mailing, legal, solicitation, travel, advertising and public relations expenses, so long as (a) the election of fewer than 50% of the directors to be elected is contested in the election, (b) one or more candidates nominated by the Nominator are elected to the corporation's board of directors, (c) stockholders are not permitted to cumulate their votes for directors, and (d) the election occurred, and the Expenses were incurred, after this bylaw's adoption. The amount paid to a Nominator under this bylaw in respect of a contested election shall not exceed the amount expended by the corporation in connection with such election.

CA, Inc., 953 A.2d at 229-30. It is important to note that the Delaware Supreme Court limited its analysis to the terms of the specific bylaw at issue.

involves the board's managerial power under section 141(a) to determine how the assets of the corporation should be used[51] and, therefore, arguably raises the perceived tension between that statute and section 109(b). Although the Delaware statute may not provide definitive guidance to test the validity of such a reimbursement bylaw, the common law provides a clear answer to whether such a bylaw is valid: under Delaware law, corporate funds cannot be used to pay any of a proxy contestant's expenses unless the directors determine, in accordance with their fiduciary duties, that the proxy contest involves issues of corporate policy and would, therefore, benefit all stockholders by informing them on the policy issues implicated by choosing one director over another.[52]

The policy test is a specific application of the more general common law requirement that fiduciaries manage the corporation: the board, in the exercise of its fiduciary duties, must determine that the proxy contest implicates matters of corporate policy (i.e., confers a benefit on the stockholders other than solely the proxy contestant) in order to justify using corporate funds to defray the contestant's expenses. A bylaw that provides for automatic payment of expenses, without any inquiry into whether the contest benefited the entire stockholder electorate, would violate the policy test and, more broadly, would violate the fiduciary underpinning of Delaware law (i.e., that corporate funds are expended only in a manner calculated to benefit all stockholders, not just a stockholder faction conducting a proxy contest for its own selfish interests). Indeed, the Delaware Supreme Court held that such a

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[51] *Cf.* UIS, Inc. v. Walbro Corp., No. 9323, 1987 Del. Ch. LEXIS 490, at *7 (Del. Ch. Oct. 6, 1987) (refusing to grant a temporary restraining order that would have prevented a corporation from expending corporate funds because the directors "are charged with deciding what is and what is not a prudent or attractive investment opportunity" for the corporation); *see also* Hollinger Inc. v. Hollinger Int'l, Inc., 858 A.2d 342, 387 (Del. Ch. 2004) (noting that even a controlling stockholder "must live with the informed . . . and good faith . . . business decisions" of the directors in deciding whether to sell corporate assets).

[52] *See* Hand v. Mo.-Kan. Pipe Line Co., 54 F. Supp. 649, 650 (D. Del. 1944) (summarizing *Hall v. Trans-Lux Daylight Picture Screen Corp.*, 171 A. 226 (Del. Ch. 1934)). The courts have applied this "policy test" to ensure that proxy solicitation expenses are paid only when that expenditure informs stockholders on policy issues decided in a proxy contest, and are therefore "in the interest of an intelligent exercise of judgment on the part of the stockholders upon policies to be pursued," rather than solely for the "personal interests" of persons seeking office. *Trans-Lux*, 171 A. at 228. *See* Levin v. Metro-Goldwyn-Mayer, Inc., 264 F. Supp. 797, 802 (S.D.N.Y. 1967); Steinberg v. Adams, 90 F. Supp. 604, 607-08 (S.D.N.Y. 1950) (applying Delaware law); *Hand*, 54 F. Supp. at 650 (applying Delaware law); *CA, Inc.*, 953 A.2d at 240; Hibbert v. Hollywood Park, Inc., 457 A.2d 339, 344 (Del. 1983); Essential Enters. Corp. v. Dorsey Corp., No. 1171, 1960 WL 56156, at *2 (Del. Ch. Dec. 15, 1960); Campbell v. Loew's, Inc., 134 A.2d 852, 864 (Del. Ch. 1957); Empire So. Gas Co. v. Gray, 46 A.2d 741, 744-45 (Del. Ch. 1946); *Trans-Lux*, 171 A. at 228.

reimbursement bylaw would violate Delaware law precisely because it does not "reserve to [the] directors their full power to exercise their fiduciary duty to decide whether or not it would be appropriate, in a specific case, to award reimbursement at all."[53]

Proponents of reimbursement bylaws would no doubt argue that such a bylaw is not as offensive to the fiduciary decision-making model as other proposals, such as rights plan bylaws, because a reimbursement bylaw is intended to enhance the stockholders' ability to elect new directors, not to make decisions for the directors that are ultimately elected. The *CA, Inc.* decision offers some indirect support for this statement. Prior to concluding that the proposal would violate Delaware law, the Delaware Supreme Court held that the reimbursement bylaw was a proper subject for stockholder action because it related to the process by which stockholders elected directors.[54] Essentially, this conclusion is a recognition that the stockholders can use their power to amend the bylaws to adopt "housekeeping" measures (e.g., provisions that relate to the process by which stockholders elect directors or by which directors make decisions). The Delaware Supreme Court also noted that the imposition of these process-related bylaws may require the company to expend funds to facilitate this exercise of stockholder power.[55] However, by holding that the reimbursement bylaw at issue was nevertheless invalid because it would impermissibly limit the board's fiduciary duties, the Delaware Supreme Court recognized that a proxy contest can have real-world effects on the management of a corporation, and a board must possess the discretion to deny reimbursement under specific circumstances.[56] Thus, the stockholders' power

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[53]*CA, Inc.*, 953 A.2d at 240. Of course, as the Delaware Supreme Court noted, a board decision to deny reimbursement, like any other board decision, is subject to judicial review of whether the board acted in accordance with its fiduciary duties. *Id.* at 240 n.35.

[54]*Id.* at 237.

[55]The Delaware Supreme Court noted:

> [A] bylaw that requires the expenditure of corporate funds does not, for that reason alone, become automatically deprived of its process-related character. A hypothetical example illustrates the point. Suppose that the directors of a corporation live in different states and at a considerable distance from the corporation's headquarters. Suppose also that the shareholders enact a bylaw that requires all meetings of directors to take place in person at the corporation's headquarters. Such a bylaw would be clearly process-related, yet it cannot be supposed that the shareholders would lack the power to adopt the bylaw because it would require the corporation to expend its funds to reimburse the directors' travel expenses.

Id. at 236.

[56]The Delaware Supreme Court offered a concrete example of an instance where the board might, consistent with its fiduciary duties, deny reimbursement: i.e., if a group of stockholders were affiliated with a competitor of the company and sought election to the company's board in order to

to adopt bylaws that relate to the process for electing directors may be trumped by the board's managerial responsibility to ensure that corporate funds are not wasted or used for an improper purpose. In the case of a reimbursement bylaw, *CA, Inc.* suggests that such bylaws are permissible, process-related provisions, but that such provisions must permit directors to exercise their fiduciary duties not to provide reimbursement under circumstances where such reimbursement would not further the interest of promoting an election contest involving valid corporate issues.

VI. BYLAWS THAT PURPORT TO REQUIRE THE CORPORATION TO INCLUDE NOMINEES OR PROPOSALS (OTHER THAN RULE 14a-8 PROPOSALS) IN THE CORPORATION'S PROXY STATEMENT

In a recent attempt to push the envelope in the arena of stockholder-adopted bylaws, Professor Lucian Bebchuk sent proposals to public companies seeking the adoption of bylaws that would have required them to include a proposal in their proxy materials if the proposal met certain criteria.[57] The criteria for including a proposal in a corporation's proxy materials would be similar, but not identical, to the requirements of Rule 14a-8 of the Securities Exchange Act of 1934.[58] Thus, Professor Bebchuk's proposal represented an attempt to use state law to require companies to include stockholder proposals in the corporation's proxy materials, even if inclusion of the proposals would not be required by Rule 14a-8.[59] The proposals follow a wave of stockholder access proposals to adopt bylaws requiring corporations to include stockholder nominees for director elections in the corporation's proxy materials.[60]

This type of proposal also violates the policies that are evidenced by the DGCL and the Delaware common law. In some respects, this proposal raises the same issues as a proxy expense reimbursement bylaw because it would require the corporation to use corporate funds (i.e., use of the corporation's own proxy materials) to allow a stockholder to solicit proxies for a nominee or

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obtain access to the company's proprietary information. *Id.* at 240 n.34.

[57]*See, e.g.*, McDonald's Corp., SEC No-Action Letter, 2008 SEC No-Act. LEXIS 115 (Jan. 31, 2008) (noting that proponent withdrew his proposal prior to a no-action determination).

[58]See the various requirements of Rule 14a-8 set forth in 17 C.F.R. § 240.14a-8 (2008).

[59]Professor Bebchuk's proposal is likely a response to his dissatisfaction with the Securities and Exchange Commission's current policies for excluding proposals under Rule 14a-8.

[60]It should be clear that the absence of such a bylaw does not in any way prevent stockholders from making proposals or nominations for director; it merely requires that such stockholders use their own resources if they wish to solicit proxies for such proposals and nominees rather than using corporate resources.

a proposal and would not afford directors the opportunity to exclude the nominee or proposal from the proxy materials if they believed their fiduciary duties so required. Thus, the stockholder access proposals relating to nominees arguably are process-related bylaws that suffer from the same deficiencies as reimbursement bylaws.

The latest proposal, which would extend access to proposals for other business, however, raises more specific problems under the DGCL. These principles are specifically embodied in section 146 of the DGCL, which governs the board's ability to agree to submit matters to a stockholder vote: "A corporation may agree to submit a matter to a vote of its stockholders whether or not the board of directors determines at any time subsequent to approving such matter that such matter is no longer advisable and recommends that the stockholders reject or vote against the matter."[61] The language "whether or not the board of directors determines at any time *subsequent to approving* such matter"[62] necessarily contemplates that a board must approve a matter before agreeing to submit it to stockholders. Similarly, the language "*no longer* advisable"[63] necessarily contemplates that a board will have previously determined that submitting the matter was advisable before agreeing to submit it to stockholders. Indeed, the purpose of section 146—permitting a corporation to agree to submit a matter to the vote of its stockholders if the board reverses its approval—is built upon a presumption that directors must first approve a matter before submitting it to a stockholder vote.[64]

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[61]DEL. CODE ANN. tit. 8, § 146 (2001).

[62]*Id.* (emphasis added).

[63]*Id.* (emphasis added).

[64]The history of section 146 confirms this plain reading. As practitioners have commented, section 146 emerged in response to two developments in Delaware corporation law—the Delaware Supreme Court's decision in *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), and the Delaware legislature's 1998 amendments to section 251 of the DGCL. *See* LEWIS S. BLACK, JR. & FREDERICK H. ALEXANDER, ANALYSIS OF THE 2003 AMENDMENTS TO THE DELAWARE GENERAL CORPORATION LAW (2003) (on file with authors). In *Van Gorkom*, the Delaware Supreme Court held that a board of directors could not submit a merger to a stockholder vote if it had withdrawn its recommendation. *Van Gorkom*, 488 A.2d at 888-89. In 1998, the Delaware legislature amended section 251, the DGCL provision addressing mergers, to reverse the *Van Gorkom* rule by providing that directors would be permitted to change their recommendation without withdrawing the merger agreement from stockholder consideration. *See* LEWIS S. BLACK, JR. & FREDERICK H. ALEXANDER, ANALYSIS OF THE 1998 AMENDMENTS TO THE DELAWARE GENERAL CORPORATION LAW (1998) (on file with authors). In 2003, the Delaware legislature introduced and passed section 146 to "clarify that the rule previously codified at Section 251 . . . applies to *any matter* submitted to stockholders." *See* 74 Del. Laws, c. 84, § 3 (2003) (emphasis added); *see generally* EDWARD P. WELCH ET AL., FOLK ON THE DELAWARE GENERAL CORPORATION LAW § 146.1 (5th ed. 2007 & Supp. 2008). Throughout this legislative history—through *Van Gorkom*, the amendments to section 251, and the passage of section 146—one rule persisted and now undergirds section 146: before a corporation agrees to submit a matter to a stockholder vote, the board must approve the

Of course, nothing in Delaware law prohibits a stockholder from soliciting its own proxies to present a proposal to the stockholders. A stockholder may spend its own funds on soliciting proxies, but the other stockholders should not be forced to foot the bill for the solicitation (either in the form of reimbursement or a Rule 14a-8-like bylaw) unless the directors have determined that this expenditure, like any other corporate expenditure, benefits the corporation and all its stockholders.

VII. CONCLUSION

Stockholder activists will certainly continue to test the limits of Delaware law with bylaw proposals that curtail board authority. When the Delaware courts confront the validity of these aggressive bylaws, however, the viability of the basic corporate model will be at issue: validation of non-process-related bylaws, or process-related bylaws without fiduciary savings provisions would constitute a serious challenge to the idea that investors can safely pool their assets in the corporate form because fiduciaries are required to manage the corporation in the best interests of all stockholders. Viewed from this perspective, it should be clear that many of these bylaw proposals should fail as an impermissible attempt to usurp for the stockholders those responsibilities vested in the board. Because stockholders do not bear the fiduciary duties to act in the best interests of all stockholders, vesting them with the power of directors to manage corporate assets would constitute a radical redistribution in managerial power under Delaware common and statutory law.[65]

The basic corporate structure—fiduciaries managing assets for stockholders—has proven to be a highly successful vehicle for building stockholder wealth that remains available to individual, long-term investors. Changing that structure—by allowing stockholders to directly manage corporate assets through bylaw changes—is a risky experiment that could do lasting damage to the ability of public corporations to function as capital raising vehicles and, consequently, could damage the global economy.

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submission.

[65]Indeed, in response to the rise in stockholder activism, two commentators have recently suggested that stockholders should be subject to a limited fiduciary duty of loyalty that would be triggered "whenever a shareholder successfully employs its shareholder status to promote a corporate action that gives it a personal, material economic benefit to the detriment or exclusion of other shareholders." Anabtawi & Stout, *supra* note 25, at 1307.