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PRIVATE ORDERING WITH SHAREHOLDER BYLAWS

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In this Article, we propose legal reforms to empower shareholders in public corporations. Currently, most shareholders participate in corporate governance in three ways: they vote, they sell, and they sue. We would expand the menu for shareholders in public corporations by enabling them to contract using shareholder bylaws. We contend that such private ordering will improve shareholder monitoring of managers and create laboratories of corporate governance that benefit the entire corporate governance system.

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INTRODUCTION

In early 2011, shareholders of Airgas, Inc. had a problem.[1] They wanted to sell their Airgas shares to Air Products and Chemicals, Inc., but the board of directors of Airgas would not take actions necessary to allow the sale.[2] Air Products had made its "best and final" offer for Airgas shares, but the Airgas board of directors said the offer was "clearly inadequate."[3] Thwarted in their desire to sell,[4] the Airgas shareholders sued the directors of Airgas in the Delaware Court of Chancery, claiming that the directors were breaching their fiduciary duties under Delaware law.[5]

In deciding the fiduciary claim, Chancellor William Chandler wrote, "[T]his case brings to the fore one of the most basic questions animating all of corporate law, which relates to the allocation of power between directors and stockholders . . . . [Namely,] in the context of a hostile tender offer, who gets to decide when and if the corporation is for sale?"[6]

1. Air Prods. & Chems., Inc. v. Airgas, Inc., 16 A.3d 48, 56 (Del. Ch. 2011).

2. Specifically, the board of directors of Airgas would not redeem the Shareholder Rights Plan (more commonly known as the "poison pill"), which effectively prevented Air Products from completing its tender offer for Airgas shares. *Id.* at 55–56.

3. *Id.* at 56.

4. In his decision, Chancellor Chandler noted that "a majority of Airgas's stock was held by merger arbitrageurs." *Id.* at 105. When a company becomes the target of a hostile takeover, the shareholders change rapidly and dramatically as arbitrageurs purchase large blocks of shares. Arbitrageurs are short-term investors attempting to profit by betting on the success of the hostile takeover bid. Having linked their financial interests to a successful takeover, arbitrageurs may be willing to accept an "inadequate offer" simply to ensure the sale of their shares. *Id.*

5. The fiduciary claim in this case arose under the *Unocal* standard, which applies when the Delaware courts are asked to consider whether a poison pill is being used in accordance with the board of directors' fiduciary obligations. Unocal Corp. v. Mesa Petrol. Co., 493 A.2d 946, 949 (Del. 1985).

6. *Airgas*, 16 A.3d at 54.

Chancellor Chandler's grudging answer to this question was the following: "[A]s Delaware law currently stands, the answer must be that the power to defeat an inadequate hostile tender offer ultimately lies with the board of directors."[7]

Chancellor Chandler felt "constrained by Delaware Supreme Court precedent" to rule in favor of the Airgas directors, even though his "personal view" was that the shareholders of Airgas should be allowed to sell.[8] The Airgas case is the latest in a long line of Delaware cases in which a board of directors defied its own shareholders.[9] Under modern corporation statutes, like Delaware's, shareholders have few options in circumstances like these. Generally speaking, shareholders in public corporations do three things: they sell, they vote, and they sue.[10] As illustrated by the Airgas case, however, even with these three powers, shareholders have limited ability to pursue their own interests.

In this Article, we propose to empower shareholders in public corporations by facilitating their ability to contract.[11] Shareholders in closely held corporations routinely use private ordering[12] in the form of shareholder agreements and other contractual arrangements to impose order on the business of the corporation and to regulate the conduct of its

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7. *Id.* at 55.

8. *Id.* at 57 ("In my personal view, Airgas's poison pill has served its legitimate purpose. . . . The record . . . confirm[s] that Airgas's stockholder base is sophisticated and well-informed, and that essentially all the information they would need to make an informed decision is available to them. In short, there seems to be no threat here—the stockholders know what they need to know (about both the offer and the Airgas board's opinion of the offer) to make an informed decision."). Air Products withdrew its tender offer immediately after the release of Chancellor Chandler's opinion. Press Release, *Air Products Withdraws Offer for Airgas*, AIR PRODS. (Feb. 15, 2011), http://www.airproducts.com/company/news-center/2011/0215-air-products-withdraws-offer-for-airgas.aspx.

9. Perhaps the most famous of these cases is *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1989), in which the board of directors of Time succeeded in merging with Warner Communications, Inc. over the objection of many shareholders who wanted to accept a tender offer from Paramount.

10. *See* Robert B. Thompson, *Preemption and Federalism in Corporate Governance: Protecting Shareholder Rights to Vote, Sell, and Sue*, 62 LAW & CONTEMP. PROBS. 215, 216 (1999).

11. Professor Julian Velasco designates the right to elect directors and the right to sell shares as "the fundamental rights of the shareholder." Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. DAVIS L. REV. 407, 409 (2007). Professor Velasco also describes other legal rights of shareholders, including the right to receive dividends, *id.* at 413–14, the right to vote on fundamental matters, *id.* at 419, the right to inspect the corporation's books and records, *id.* at 420, and the right to sue, *id.* at 421–24. Professor Velasco does not mention the right to contract, perhaps because this right is not distinctive to shareholders, but is a general right available to all persons having the capacity to contract.

12. Consistent with the most common usage in corporate law scholarship, we use the term "private ordering" as a near synonym for "contracting" or "transacting." *See, e.g.*, Lucian A. Bebchuk & Scott Hirst, *Private Ordering and the Proxy Access Debate*, 65 BUS. LAW. 329, 334 (2010). Some legal scholars use "private ordering" to connote a "delegation of regulatory authority to private actors." Steven L. Schwarcz, *Private Ordering*, 97 NW. U. L. REV. 319, 319 n.2 (2002). Economists use "private ordering" in an entirely different way, to suggest the enforcement of contracts outside of public courts. *See, e.g.*, Barak D. Richman, *Firms, Courts, and Reputation Mechanisms: Towards a Positive Theory of Private Ordering*, 104 COLUM. L. REV. 2328, 2329 (2004).

affairs.[13] We embrace the notion that the main purpose of governance rules is to mitigate transaction costs,[14] and the private ordering that we observe in closely held corporations is widely admired for tailoring the general principles of corporate law to particular firms.[15]

We believe that shareholders in public corporations would also benefit from expanded private ordering. This belief is inspired by a simple but profound insight from transaction cost economics, namely, that different firms have different attributes that require different governance structures.[16] This so-called "discriminating alignment hypothesis" implicitly motivates praise for "enabling" statutes in corporate law,[17] the assumption being that an "enabling statute allows managers and investors to write their own tickets, to establish systems of governance without substantive scrutiny from a regulator and without effective restraint on the permissible methods of corporate governance."[18] But those statutes, when combined with federal regulations of corporate governance, have produced public corporations that are almost uniform in one important respect: managers govern corporations, and shareholders participate only on the margins. We contend that this one-size-fits-all governance structure—typified by almost complete reliance on centralized decision making by directors and officers—is not merely an expression of market preferences, but a result of the hard wiring of corporate law. We propose several modest reforms that would enable private ordering by shareholders. We believe that these reforms would produce more diversity and experimentation in corporate governance, with benefits to particular firms and to the system as a whole.

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13. *See* Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 278–83 (1986) (observing that the lack of separation between management and risk bearing in closely held corporations has resulted in reliance on contractual arrangements for firm governance).

14. *See* Oliver E. Williamson, *Comparative Economic Organization: The Analysis of Discrete Structural Alternatives*, 36 ADMIN. SCI. Q. 269, 277 (1991) ("The discriminating alignment hypothesis to which transaction-cost economics owes much of its predictive content holds that transactions, which differ in their attributes, are aligned with governance structures, which differ in their costs and competencies, in a discriminating (mainly, transaction-cost-economizing) way.").

15. *See* Charles R. O'Kelley, Jr., *Filling Gaps in the Close Corporation Contract: A Transaction Cost Analysis*, 87 NW. U. L. REV. 216, 242–53 (1992).

16. See Williamson, supra note 14, at 277.

17. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, The Corporate Contract, 89 Colum. L. Rev. 1416, 1418 (1989) ("No one set of terms will be best for all; hence the 'enabling' structure of corporate law.").

18. *Id.* at 1417. Of course, even an "enabling" account acknowledges the fact that "many features of corporate law, great and small, are mandatory." *See* Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1553 (1989). Likewise, we acknowledge that mandatory terms can have value, even in a system characterized by freedom of contract. *See id.* at 1554 ("The existence of some mandatory rules may lead to better contracts."); Edward P. Welch & Robert S. Saunders, *Freedom and Its Limits in the Delaware General Corporation Law*, 33 DEL. J. CORP. L. 845, 847–48 (2008) ("[M]andatory terms guarantee that certain core qualities are associated with the particular 'brand' of business entity called a 'Delaware corporation.'"). Our goal here is not to change the mix of enabling and mandatory terms within corporate law, but to encourage the participation of shareholders in those areas where corporate decision makers are given discretion.

The potential of private ordering to benefit shareholders in public corporations is evident in comparing *Airgas* with another Chancellor Chandler case, *UniSuper Ltd. v. News Corp.*,[19] in which shareholders of Rupert Murdoch's News Corporation entered into a contract regarding the corporation's poison pill.[20] This contract, which required a shareholder vote to extend the life of the poison pill, was part of a package of agreements between the corporation and the shareholders made in connection with News Corporation's re-incorporation from Australia to Delaware.[21] When the board of directors of News Corporation extended the term of the poison pill without a shareholder vote, the shareholders sued for breach of contract. The *UniSuper* case was settled prior to trial,[22] but in a pretrial opinion, Chancellor Chandler held that the complaint stated a cause of action for breach of contract.[23] If the Airgas shareholders had been parties to such a contract and had voted not to extend the life of the poison pill, they would have been able to accept the tender offer from Air Products.[24]

The main impediment to private ordering in public corporations is the difficulty of conducting a negotiation involving widely dispersed shareholders. Even in *UniSuper*, the contract was formed in a rather unusual way, through the combination of a press release and a letter sent by the company to all of its shareholders.[25] This unconventional method of

19. No. 1699-N, 2005 WL 3529317 (Del. Ch. Dec. 20, 2005).

20. Chancellor Chandler initially expressed skepticism regarding the alleged contract. *Id.* at *4 n.39 ("[I]t is not entirely clear why . . . plaintiffs accepted a promise to adopt a board policy, which is a more transitory right than a charter provision, especially when sophisticated parties such as these must have understood the significant difference between a charter provision and a board policy."). In a later proceeding, however, the defendants conceded the existence of the contract. *UniSuper Ltd. v. News Corp*, No. Civ.A. 1699-N, 2006 WL 207505, at *1 (Del. Ch. Jan. 19, 2006).

21. The package of agreements included three amendments to News Corporation's proposed certificate of incorporation, a voting agreement between News Corporation and Rupert Murdoch, and the agreement relating to the continuation of News Corporation's poison pill. *UniSuper*, 2006 WL 207505, at *1.

22. UniSuper Ltd. v. News Corp., 898 A.2d 344 (Del. Ch. 2006).

23. *See UniSuper*, 2006 WL 207505, at *5.

24. This statement assumes the contract would have been enforceable. The defendants in *UniSuper* argued that the contract would be unenforceable on two grounds: (1) the contract impinged on the board's management authority under Section 141(a) of the Delaware General Corporation Law (DGCL); and (2) the contract compromised the board's fiduciary discretion. *Id.* at *2–3. Chancellor Chandler found both claims facially implausible, but he certified the questions to the Delaware Supreme Court, which declined to answer. In *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227, 238 (Del. 2008), the Delaware Supreme Court subsequently decided that the board of directors' fiduciary duties did, in fact, constrain the ability of shareholders to engage in private ordering. We criticize that opinion below in Part II.B.3.

A contract purporting to limit the power of the board of directors with respect to a poison pill would face challenges beyond those raised in UniSuper. For example, two Delaware practitioners read section 157(a) of the DGCL as "vest[ing] the board with the exclusive power to issue rights to buy stock." 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, 759 (2008).

25. *UniSuper*, 2006 WL 207505, at *1–2.

negotiating and concluding a contract—with the attendant uncertainty over whether a contract was even formed—cannot serve as a reliable foundation for private ordering.

Given the obstacles, it is not surprising that shareholders in public corporations rarely enter into governance contracts with each other or with the corporation,[26] aside from the two organizational documents of the corporation: the charter and the bylaws.[27] We would promote private ordering in public corporations by lowering the barriers to contracting through the adoption of shareholder bylaws.

Part I describes the shareholder empowerment debate, which has arisen in conjunction with the ascent of shareholder activism over the past two decades. Proponents of shareholder empowerment have focused intently on director elections, rather than making a broader case for private ordering by shareholders. Opponents of shareholder empowerment worry primarily about the potential for shareholder opportunism, and we respond to that concern in the last section of the Article. Parts II and III examine the legal rules that govern the adoption of shareholder bylaws in the Delaware General Corporation Law (DGCL) and in Rule 14a-8 under the Securities Exchange Act of 1934. Both the Delaware General Assembly and the Securities and Exchange Commission (SEC) have made recent moves to expand shareholder empowerment with respect to director elections, but both continue to rely on a board-centered view of corporate governance generally. Part IV concludes by describing a world in which shareholders are allowed to engage in private ordering with shareholder bylaws. We begin with the affirmative case for private ordering, which rests in part on the benefits of private ordering to a particular firm (micro-benefits) and in part on the benefits of private ordering to the corporate governance system as a whole (macro-benefits). We then argue that the fears expressed by opponents of shareholder empowerment, including concerns over the potential for shareholder opportunism, are unfounded because of legal and market constraints on shareholder power. We conclude with a description of our proposed legal reforms to facilitate private ordering in public corporations.

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26. Indeed, the law governing public corporations is widely viewed as "an institutional substitute for explicit contracts." Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 250 (1999).

27. Although lacking some of the trappings of conventional contracts, according to the Delaware Supreme Court, "charters and bylaws are contracts among a corporation's shareholders." Airgas, Inc. v. Air Prods. & Chems., Inc., 8 A.3d 1182, 1188 (Del. 2010); *cf.* Ilya Beylin, *Tax Authority as Regulator and Equity Holder: How Shareholders' Control Rights Could Be Adapted to Serve the Tax Authority*, 84 ST. JOHN'S L. REV. 851, 865 (2010) ("[T]he bylaws are a contract between shareholders, whereas the certificate is a contract with the state.").

I. THE SHAREHOLDER EMPOWERMENT DEBATE

Shareholder activism has been part of corporate governance in the United States since the early 1900s,[28] but until the 1980s, most shareholders observed the "Wall Street Rule," which dictated that dissatisfied shareholders vote with their feet by selling their shares, rather than attempting to participate more directly in corporate decision making.[29] While many large shareholders view selling shares as a form of activism,[30] shareholders traditionally seemed either unwilling or unable to directly implement any substantial changes to corporate affairs.[31] All of this has changed dramatically over the past quarter century with the advent of institutional investor activism, which we describe briefly in this section.

Prior to the 1980s, the stylized shareholders who populated accounts of corporate law were highly dispersed,[32] and the conventional wisdom was that these shareholders were rationally passive on matters of corporate governance.[33] Institutional investors, including pension funds, mutual funds, banks, and life insurance companies, had long made substantial investments in corporations, and, in the 1980s, these investors began to assert themselves.[34] Nevertheless, such activism remained limited and, as late as the early 1990s, two prominent commentators identified only three ways in which institutional investors had become active in corporate governance: (1) by protecting "the market for corporate control by seeking to block or dismantle takeover defenses erected by portfolio companies without shareholder approval"; (2) by urging "the creation of shareholder advisory committees"; and (3) by seeking "direct input into the selection of outside directors."[35] Thus, despite increased interest in shareholder

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28. *See* Stuart L. Gillian & Laura T. Starks, *The Evolution of Shareholder Activism in the United States*, 19 J. APPLIED CORP. FIN. 55, 55 (2007).

29. Robert B. Thompson & Paul H. Edelman, *Corporate Voting*, 62 VAND. L. REV. 129, 130 (2009).

30. Anat Ruth Admati & Paul Pfleiderer, *The "Wall Street Walk" and Shareholder Activism: Exit as a Form of Voice*, 22 REV. FIN. STUD. 2645, 2647 (2009); Joseph A. McCahery et al., *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, at *6 (AFA 2011 Denver Meetings Paper, Tilburg Law Sch. Research Paper No. 010/2010, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1571046. Empirical evidence suggests that large sales of shares affect corporate decision making. *See* Alex Edmans, *Blockholder Trading, Market Efficiency, and Managerial Myopia*, 64 J. FIN. 2481, 2481, 2500–06 (2009); Radhakrishnan Gopalan, Institutional Stock Sales and Takeovers: The Disciplinary Role of Voting with Your Feet (June, 2009) (working paper), *available at* http://apps.olin.wustl.edu/faculty/Gopalan/job_paper.pdf.

31. *See* STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 1, 22 (2008).

32. For the canonical description, see ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

33. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 197 (1991).

34. *See, e.g.*, Roberta Romano, *Less Is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174, 175–76 (2001) (describing increased shareholder activism in the 1980s and 1990s).

35. Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 868 (1991).

activism among scholars in the early 1990s,[36] shareholder governance in the United States at that time was still "largely aspirational."[37]

By the late 1990s, however, the landscape had changed dramatically. Led largely by public pension funds and labor unions[38]—and, more recently, hedge funds[39]—institutional investors attained increased prominence in the securities market and began exercising influence as shareholders due to regulatory developments, economic changes, and the growth of infrastructures facilitating shareholder activity.[40] Some activist shareholders were arguing that shareholder bylaws would provide an effective avenue for direct shareholder participation in corporate governance.[41]

Shareholders gravitated to bylaws because, under state corporation codes, adopting bylaws is one of the few actions that may be initiated by shareholders.[42] Shareholders have the right to vote on various corporate actions, including election and removal of directors,[43] amendment of the corporation's charter,[44] approval of a merger or consolidation,[45] and other fundamental transactions,[46] as well as the ratification of conflict-of-interest transactions.[47] But with the exception of election and removal of directors

36. *See generally* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991).

37. William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C. L. REV. 1861, 1871 (1995).

38. *See, e.g.*, Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018, 1019–20 (1998).

39. Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1278 (2008); William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1378–79 (2007); Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681, 682–85 (2007); Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 TEX. L. REV. 987, 998–1001 (2010); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1024 (2007).

40. Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1283–87 (1999).

41. One key event in changing the course of shareholder activism was the 1992 amendment of the federal proxy rules to allow for more expansive communications among shareholders without triggering the onerous burdens of proxy disclosure. For a description of the 1992 changes, see Briggs, *supra* note 39, at 686–89. For an early attempt to show the effect of those rules on corporate governance, see D. Gordon Smith, *Corporate Governance and Managerial Incompetence: Lessons from Kmart*, 74 N.C. L. REV. 1037 (1996).

42. DEL. CODE ANN. tit. 8, § 109(a) (2005); MODEL BUS. CORP. ACT § 10.20(a) (2007).

43. DEL. CODE ANN. tit. 8, § 211(b); MODEL BUS. CORP. ACT §§ 8.03, 8.08.

44. DEL. CODE ANN. tit. 8, § 242(b); MODEL BUS. CORP. ACT § 10.03.

45. DEL. CODE ANN. tit. 8, § 251(c); MODEL BUS. CORP. ACT § 11.04(b).

46. Other fundamental transactions include approving the sale of assets not in the ordinary course of business, i.e., selling all or substantially all of the assets of the company, DEL. CODE ANN. tit. 8, § 271; MODEL BUS. CORP. ACT § 12.02, and approving the dissolution of the company. DEL. CODE ANN. tit. 8, § 275(b); MODEL BUS. CORP. ACT § 14.02.

47. DEL. CODE ANN. tit. 8, § 144(a)(2); MODEL BUS. CORP. ACT § 8.31(b)(2).

and amendment of bylaws, all of these votes must be initiated by the board of directors.[48]

As certain institutions have sought more active participation in the affairs of the corporation,[49] they have been forced to confront the collective action problem inherent in organizing large numbers of shareholders.[50] A determined shareholder could take the initiative and pay all of the costs associated with a proxy campaign,[51] but this strategy is expensive enough that it is typically reserved for high-stakes hostile takeovers.[52] For less dramatic challenges to incumbent managers, an alternative to self-sponsored campaigns exists through Rule 14a-8 under the Securities Exchange Act of 1934,[53] which entitles shareholders to have their proposals included on company proxy ballots, provided those proposals are not properly excluded by the company.[54] The predecessor to Rule 14a-8 was adopted in 1942,[55] but many shareholder proposals prior to the 1990s were brought by so-called "gadfly" investors,[56] leading some commentators to advocate for the repeal of the Rule.[57] In the 1990s, institutional investors began to see success with shareholder proposals, and, over the past decade, the importance of Rule 14a-8 as a tool of shareholder activism has continued to grow, resulting in a substantial shift of power to the SEC and increased concerns over federalism.[58]

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48. On the right of initiation versus the right of ratification, see Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 303–04 (1983).

49. *See* Edward D. Herlihy et al., *Financial Institutions M&A 2008: Deal Activity Continues in a Diverse M&A Market—An Annual Review of Leading Developments*, 1708 PLI/CORP 109, 132 (2008) (noting "a continued rise in the level and intensity of shareholder activism").

50. *See generally* MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (rev. ed. 1971).

51. Corporation statutes permit shareholders to vote at a shareholders' meeting either in person or by proxy. *See* DEL. CODE ANN. tit. 8, § 212(b); MODEL BUS. CORP. ACT §§ 7.22(a), 7.25(c). In corporations with a large number of shareholders, most votes are cast by proxy.

52. Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 114 (1965) (noting that in the fight for corporate control, proxy contests are "the most expensive, the most uncertain, and the least used of the various techniques"). Professor Stephen Bainbridge notes that proxy contests are "enormously expensive," requiring "the services of lawyers, accountants, financial advisers, printers, and proxy solicitors." *See* BAINBRIDGE, *supra* note 31, at 210.

53. 15 U.S.C. §§ 78a–78nn (2006).

54. Shareholder Proposals, 17 C.F.R. § 240.14a-8 (2011); *see* Jeffrey N. Gordon, *Proxy Contests in an Era of Increasing Shareholder Power: Forget Issuer Proxy Access and Focus on E-Proxy*, 61 VAND. L. REV. 475, 478–80 (2008).

55. Solicitation of Proxies Under the Act, 7 Fed. Reg. 10,655, 10,655–56 (1942).

56. Among these "gadfly investors" were Lewis Gilbert, John Gilbert, and Evelyn Davis. *See* Nancy L. Ross, *Gadflies Set to Buzz Shareholders' Meetings*, WASH. POST, Apr. 17, 1983, at G1.

57. *See, e.g.*, George W. Dent, Jr., *SEC Rule 14a-8: A Study in Regulatory Failure*, 30 N.Y.L. SCH. L. REV. 1 (1985); Susan W. Liebeler, *A Proposal to Rescind the Shareholder Proposal Rule*, 18 GA. L. REV. 425 (1984).

58. *See, e.g.*, Sean J. Griffith & Myron T. Steele, *On Corporate Law Federalism: Threatening the Thaumatrope*, 61 BUS. LAW. 1, 2 (2005) (asserting the advantages of state law's ability to "alternate between lax and stringent regulation" and "warn[ing] of the consequences of its destruction"); Robert B. Thompson, *Corporate Federalism in the*

Opponents of shareholder empowerment fear both shareholder misuse and shareholder mistake.[59] One chief contention is that the recent rise in shareholder activism has opened the doors for significant abuse by allowing progressive shareholders to, among other things, "utilize the proxy process and other activist initiatives to gain private benefits not shared with other shareholders."[60] Another common concern is that dispersed and inexperienced shareholders, who are not privy to the same information as management, will make under-informed—if not altogether uninformed—business or policy decisions.[61]

Professor Stephen Bainbridge is firmly in this camp. He argues that the board of directors is the proper decision maker in a corporation and suggests that shareholders should be content with this centralization of power because most shareholders are "rationally apathetic" about corporate decisions, and those shareholders who are not apathetic would be likely to misuse any powers allocated to them.[62] He worries that the non-apathetic shareholder group would likely be limited to institutional investors like pension funds—the type of shareholders with the greatest incentive to "misuse [their] powers in the pursuit of private benefits."[63] Moreover, he cites market evidence to back director primacy, asking why, if empowering shareholders would be so "value-enhancing," firms have not voluntarily done so.[64]

There has been ample scholarship written in support of Professor Bainbridge's concerns with shareholder empowerment.[65] For example, Iman Anabtawi argues that increasing any given shareholder's power to influence the corporation concomitantly increases the likelihood that the

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Administrative State: The SEC's Discretion to Move the Line Between the State and Federal Realms of Corporate Governance, 82 NOTRE DAME L. REV 1143 (2007). *But see* William W. Bratton & Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism*, 41 WAKE FOREST L. REV. 619, 620 (2006) (arguing that there is "no support for the view that recent federal expansion . . . destabilizes or impairs corporate law's federal structure" and that "corporate federalism remains robust, offering a positive political economy").

59. *See generally* Harry G. Hutchison & R. Sean Alley, *The High Costs of Shareholder Participation*, 11 U. PA. J. BUS. L. 941 (2009) (outlining the costs associated with increased shareholder participation in a corporation).

60. Brishen Rogers, *The Complexities of Shareholder Primacy: A Response to Sanford Jacoby*, 30 COMP. LAB. L. & POL'Y J. 95, 108 (2008).

61. *See, e.g.*, William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 666 (2010).

62. Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1745 (2006); *see also* Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 564 (2005) ("[S]hareholders . . . may use any incremental power conferred upon them to pursue those interests to the detriment of shareholders as a class.").

63. *See* Bainbridge, *supra* note 62, at 1751.

64. *See id.* at 1736.

65. In addition to the articles described below, see, e.g., Harry G. Hutchison & R. Sean Alley, *Against Shareholder Participation: A Treatment for McConvill's Psychonomicosis*, 2 BROOK. J. CORP. FIN. & COM. L. 41, 42 (2007) ("[M]ost (but not all) initiatives [in support of shareholder empowerment] ignore evidence showing that separation of ownership and control justifies the current regime of limited shareholder voting rights and director control as the default rule.").

shareholder will use that power to pursue its own interests without regard to what would benefit the whole group,[66] contra to what the directors' fiduciary duties would compel them to do. Jonathan R. Macey contends that calls for shareholder empowerment stem from the flawed premise that shareholder involvement legitimates directors exercising authority.[67] He rejects the agency analogy that would derive directors' authority from a shareholder grant of power, and, rather, contends that director legitimacy comes directly from state law and from the individual directors' competence and consistent performance.[68]

A key area in which opponents of shareholder empowerment are concerned—especially in light of recent Delaware legislation and SEC rulemaking—is with respect to director elections and access to the firm's proxy ballots. One concern, voiced by Martin Lipton and Steven A. Rosenblum, is that companies may have difficulty recruiting and retaining high-quality directors if shareholders can contest elections easily.[69] Joseph A. Grundfest worries that the recent legal changes proposed by the SEC making proxy access more available to shareholders would exacerbate the potential for shareholders to distract the firm by using the proxy process to voice their own private concerns, rather than as a vehicle to further the interests of the corporation as a whole.[70]

Professors William W. Bratton and Michael L. Wachter assert that the case against shareholder empowerment is particularly convincing in the wake of the recent financial crisis, which demonstrated the need for managers to focus on risk management, not maximization of stock prices in the near term.[71] Bratton and Wachter make their case by attacking some of

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66. *See* Anabtawi, *supra* note 62, at 598–99; *see also* Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 796 (1993) ("[P]ublic pension funds face distinctive investment conflicts that limit the benefits of their activism.").

67. Jonathan R. Macey, *Too Many Notes and Not Enough Votes: Lucian Bebchuk and Emperor Joseph II Kvetch About Contested Director Elections and Mozart's Seraglio*, 93 VA. L. REV. 759, 772 (2007) ("But the legitimacy of corporate directors comes, in the first instance, from the fact that state law confers upon directors both the power and the obligation to manage the business and the affairs of the corporation.").

68. *See id.*

69. Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67, 86–87 (2003).

70. *See* Joseph A. Grundfest, *The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law*, 65 BUS. LAW 361, 380–83 (2010) (worrying that "megaphone externalities" would distract from items on proxy ballets that concern the firm as a whole). For an interesting commentary on the shareholder proxy access debate, see Christopher M. Bruner, *Managing Corporate Federalism: The Least-Bad Approach to the Shareholder Bylaw Debate*, 36 DEL. J. CORP. L. 1, 43 (2011) (arguing that the SEC should remove itself from the proxy process and leave it to Delaware, "subject to . . . intervention by Congress"). *See generally* Mark J. Roe, *The Corporate Shareholder's Vote and its Political Economy, in Delaware and in Washington* (Paolo Baffi Centre, Working Paper No. 2011-94, 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1884110 (describing Delaware's relationship with the SEC and its influence in the recent proxy amendments to the DGCL and SEC's rules).

71. *See* Bratton & Wachter, *supra* note 61, at 726–28; *see also* Bruner, *supra* note 70, at 22, 51 (criticizing the move for shareholder empowerment in the wake of the financial crisis).

the common arguments for shareholder empowerment, including the argument that an increased role for shareholders will ensure greater managerial accountability and thus reduce agency costs.[72] They argue that informational asymmetries between directors and shareholders, coupled with directors' expertise, tip the scale in favor of maintaining the "prevailing legal model, which vests business decisionmaking in managers."[73] Moreover, they maintain that the current model of director primacy has been "highly responsive to shareholder interests and demands" over the years since the takeover-crazed 1980s, and that consequently agency costs continue to decrease in response to money that has been left "on the table."[74] They assert that agency costs will never be entirely reducible, and any that remain do so because it is too costly to eliminate them.[75]

Bratton and Wachter acknowledge that proponents of shareholder empowerment have used the financial crisis as a case-in-point example for the need of greater managerial accountability to shareholders.[76] However, they contend that the crisis bolsters the opposite argument. They bemoan the "shareholder-based agency model of the corporation,"[77] oft-used by proponents of shareholder-rights, as motivating management to unfailingly "manage to maximize the market price of the stock."[78] They argue that this "management to the market" is what brought about the demise of many financial firms, as they continued to ride high stock prices in the face of treacherous long-term risk.[79] Instead of analogizing directors as agents to their shareholder principals, they, like Macey, maintain that directors' authority and powers derive directly from the law.[80] Accordingly, they argue that directors—with their privy-to-information and expertise—are better suited for corporate decisionmaking than "dispersed, diversified shareholders."[81] They fear that an increased shareholder role risks overly influencing managers to manage to the market when experienced directors

72. *See* Bratton & Wachter, *supra* note 61, at 655–56, 724.

73. *Id.* at 656; s*ee also* Fama & Jensen, *supra* note 48, at 301–02 (1983) ("We contend that separation of decision and risk-bearing functions survives in these organizations in part because of the benefits of specialization of management and risk bearing but also because of an effective common approach to controlling the agency problems caused by separation of decision and risk-bearing functions. . . . [O]ur hypothesis is that the contract structures of all of these organizations separate the ratification and monitoring of decisions from initiation and implementation of the decisions.").

74. *See* Bratton & Wachter, *supra* note 61, at 675 ("In our view, once these countervailing points are on the table, the shareholder empowerment case falls well short of surmounting the burden of proof that ordinarily confronts proposals for fundamental structural change.").

75. *See id.*

76. *See id.* at 658–59.

77. *Id.* at 658. Later, Professors Bratton and Wachter clearly state that "[a]s a legal matter, directors are not agents of the shareholders." *Id.* at 662.

78. *Id.* at 658–59.

79. *See id.* at 659.

80. *See id.* at 662.

81. *See id.* at 666.

would, without that pressure, make wiser decisions to sacrifice in the short-term in order to receive long-term gain.[82]

Despite the voluminous scholarship discouraging shareholder empowerment, in this Article we side with those who view shareholder activism as having many potential benefits for U.S. corporations.[83] One of the leading voices for increasing shareholder power has been Lucian Arye Bebchuk, who has long argued that involving shareholders more in corporate governance would reduce agency costs and add value to corporations.[84] In a seminal piece calling for shareholder empowerment, Professor Bebchuk resisted the argument that informational asymmetry between management and shareholders justifies "management insulation from shareholder intervention,"[85] arguing that, while management might have some "informational advantage" on a given business decision, that should not preclude shareholders from making "rules-of-the-game decisions" in corporate governance, or from "decid[ing] for themselves to what extent to defer to management" on a given decision.[86] He also counters his opponents' argument that private-benefit seeking shareholders will pursue their own interests above the corporation's by pointing out that shareholder proposals would still require a majority vote[87]—one of the frictions that we argue would constrain shareholders under our proposed rules.

Many other commentators have long recognized the possible benefits of increased shareholder monitoring.[88] One way in which scholars have recently proposed measured expansions of shareholder power is through director elections[89] and shareholders' access to the proxy ballot.[90] Professor Brett H. McDonnell has built on Bebchuk's analysis that the current proxy system does not adequately allow shareholders to monitor board performance effectively.[91] He submits that greater proxy access would greatly strengthen shareholders' voting opportunities and impose

82. *See id.* at 726–27.

83. *See generally* Julian Velasco, *Shareholder Ownership and Primacy*, 2010 U. ILL. L. REV. 897.

84. Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 836 (2005).

85. *Id.* at 913.

86. *See id.* at 893–94.

87. *See id.* at 872.

88. For early contributions to this position, see generally Jayne W. Barnard, *Shareholder Access to the Proxy Revisited*, 40 CATH. U. L. REV. 37 (1990); Black, *supra* note 36; Henry Hansmann & Reinier Kraakman, *The End History for Corporate Law*, 89 GEO. L.J. 439, 468 (2001) (arguing that the "shareholder-oriented model of the corporation" is "superior[]" and "establish[es] a strong corporate management with duties to serve the interests of shareholders alone, as well as strong minority shareholder protections," and that "as the goal of shareholder primacy becomes second nature even to politicians, convergence in most aspects of the law and practice of corporate governance is sure to follow").

89. *See, e.g.*, Smith, *supra* note 41, at 1116–39.

90. *See generally* Brett H. McDonnell, *Setting Optimal Rules for Shareholder Proxy Access*, 43 ARIZ. ST. L.J. 67 (2011).

91. *See id.* at 79–80.

greater accountability on directors.[92] He counters any arguments that it would only distract directors from their jobs by noting that it would only arise in elections in which there is a strong likelihood that the incumbent nominees would lose—cases, he notes, in which the board is likely "not performing well," and, as such, where "getting the attention of the directors . . . is not such a bad thing."[93] In addition, he downplays Grundfest's "megaphone externality" argument as something that is not significant enough to deter increased access (and that will probably subside over time).[94]

Professor McDonnell also counters several other main arguments that opponents make regarding increased shareholder power through proxy access. First, he asserts that shareholders are "aware of their own ignorance" and normally insert themselves only when necessary.[95] Moreover, he contends that institutional investors—those most likely to engage in proxy campaigns—are normally well-informed.[96] He also cites a lack of evidence that pension funds and other institutional investors are the rogue, self-interested shareholders that opponents portray them to be.[97] Ultimately, Professor McDonnell argues that the optimal proxy access rules would have a default rule of access, with an altering rule that would allow shareholders to either increase or decrease that access through private ordering.[98]

Other commentators have advocated increased shareholder monitoring by enhancing the ability of shareholders to sell the corporation[99] and to correct errors made by the board of directors.[100] The shareholders' ability to sell the corporation in the face of hostile takeover defenses—like the poison pill and staggered board in *Airgas*—has been an especially germane topic in the wake of the *Airgas* decision.[101] Proponents of shareholder empowerment argue that shareholders should be able to decide for themselves whether a hostile tender offer is adequate, at least after enough time has elapsed so that shareholders are able to make an informed decision.[102] Under our

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92. *See id.*

93. *See id.* at 80.

94. *See id.* at 81–82.

95. *Id.* at 81.

96. *See id.*

97. *See id.*

98. *See id.* at 71.

99. *See* Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers*, 80 TEX. L. REV. 261, 304–05 (2001).

100. *See* Thompson & Edelman, *supra* note 29, at 149.

101. *See supra* notes 1–9 and accompanying text.

102. *See, e.g.*, Bebchuk, *supra* note 84, at 896 ("Under the view to which I subscribe, however, defensive tactics are acceptable only to protect shareholders from being pressured into tendering."); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV 1161, 1161 (1981) (arguing that "resistance by a corporation's managers to premium tender offers . . . ultimately decreases shareholder welfare"); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 819–20 (1981) (arguing that *both* managers and stockholders have responsibility in tender offers); Jeffrey N.

proposed regime, shareholders—like those in *Airgas*—would have a say in whether or not to sell the corporation, through the bylaws.

As for the risk of shareholder opportunism, we believe that "there is no reason to suppose that the threat of shareholder misconduct is any greater than that of director misconduct, or even nearly as great."[103] In fact, Ronald J. Gilson and Jeffrey N. Gordon have made a compelling argument that due to existing restraints in Delaware law, the involvement of large, controlling shareholders in firm governance can benefit the firm by reducing managerial agency costs in a way that would "exceed the costs of the controlling shareholders' private benefits of control."[104] Indeed, as we argue in Part IV below, shareholders who try to act opportunistically must overcome significant legal and economic obstacles.

We build on the foundation laid by this prior work, arguing that shareholders in the modern American corporation can, and should be allowed to, do more than vote, sell, and sue. While these are appropriate functions for widely dispersed shareholders, the more concentrated shareholders that typify the modern American corporation can also contract, much like shareholders in closely held firms. We argue that corporate bylaws serve as a contracting platform for shareholders, providing a logical, accessible channel for private ordering in public corporations. We enlist both Delaware corporate law and Rule 14a-8 in the effort to facilitate this private ordering. In Part IV, we propose several legal reforms that would enable expanded private ordering with shareholder bylaws.

Gordon, *"Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett*, 19 CARDOZO L. REV. 511, 551 (1997) ("The shareholder choice model does not collapse into unfettered shareholder control over the business decisions involved in response to an unsolicited offer. It does, however, open up the opportunity for a conversation between shareholders and the board about the shape of governance mechanisms like the poison pill."); Lucian A. Bebchuk, Comment, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1030 (1982) ("[F]acilitating competing tender offers is desirable both to targets' shareholders and to society."). *But see* John C. Coffee, Jr., *The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?*, 51 U. MIAMI L. REV. 605, 616 (1997) ("[T]he basic structure of Delaware law suggests that shareholders do have the right to restrict the board for the future (but not to require the repeal or modification of an existing pill).").

103. Julian Velasco, *Taking Shareholder Rights Seriously*, 41 U.C. DAVIS L. REV. 605, 628 (2007). Some commentators have suggested applying fiduciary duties to activist shareholders to eliminate the specter of shareholder self-interest. *See generally* Anabtawi & Stout, supra note 39.

104. Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 843 (2003); *see also* Roe, *supra* note 70, at 30–31 (explaining that proponents of increased proxy access feel that the value in reducing "managerial agency costs" and increasing proxy access "arguably could better than the status quo cabin managerial self-interest in their own compensation and accountability," while opponents come out the other way on that balancing test).

II. SHAREHOLDER BYLAWS IN DELAWARE

In the federal system of corporate governance that prevails in the United States, Delaware is cast by some as the hero[105] and by others as the villain.[106] In either role, Delaware is typically portrayed as the defender of private ordering.[107] The law of Delaware is said to be "enabling," not "regulatory."[108] This stands in contrast to the SEC, which tends to dictate processes and procedures. Even if these caricatures were generally true, they seem less apt in the shareholder empowerment debate, where both Delaware and the SEC place substantial limits on shareholder action. In this section, we describe the limits of shareholder power under Delaware law.

A. The Conflict Between DGCL Section 109 and Section 141(a)

The heavily-disputed question of what power shareholders have to alter or enact corporate bylaws in light of the board's authority to manage the corporation is rooted in one of corporate law's most persistent statutory knots—a Delawarean puzzle arising from the interplay between section 109 and section 141(a) of the DGCL. Any reasonable assessment of these two sections inevitably leads to one conclusion: textual analysis of the relevant statutes is not enough to solve the puzzle and, consequently, any reconciliation of the two sections must rely on policy considerations.[109]

In stark contrast to the solution, the problem is relatively clear. Section 109 empowers shareholders to adopt, alter, or repeal bylaws,[110] which "may contain 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 or the rights or powers of its stockholders, directors, officers or employees."[111] Meanwhile, section 141(a) empowers a board of directors to manage the "business and affairs of every corporation . . . *except as may be otherwise provided in this chapter* or in its certificate of incorporation."[112]

Jeffrey Gordon has described these two sections as linked in a "recursive loop"[113]: the shareholder power to adopt, alter, or repeal bylaws is limited

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105. *See, e.g.*, ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 9 (1993) (arguing that shareholders benefit from the federalist system, in which Delaware plays a leading role).

106. *See, e.g.*, Kent Greenfield, *Proposition: Saving the World with Corporate Law*, 57 EMORY L.J. 948 (2008).

107. *See, e.g.*, Lisa M. Fairfax, *Delaware's New Proxy Access: Much Ado About Nothing?*, 11 TRANSACTIONS: TENN. J. BUS. L. 87, 101 (2009).

108. *See, e.g.*, Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 DEL. J. CORP. L. 673, 674 (2005).

109. *See, e.g.*, CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 232–33 (Del. 2008); Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-adopted By-laws: Taking Back the Street?*, 73 TUL. L. REV. 409, 444–45 (1998).

110. DEL. CODE ANN. tit. 8, § 109(a) (2005).

111. *Id.* § 109(b) (emphasis added).

112. *Id.* § 141(a) (emphasis added).

113. Gordon, *supra* note 102, at 546 (1997).

by "law," which includes the power of the board of directors to manage or supervise the management of the corporation detailed in section 141(a); meanwhile, the board's power to manage or supervise the management of the corporation is limited by other provisions in the DGCL, which include the shareholder power to adopt, alter, or repeal bylaws found in section 109. Though there is some debate about the degree to which these sections are, in fact, circular,[114] we believe that any purely textual examination of the DGCL reveals this unremitting circularity.[115]

In an effort to untie the loop, Professor McDonnell has suggested three possible extra-textual readings that would resolve the conflict between sections 109 and 141(a):

> First, section 109(b) does not on its own validate any sort of bylaw provision, because section 141(a) always trumps it. Second, section 141(a) does not provide any sort of limitation whatsoever on the provisions that section 109(b) allows, because section 109(b) always trumps 141(a). Third, one can split the difference so that section 109(b) does allow for some limitations on matters that otherwise would be subject to board authority, but section 141(a) limits how far such bylaw provisions can go. The question then arises as to how to split the difference.[116]

The arguments in favor of each of these three approaches rely heavily on underlying policy considerations and, understandably, each approach has found supporting arguments in the legal community. For example, proponents of the first view suggest that allowing shareholders to enact bylaws mandating board action would "constitute an invalid intrusion by the shareholders into the realm protected by [section] 141(a)."[117] Conversely, those who support the second reading argue that section 109(b)'s express allowance for shareholders to adopt bylaws that regulate "the business of the corporation, the conduct of its affairs, and . . . the rights or powers of [the corporation's] directors" would be rendered meaningless were section 141(a) to trump.[118] Given the extreme nature of the first two

114. *See, e.g.*, Hamermesh, *supra* note 109, at 430 (arguing that "sections 109(b) and 141(a) may not be as opaque or circular as Gordon suggests"); Julian Velasco, *Just Do It: An Antidote to the Poison Pill*, 52 EMORY L.J. 849, 852–53 (2003) ("Notwithstanding the claims to the contrary, the two sections do not create a truly recursive loop."); R. Matthew Garms, Note, *Shareholder By-Law Amendments and the Poison Pill: The Market for Corporate Control and Economic Efficiency*, 24 J. CORP. L. 433, 443 (1999) ("Sections 141(a) and 109 *can* indeed be harmonized through statutory formalism.").

115. *See, e.g.*, Gordon, *supra* note 102, at 547.

116. Brett H. McDonnell, *Shareholder Bylaws, Shareholder Nominations, and Poison Pills*, 3 BERKELEY BUS. L.J. 205, 214 (2005).

117. *See, e.g.*, WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 608 (3d ed. 2009).

118. *See*, *e.g.*, Velasco, *supra* note 114, at 852–53 ("Section 141(a) allows directors' powers to be limited pursuant to other provisions of the [DGCL], including section 109(b). Section 109(b), on the other hand, only says that bylaws cannot be inconsistent with other laws. Because section 141(a) is subject to modification pursuant to section 109(b), however, most bylaws would be consistent with section 141(a). On the other hand, the argument that the bylaws cannot interfere with directors' powers under section 141(a) is plainly inconsistent with the language of section 109(b), which expressly provides that bylaws can

approaches, however, many legal scholars support a "split the difference" reading and seek to harmonize the two sections with conclusions that lie somewhere in between.[119]

Having rejected the possibility of statutory closure, Professor Lawrence A. Hamermesh provides one version of the "split the difference" reading after taking an important analytical step: if the statutes provide no guidelines for distinguishing bylaws that appropriately infringe on director power from bylaws that go too far, then we should interpret the statutes to preclude *any* bylaw that infringes on director power, unless that infringement is expressly authorized by the DGCL outside of section 109(b).[120] Professors Robert Thompson and Gordon Smith have criticized Professor Hamermesh's narrow reading of the shareholder bylaw power on the ground that the language in section 109(b) offers no hint of such a limitation on shareholder bylaws.[121] Indeed, that section allows for bylaws relating to *any* aspect of "the business of the corporation" and "the conduct of its affairs," which seems on its face much more expansive than Professor Hamermesh's reading.[122]

The fundamental shortcoming of Professor Hamermesh's position—which seems endemic to the writing on shareholder bylaws, including the Delaware Supreme Court's decision in *CA, Inc. v. AFSCME Employees Pension Plan*[123]—is that it privileges the grant of authority to the board of

regulate 'the business of the corporation, the conduct of its affairs, and . . . the rights or powers of [the corporation's] . . . directors.' These words are rendered meaningless by the opponents' interpretation of section 141(a). Ultimately, their arguments simply prove too much; virtually every bylaw interferes with directors' powers in some sense."); Garms, *supra* note 114, at 443 ("When this is done, it becomes clear that the Delaware courts should . . . validate shareholders' power to propose and adopt by-laws limiting the board's ability to adopt a poison pill or requiring the board to redeem a pill that is already in existence. A decision prohibiting shareholders from adopting by-law amendments would clearly be contrary to Section 109. Such a decision would render section 109 meaningless. On the other hand, allowing shareholders to adopt by-law amendments would not be contrary to Section 141(a).").

119. *See, e.g.*, Christopher M. Bruner, *The Enduring Ambivalence of Corporate Law*, 59 ALA. L. REV. 1385, 1444–45 (2008) (noting that a "split the difference" reading is "an eminently sensible approach ensuring that each of §§ 141 and 109 actually means something in reality" and that "such a reading is substantially strengthened by the analysis of corporate law's larger structure"); McDonnell, *supra* note 116, at 214.

120. Hamermesh, *supra* note 109, at 444 ("As a matter of formal statutory construction, then, it is preferable to read section 141(a) as an absolute preclusion against by-law limits on director management authority, in the absence of explicit statutory authority for such limits outside of section 109(b).").

121. Thompson & Smith, *supra* note 99, at 320–21.

122. *Id.* (quoting DEL. CODE ANN. tit. 8, § 109(b) (1991)). In this Article, we offer an even more ambitious reading of section 109(b) than the reading offered by Professor Smith in his article with Professor Robert B. Thompson. That earlier article conceded more ground to Professor Hamermesh than seems warranted by the text of the DGCL. For example, Professors Thompson and Smith granted Professor Hamermesh the following point: "When section 141(a) refers to limitations on board authority 'provided in this chapter,' it does not refer to all by-laws that could conceivably be adopted pursuant to the general authority conferred by section 109(b)." *Id.* at 320 (quoting Hamermesh, *supra* note 109, at 430–31). In this Article, we ask, "Why not?"

123. 953 A.2d 227 (Del. 2008).

directors in section 141(a) over the grant of authority to the shareholders in section 109(b). Stated another way, Professor Hamermesh reads the DGCL in a manner that essentially "calls a draw" between the grants of authority in the two sections, then decides the issue in favor of the grant of authority to the board of directors seemingly on the ground that directors should win, unless the statute explicitly dictates a contrary result.

Of course, we recognize that the board of directors occupies a central role in the governance of corporations, and the Delaware courts have long recognized the "large reservoir of authority" possessed by the board of directors as a result of section 141(a).[124] But some important considerations qualify these declarations on board authority. First, these judicial proclamations upholding the board's authority have been made in the context of shareholder challenges to board authority via litigation—that is, challenges to the board's power after a decision has already been made.[125] Shareholder bylaws, by contrast, involve advanced planning by shareholders. Such ex ante action involves different considerations than the ex post challenges that have shaped the precedents on section 141(a). Second, the Delaware courts have repeatedly recognized that a board's authority to manage the corporation may be limited via contract with third parties[126] or by shareholder bylaws that regulate the processes by which the board acts,[127] and that such "limitations" on the board's power to act may, in actuality, be essential to the running of the corporation.[128] Thus, as *Hollinger International, Inc. v. Black* and *UniSuper* suggest, in Delaware

124. Unocal Corp. v. Mesa Petrol. Co., 493 A.2d 946, 953 (Del. 1985); *see also* UniSuper, Ltd. v. News Corp., No. Civ.A. 1699-N, 2006 WL 207505, at *2 (Del. Ch. Jan. 19, 2006) ("Ultimately, of course, a board's power to bind itself through contract is limited by the board's fiduciary duties . . . but strictly speaking not by section 141(a) itself.").

125. *See, e.g.*, Ryan v. Lyondell Chem. Co., No. 3176, 2008 WL 2923427, at *12 (Del. Ch. July 29, 2008) ("The board of directors is tasked with managing the business and affairs of a Delaware corporation and, ordinarily, its decisions are shielded from intense *post hoc* judicial review . . . ." (citation omitted)); Postorivo v. AG Paintball Holdings, Inc., No. 2991, 2008 WL 553205, at *4 (Del. Ch. Feb. 29, 2008) ("As a general principle, the board of directors, not the shareholders, manages the business and affairs of a Delaware corporation."); *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 746 (Del. Ch. 2005) ("[C]ourts are ill equipped to engage in *post hoc* substantive review of business decisions . . . .").

126. *See UniSuper*, 2006 WL 207505, at *2 ("[T]o vest the board with plenary authority and then to insist . . . that the board may *never* limit its powers through contract would . . . have the unintended effect of severely limiting the board's power to manage the business and affairs of the corporation. As a matter of routine, boards of directors enter into contracts with third parties that limit the board's management of the business and affairs of the corporation, most notably agreements to merge with or to acquire other companies. Although such contracts are limiting in one sense, they are also enabling in another.").

127. *See* Hollinger Int'l, Inc. v. Black, 844 A.2d 1022, 1080 n.136 (Del. Ch. 2004) ("Sections 109 and 141, taken in totality . . . make clear that bylaws may pervasively and strictly regulate the process by which boards act, subject to the constraints of equity."). In *Hollinger*, Vice Chancellor Strine cited *Frantz Manufacturing Co. v. EAC Industries*, 501 A.2d 401 (Del. 1985), noting that, in *Frantz*, "the Delaware Supreme Court made clear that bylaws could impose severe requirements on the conduct of a board without running afoul of the DGCL." *Hollinger*, 844 A.2d at 1079.

128. *UniSuper*, 2006 WL 207505, at *2.

the board's authority is not now, and has never been, absolute or immutable.

Noting the foregoing considerations, we ask: what if we started the analysis by considering the position and power of the shareholders, rather than by merely deferring to the expansive power of the board of directors? To invoke the agency metaphor that is commonly used in corporate law, we ask whether it makes sense to limit the power of the "principal" (i.e., the shareholders) on account of the authority of the "agent" (i.e., the board of directors)?[129]

In answering this question, we reiterate that reliance solely on the language of section 109 and section 141(a) will not give either section the victory.[130] As Professor Hamermesh states, "the efforts to distinguish by-laws that permissibly limit director authority from by-laws that impermissibly do so have failed to provide a coherent analytical structure, and the pertinent statutes provide no guidelines for distinction at all."[131] We agree.

But even if a textual analysis fails,[132] the crucial question remains whether shareholders can or should be able to "unilaterally adopt bylaws substantially limiting the board's governance authority under [section] 141(a)."[133] Clearly, if the DGCL does not explicitly preclude a grant of unlimited shareholder power to adopt, alter, and repeal bylaws, as even the most vigorous proponents of directorial supremacy must admit, this question must be answered in light of important policy considerations. As Vice Chancellor Strine noted:

> These provisions [section 109 and 141(a)] have been said to create a "recursive loop," and arguably to make it impossible to resolve the question of when a bylaw may restrict board authority solely by reference to the text of the DGCL**,** requiring courts to resort to their understanding of the most important policy values at stake in that debate as a method to resolve that question.[134]

129. We acknowledge the agency metaphor is employed only sparingly by the Delaware courts, and rarely, if ever, by the Delaware Supreme Court. *See, e.g.*, UniSuper Ltd. v. News Corp., No. 1699-N, 2005 WL 3529317, at *8 (Del. Ch. Dec. 20, 2005); *In re* Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 604, 619 (Del. Ch. 2005); ACE Ltd. v. Capital Re Corp., 747 A.2d 95, 109–10 (Del. Ch. 1999); *In re* Gaylord Container Corp. S'holders Litig., 747 A.2d 71, 78 n.10 (Del. Ch. 1999).

130. *See* Hamermesh, *supra* note 109, at 416 ("[N]either the courts, the legislators, the SEC, nor legal scholars have clearly articulated the means of . . . determining whether a stockholder-adopted by-law provision that constrains director managerial authority is legally effective." (citation omitted)).

131. *Id.* at 444.

132. Gordon, *supra* note 102, at 547 (noting, after examining the circularity of section 109 and 141(a), that "statutory formalism really runs out").

133. Bruner, *supra* note 119, at 1424.

134. Jones Apparel Grp. v. Maxwell Shoe Co., 883 A.2d 837, 846 (Del. Ch. 2004) ("[A]s skilled as the drafters of the DGCL are, I will not pretend that the DGCL is a model of drafting consistency and that there are not ambiguities within it."); *see also* Gordon, *supra* note 102, at 547 ("The Delaware court needs a theory to explain the appropriate boundary between shareholder power and the board's authority—a theory presumably richer in normative appeal than 'management wins.'"); Thompson & Smith, *supra* note 99, at 320

Ultimately, any hope of breaking away from the circularity of sections 109 and 141(a) depends on analysis that lies beyond the text of the DGCL, and this is precisely the analysis the Delaware Supreme Court undertook in connection with *CA, Inc.*, which we examine in the following section.

B. CA, Inc. *and the Scope of Shareholder Power*

In recent years, the Delaware courts have taken several significant steps to shape the scope of shareholder power to adopt, alter, or repeal bylaws. In this section we analyze the steps leading up to the court's decision in *CA, Inc.* as well as the faulty premises underlying that decision. We will also examine a decision by the U.S. District Court for the Southern District of New York, *Bebchuk v. Electronic Arts, Inc.*,[135] focusing on shareholder power and Rule 14a-8 as well as two recent amendments to the DGCL that appear to favor a more expansive shareholder bylaw power than that articulated by the courts in *CA, Inc.* and *Electronic Arts*.

1. *Bebchuk v. CA, Inc.*

In 2006, Harvard Law Professor Lucian Bebchuk, a prominent proponent of shareholder rights,[136] sought to place a bylaw on the ballot of CA, Inc. under Rule 14a-8. The bylaw would have required unanimous approval of the board of directors of CA, Inc. for the adoption of a Stockholder Rights Plan (poison pill).[137] In addition, the bylaw would have limited the term of any poison pill to "no later than one year."[138]

Although section 141(b) expressly authorizes the unanimous vote provision,[139] the provision limiting the term of the poison pill ignites the conflict between sections 109 and 141(a) of the DGCL discussed above. When Professor Bebchuk sought a declaration regarding the validity of his

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("[T]he plain words of the statute are too contradictory to be interpreted without employing external policy considerations.").

135. Bebchuk v. Elec. Arts, Inc., No. 08 Civ. 3716 (S.D.N.Y. Nov. 13, 2008) (order granting defendant's motion to dismiss).

136. For the past several years, Professor Bebchuk has stood as one of the leading advocates of shareholder rights. *See, e.g.*, Bebchuk, *supra* note 84. In support of this agenda, Professor Bebchuk has submitted shareholder proposals to several companies. *See* Marc H. Folladori, *Shareholder Proposals*, 1711 PLI/CORP. 153, 177 n.10 (2009) ("[D]uring 2008, Professor Bebchuk submitted a number of shareholder proposals to companies to amend their bylaws to limit the companies' rights to adopt poison pills. A number of these companies (FedEx Corporation, JCPenney, Safeway, CVS Caremark, Disney, and Bristol-Myers Squibb) subsequently entered into agreements with Bebchuk for them to amend their bylaws in a manner consistent with his proposal if he would withdraw his shareholder proposal."). Some of these proposals have been litigated in federal and state courts including the two cases discussed below. For more on Professor Bebchuk's policies and advocacy, see *Professor Lucian A. Bebchuck*, HARVARD LAW SCH., http://www.law.harvard.edu/faculty/bebchuk (last visited Sept. 21, 2011).

137. Bebchuk v. CA, Inc., 902 A.2d 737, 739 (Del. Ch. 2006).

138. *Id.*

139. DEL. CODE ANN. tit. 8, § 141(b) (2005) ("The vote of the majority of the directors present at a meeting at which a quorum is present shall be the act of the board of directors unless the certificate of incorporation or the bylaws shall require a vote of a greater number.").

bylaw in the Delaware courts, however, the focus shifted from the conflict between sections 109 and 141(a) to the procedural posture of this case. Professor Bebchuk had asked CA, Inc. to include the bylaw on its ballot for an upcoming annual meeting of stockholders, and CA, Inc., in response, requested a no-action letter from the SEC in connection with its plan to exclude the bylaw proposal from the ballot.[140] The basis for CA Inc.'s no-action letter request was that the bylaw was unlawful in Delaware.[141] Under SEC Rule 14a-8(i)(2), a company may exclude a shareholder proposal "if the proposal would, if implemented, cause the company to violate any state, federal, or foreign law to which it is subject."[142] Of course, that is the very question Professor Bebchuk hoped the Delaware courts would answer. In the meantime, the staff of the SEC refused to grant CA's no-action request, expressing "no view with respect to CA's intention to omit the [proposal] from the proxy materials relating to its next annual meeting of security holders."[143]

Though the parties did not raise a "ripeness" objection to Professor Bebchuk's lawsuit, Professor Smith blogged about the possibility.[144] In his decision in *Bebchuk*, Vice Chancellor Lamb raised the issue of ripeness sua sponte,[145] seemingly taking Professor Smith's hint. The court reasoned that only bylaws passed by shareholders had reached the level of "justiciable controversy."[146] This resolution revealed that the most important unanswered question about Delaware corporate law was in perpetual limbo.[147] Shareholders could not feasibly adopt, alter, or repeal the bylaws of a Delaware corporation without the assistance of Rule 14a-8,[148] but the

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140. *See Bebchuk*, 902 A.2d at 740 ("The board of CA, by letter dated April 21, 2006 to the SEC's Division of Corporation Finance, stated its belief that the proposed bylaw could be omitted from its proxy materials in accordance with SEC rules because, if implemented, the proposed bylaw would violate Delaware law."). For an excellent summary of the SEC's no-action process, see Donna M. Nagy, *Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters: Current Problems and a Proposed Framework*, 83 CORNELL L. REV. 921, 929–66 (1998).

141. *See Bebchuk*, 902 A.2d at 740.

142. 17 C.F.R. § 240.14a-8 (2011).

143. CA, Inc., SEC No-Action Letter, 2006 WL 1547985, at *1 (June 5, 2006).

144. *See* Gordon Smith, Bebchuk v. CA, Inc., THE CONGLOMERATE (June 16, 2006), http://www.theconglomerate.org/2006/06/bebchuk_v_ca_in.html.

145. *See Bebchuk*, 902 A.2d at 741.

146. J.W. Verret, *Federal vs. State Law: The SEC's New Ability to Certify Questions to the Delaware Supreme Court,* CORP. GOVERNANCE ADVISOR, Mar.–Apr. 2008, at 12, 13.

147. Even though the court rejected the case on ripeness grounds, some commentators argued that the reasoning employed by the Chancery Court in the case provided "tantalizing hints as to how it might assess a challenge to an enacted bylaw of this sort." Bruner, *supra* note 119, at 1446. For instance, the court's "'review of the divergent authorities concerning the validity of stockholder bylaws which limit a board of director's exercise of one of its powers'" suggested that

> [f]rom a purely legal standpoint, it is not necessarily clear that a bylaw limiting the duration of a board-authorized rights plan to one year is either facially illegal as an unauthorized impingement upon the board's powers under the DGCL or an unreasonable intrusion into the board's exercise of its fiduciary duties.

Id. (alteration in original) (quoting *Bebchuck*, 902 A.2d at 742–43).

148. *See* Lynne L. Dallas, *The Control and Conflict of Interest Voting Systems*, 71 N.C. L. REV. 1, 16 n.56 (1992) ("The Commission has consistently maintained that Rule 14a-8 may

SEC would not resolve no-action requests without more guidance from the Delaware courts. Furthermore, as illustrated by *Bebchuk*, the Delaware courts would not intervene to break the stalemate by providing the SEC with that necessary guidance until the shareholders had adopted their bylaw.[149] In the wake of the *Bebchuk* decision, and ironically reminiscent of sections 109 and 141(a), the procedural rules of the Delaware courts and the SEC seemed trapped in a recursive loop.

2. Certification and the Road to *CA, Inc. v. AFSCME*

Less than a year after *Bebchuk* was decided, the Delaware General Assembly eliminated this procedural logjam by amending the Delaware Constitution to allow the Delaware Supreme Court to "hear and determine questions of law certified to it by . . . the United States Securities and Exchange Commission."[150] A corresponding amendment to the Delaware Supreme Court's rules solidified the process.[151] This move was a remarkable step for corporate law and added "a fascinating chapter to the symbiotic, though at times rival, relationship between the SEC and Delaware."[152]

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not be used by shareholders to nominate or recommend board members. It has maintained this position despite its recognition that: 'For the vast majority of shareholders, an election contest is not feasible because of the huge expenses involved.'" (quoting Reexamination of Rules Relating to Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, 42 Fed. Reg. 23,901, 23,902 (May 11, 1977))); A.A. Sommer, Jr., *Corporate Governance in the Nineties: Managers vs. Institutions*, 59 U. CIN. L. REV. 357, 370 (1990) ("The only formal, institutional, and feasible means available to the institutional holder to use 'voice' as opposed to 'exit' is the shareholder proposal mechanism provided by SEC rule 14a-8 under the Securities Exchange Act.").

149. *Cf.* Verret, *supra* note 146, at 13 ("This holding would make placing bylaws on the ballot nearly impossible, however, as the target could exclude it claiming a state law violation under 14a-8 (despite the DGCL's murky jurisprudence on that matter) and the shareholders would be left with only the remedy of ex-post challenge in federal courts. In the risk-averse institutional investor community, such a remedy would be insufficient to permit bylaw challenges to succeed.").

150. DEL. CONST. art. IV, § 11(8). Before the amendment was passed, "only federal courts and other state Supreme Courts were able to certify questions of law to Delaware's Supreme Court." Frederick H. Alexander et al., *Corporate Governance: The View from Delaware* (ALI-ABA Continuing Legal Education, Washington, D.C.) Feb. 21–22, 2008, 162–63 (quoting *2007 Amendments to Delaware Corporate Law*, DEL. DIV. OF CORPS. (July 17, 2007), http://www.corp.delaware.gov/2007amend.shtml).

151. *See* Junis L. Baldon, *Taking a Backseat: How Delaware Can Alter the Role of the SEC in Evaluating Shareholder Proposals*, 4 ENTREPRENEURIAL BUS. L.J. 105, 105–07 (2009). Interestingly, this amendment did not go through the usual process for revising corporate law in Delaware, a process that typically begins with the Council of the Delaware State Bar Association's Corporation Law Section. For an account of this process, see Lawrence Hamermesh, *How We Make Law in Delaware, and What to Expect from Us in the Future*, 2 J. BUS. & TECH. L. 409 (2007).

152. Verret, *supra* note 146, at 12. Clearly, this process also has the potential to enhance "Delaware's dominance as the state of incorporation for publicly traded corporations." *Id.*

While there are certainly problems arising from SEC certification,[153] the process enables Delaware courts to decide significant questions of Delaware law that may otherwise remain outside court doors. Such questions include: (1) "whether a bylaw proposal purporting to remove board authority to alter or amend that bylaw would be legal under Delaware law";[154] (2) what power shareholders may maintain over the process by which the board of directors is elected; (3) to what extent shareholders may prevent a board from adopting a poison pill (as was the case in *Bebchuk*[155]); and (4) whether shareholders may adopt bylaws requiring corporations to "de-stagger" their board of directors.[156] Indeed, it seems clear that at this time of increasing shareholder activism, the "types of bylaws that [may] be proposed are limited only by the creativity of the shareholders" proposing them.[157]

How often the certification process will actually be utilized (and the ways such utilization will affect corporate governance) remains to be seen. What we know is that slightly over one year after Delaware amended its Constitution, the SEC certified two questions to the Delaware Supreme Court, spawning a decision in which, for the first time, Delaware courts directly examined the interplay between section 109 and section 141(a).[158]

3. *CA, Inc. v. AFSCME Employees Pension Plan*

The first questions certified from the SEC were answered by the court in *CA, Inc. v. AFSCME Employees Pension Plan*, which involved a shareholder proposal by the American Federation of State, County, and Municipal Employees (AFSCME), a large labor union. AFSCME sought to amend CA's bylaws by adding a requirement that the board of directors "reimburse a stockholder or group of stockholders . . . for reasonable

153. For instance, the certification process circumvents the Court of Chancery, cutting out its reasoned (and intelligent) analysis and removing the possibility of appeal for losing litigants. Additionally, the certification process enables certain parties to seek legal recourse that would otherwise lack standing. Finally, as Justice Jacobs points out in *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227, 238 (Del. 2008), certification requires the justices to make "determination[s] . . . in the abstract"—that is, legal analysis without adequate factual foundations. In that case, such determinations enabled the court to hold that the proposed bylaw would, if passed, cause CA to violate Delaware law by finding at least one "hypothetical" instance where "directors would breach their fiduciary duties if they complied with the Bylaw." *Id.*

154. Verret, *supra* note 146, at 12.

155. Bebchuck v. CA, Inc., 902 A.2d 737, 737–38 (Del. Ch. 2006).

156. *See* Verret, *supra* note 146, at 12–14.

157. *Id.* at 13.

158. John W. White, the Division Chief of Corporate Finance at the SEC, commented positively on the first use of the certification process in *CA, Inc.* by noting that "[the SEC is] very excited to have this tool at our disposal, and look[s] forward to using it further, as appropriate, in coming years." John W. White, Dir., Div. of Corporate Fin., Sec. & Exch. Comm'n, Corporation Finance in 2008—A Year of Progress, Speech at Meeting of ABA Section of Business Law, Committee on Federal Regulation of Securities (Aug. 11, 2008), *available at* http://www.sec.gov/news/speech/2008/spch081108jww.htm ("This was obviously an important decision substantively, but it also was very important to us in terms of process, as it was the first time we had certified a question under the new procedure.").

expenses . . . incurred in connection with nominating one or more candidates in a contested election of directors."[159] The ultimate issue presented in this case was whether CA, Inc. would be allowed to exclude the proposal from its proxy statement on the ground that the proposed bylaw would be an improper subject for shareholder action under Delaware law or, alternatively, that the bylaw would cause CA, Inc. to violate Delaware law.

The board of directors of CA, Inc. opposed the bylaw and requested a no-action letter from the SEC.[160] In connection with its no-action letter request, CA, Inc. submitted an opinion letter from the Delaware law firm of Richards, Layton & Finger P.A. stating, "[I]n our opinion the Proposal is not a proper subject for stockholder action and, if implemented by the Company, would violate the General Corporation Law."[161] In response, AFSCME submitted an opinion letter from the Delaware law firm of Grant & Eisenhofer P.A. stating, "Our Opinion [is that] the Proposed Bylaw is valid under Delaware law [and that] Delaware law recognizes stockholders' ability to enact bylaws such as the one contained in the Proposal."[162] Faced with these directly contradictory opinions, the SEC certified the following questions to the Delaware Supreme Court: "(I) Is the AFSCME Proposal a proper subject for action by shareholders as a matter of Delaware law? (II) Would the AFSCME Proposal, if adopted, cause CA to violate any Delaware law to which it is subject?"[163]

As a matter of Delaware law, these questions implicate sections 109 and 141(a). Given that this was the Delaware Supreme Court's first opportunity to resolve the seemingly insoluble tension between sections 109 and 141(a), the resulting opinion was—perhaps inevitably—somewhat contradictory.

For instance, Professor McDonnell noted that the court's answer to the first question was clearly a "victory for shareholders," but their response to the second was both "unclear and ominous," effectively undercutting the previous five pages of analysis.[164] Professor Robert B. Thompson echoed this sentiment when he wrote that "[t]he court's answers seemed to simultaneously point in two directions."[165] The issue will undoubtedly

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159. CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 229–30 (Del. 2008).

160. Letter from Sec. & Exch. Comm'n to Del. Supreme Court, Certification of Questions of Law Arising from Rule 14a-8 Proposal by Shareholder of CA, Inc. 1 (June 27, 2008), *available at* http://www.sec.gov/rules/other/2008/ca14a8cert.pdf.

161. *Id.* at 1.

162. *Id.* at 2.

163. *Id.* at 4.

164. Brett H. McDonnell, *Bylaw Reforms for Delaware's Corporation Law*, 33 DEL. J. CORP. L. 651, 664 (2008). As Professor McDonnell notes:

> Virtually all bylaws limit board discretion in some way, and with some creativity one should almost always be able to come up with circumstances where doing what the bylaw requires would force the board to act in a way that violates its duty if it had discretion to act as it chose. So what bylaws remain valid under *CA, Inc.*?

Id.

165. Robert B. Thompson, *Defining the Shareholder's Role, Defining a Role for State Law: Folk at 40*, 33 DEL. J. CORP. L. 771, 782 (2008). Professor Thompson further commented on the effect of these bylaws on shareholder power, suggesting that such power was

require additional litigation before the scope of *CA, Inc.* is understood (unless, of course, the Delaware General Assembly decides to amend the DGCL to resolve the lingering issues directly).[166]

In *CA, Inc.*, the court made two novel and somewhat startling assertions: (1) that "the DGCL has not allocated to the board and the shareholders the identical, coextensive power to adopt, amend and repeal the bylaws";[167] and (2) "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."[168]

The first assertion seems plausible enough on the face of section 109, which states without qualification that the shareholders of a corporation are invested with "the power to adopt, amend or repeal bylaws," while the directors have no statutory "power to adopt, amend or repeal bylaws," but only such power as is conferred upon them by the certificate of incorporation.[169] Indeed, the concluding sentence of section 109(a) seems designed to drive the point home that shareholders have an immutable statutory power, whereas the power of directors is dependent on the certification of incorporation,[170] which the Delaware courts routinely treat as a contract.[171]

Whether the source of the bylaw power is the DGCL or the certificate of incorporation probably should not matter, but what else could be the basis of a distinction between the board's power to change the bylaws and shareholders' power to change the bylaws? If the source of the bylaw power mattered, we would probably assume that the statutory grant of authority would be weightier than the grant in the certificate of incorporation. Nevertheless, the court drew exactly the opposite inference from the language of the statute, namely, that the bylaw power of the shareholders was not as broad as the bylaw power of directors.[172]

> hobbled by two significant limitations. First, the court said bylaws can only decide the process for decision making but not mandate the decision itself, which must be left to directors. Second, and more generally, the world of shareholder power as illustrated by this opinion is not one of shareholder self-help, but rather one of shareholders having to rely on two filters to protect their interests: the first being the board of directors and the second being the courts through enforcement of fiduciary duty.

Id. at 783.

166. *See* McDonnell, *supra* note 164, at 664.

167. CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 231 (Del. 2008).

168. *Id.* at 234–35.

169. DEL. CODE ANN. tit. 8, § 109(a) (2005).

170. *Id.* ("The fact that such power has been so conferred upon the directors or governing body, as the case may be, shall not divest the stockholders or members of the power, nor limit their power to adopt, amend or repeal bylaws.").

171. *See, e.g.*, Benihana of Tokyo, Inc. v. Benihana, Inc., 906 A.2d 114, 120 (Del. 2006) ("It is settled law that certificates of incorporation are contracts, subject to the general rules of contract and statutory construction.").

172. *CA, Inc.*, 953 A.2d at 232.

To reach this result, the court observed that section 109(a) "does not exist in a vacuum," but it must be read together with section 141(a).[173] After quoting that section, which grants to the board of directors the authority to manage or supervise the management of the "business and affairs of every corporation,"[174] the court asserted:

> No such broad management power is statutorily allocated to the shareholders. Indeed, it is well-established that stockholders of a corporation subject to the DGCL may not directly manage the business and affairs of the corporation, at least without specific authorization in either the statute or the certificate of incorporation. Therefore, the shareholders' statutory power to adopt, amend or repeal bylaws is not coextensive with the board's concurrent power and is limited by the board's management prerogatives under Section 141(a).[175]

In observing that this principle of director primacy[176] is "well-established," the court cited a raft of cases,[177] the earliest of which is *Aronson v. Lewis*,[178] Justice Moore's enigmatic decision articulating the standard (though incoherent) definition of the business judgment rule.[179] In that case, Justice Moore stated, "A *cardinal precept* of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation."[180] The *CA, Inc.* court relied on *Aronson*'s "cardinal precept" in another footnote to escape the recursive loop of sections 109(a) and 141(a). The court reasoned:

> Because 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).[181]

Although bylaws adopted under section 109 are invalid if they are inconsistent with section 141(a), the court rejected CA Inc.'s argument that "*any* bylaw that in *any* respect might be viewed as limiting or restricting the power of the board of directors automatically falls outside the scope of permissible bylaws."[182] The court correctly observed, "That reasoning, taken to its logical extreme, would result in eliminating altogether the

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173. *Id.*
174. DEL. CODE ANN. tit. 8, § 141(a).
175. *Id.*
176. On the theory of director primacy, see BAINBRIDGE, *supra* note 31.
177. *CA, Inc.*, 953 A.2d at 232 n.6.
178. 473 A.2d 805 (Del. 1984).
179. *Id.* at 812 ("The business judgment rule . . . is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.").
180. *Id.* at 811 (emphasis added) (quoting DEL. CODE ANN. tit. 8, § 141(a)).
181. *CA, Inc.*, 953 A.2d at 232 n.7 (alteration in original).
182. *Id.* at 234.

shareholders' statutory right to adopt, amend or repeal bylaws."[183] But if neither section clearly trumped, the court was left with the perennial (and nasty) "split the difference" problem.

Before turning to the court's solution, however, we pause to highlight what we consider to be the fundamental flaw in the court's reasoning, namely, the "cardinal precept" the court relies upon was articulated and propagated in cases deciding the appropriate scope of *shareholder intervention via litigation*.[184] The cases in which the "cardinal precept" language appears are not cases in which shareholders deliberately intervened in corporate governance ex ante, but rather cases in which the shareholders attempted to undo a board action ex post.[185] In our view, this makes all the difference. Certainly, to maintain the efficiency of corporate governance, shareholders should not have the power to retroactively second-guess decisions the board of directors legitimately made using their broad grant of authority in section 141(a). But nothing in these cases suggests that shareholders may not guide the decisions of the board of directors *before* they act. The context of this case as an ex ante intervention completely undercuts the "cardinal precept" espoused by the court and, consequently, the corresponding notion that board power necessarily trumps shareholder power.

We now turn to the second assertion mentioned above, that the "proper function of bylaws" is to lay down procedural rules, not to make substantive decisions. The court made this assertion as part of its "split the difference" analysis. The assertion seems problematic in light of the broad description of bylaws in section 109(b).[186] The only authorities cited for the court's distinction between procedural and substantive bylaws are two Court of Chancery opinions,[187] neither of which stands for the proposition that bylaws must be exclusively procedural.[188]

183. *Id.*

184. *Id.* (citing McMullin v. Beran, 765 A.2d 910, 916 (Del. 2000); Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281, 1291–92 (Del. 1998); *Aronson*, 473 A.2d at 811).

185. *Id.*

186. DEL. CODE ANN. tit. 8, § 109(b) (2005).

187. *CA, Inc.*, 953 A.2d at 235 n.15.

188. For instance, the Court of Chancery in *Hollinger International, Inc. v. Black*, 844 A.2d 1022, 1078–79 (Del. Ch. 2004), observed that "bylaws have been the corporate instrument used to set forth the rules by which the corporate board conducts its business," and noted a "general consensus that bylaws that regulate the process by which the board acts are statutorily authorized." The *Hollinger* opinion also concluded that "bylaws may pervasively and strictly regulate the process by which boards act, subject to the constraints of equity." *Id.* at 1080 n.136. Thus, bylaws may be procedural, and if they are procedural, the Delaware courts are likely to defer. But nothing in this language suggests that bylaws *must* be procedural.

The Delaware Supreme Court in *CA, Inc.* also cited *Gow v. Consolidated Coppermines Corp.*, 165 A. 136, 140 (Del. Ch. 1933), which stated, "[A]s the charter is an instrument in which the broad and general aspects of the corporate entity's existence and nature are defined, so the by-laws are generally regarded as the proper place for the self-imposed rules and regulations deemed expedient for its convenient functioning to be laid down." Here the operative words seem to be "generally regarded."

An even more problematic aspect of this part of the opinion, however, is that the court has now invited litigation of the nature of bylaws without much guidance on how to distinguish procedural and substantive bylaws.[189] After characterizing various bylaws as "purely procedural," the court analyzed the AFSCME bylaw proposal and concluded that, "though infelicitously couched as a substantive-sounding mandate to expend corporate funds, has both the intent and the effect of regulating the process for electing directors of CA."[190] As a result, the bylaw was a "proper subject for shareholder action" under Rule 14a-8.[191]

Despite ruling for the shareholders on the first certified question, the court nevertheless held that the bylaw was "inconsistent with law" (the second certified question) because "the board of directors would breach their fiduciary duties if they complied with the Bylaw."[192] In our view, the court misapprehended the proper relationship between shareholder bylaws and fiduciary duty.

To explain the difficulties with the court's opinion, we invoke the analogy of an agency relationship in which the shareholders are the "principal" and the board of directors is the "agent."[193] The very definition of an agency relationship contemplates the right of control by the principal, and the agent has a concomitant duty of obedience.[194] It is axiomatic that the agent does not breach its duty by following the principal's orders.

Despite limited precedential authority, however, the distinction between substantive and procedural bylaws has been endorsed by some commentators. *See, e.g.*, Coffee, Jr., *supra* note 102, at 614.

189. For example, at one point in the opinion, the court reasoned, "[T]he Bylaw's wording, although relevant, is not dispositive of whether or not it is process-related." *CA, Inc.*, 953 A.2d at 236.

190. *Id.* at 235–36.

191. *Id.* at 236.

192. *Id.* at 238.

193. This analogy is, of course, not unique to this Article. In fact, corporate law scholars have long invoked this metaphor to explain the purpose and nature of fiduciary duties owed by the board of directors to the shareholders. *See, e.g.*, WILLIAM T. ALLEN & REINIER KRAAKMAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 97 (2003) (suggesting that directors serve as "quasi-principal[s]" and "economic agent[s]" of the shareholders) (emphasis omitted); Rob Atkinson, *Obedience as the Foundation of Fiduciary Duty*, 34 J. CORP. L. 43, 45 (2008); Geoffrey A. Manne, *Agency Costs and the Oversight of Charitable Organizations*, 1999 WIS. L. REV. 227, 233 ("Corporations . . . are contractual relationships in which a principal (a shareholder . . .) contracts with an agent (a director . . .) to provide some service."). *But see* Paula J. Dalley, *Shareholder (and Director) Fiduciary Duties and Shareholder Activism*, 8 HOUS. BUS. & TAX L.J. 301, 329 (2008) ("Shareholders, whether controlling or not, are not 'principals' of the board and therefore have no legal control over the board.").

194. While no formal "duty of obedience" has ever been articulated by Delaware courts, such a principle underlies both the duty of care and the duty of loyalty and fits within the framework of corporate common sense. If the directors owe no obedience to the shareholders, to whom do they owe it? *See* Atkinson, *supra* note 193, at 48 ("The irreducible root of the fiduciary relationship is one person's acting for another. The duty of obedience derives directly from—indeed, is virtually synonymous with—that basic principle. The root of the fiduciary relationship is this directive from the principal to the fiduciary: Serve the one the principal designates, as the principal designates. The fiduciary must, at the most basic level, obey that directive; that directive is the duty of obedience.").

Following this line of reasoning in the corporate context, we contend that the court in *CA, Inc.* erred by reaching the conclusion that "the Bylaw, as drafted, would violate the prohibition, which our decisions have derived from Section 141(a), against contractual arrangements that commit the board of directors to a course of action that would preclude them from fully discharging their fiduciary duties to the corporation and its shareholders."[195]

As with its analysis of *Aronson*'s "cardinal precept," the court failed to account for the unique factual context presented by shareholder bylaws.[196] In doing so, the court erroneously looked to the fiduciary principle from *Paramount Communications, Inc. v. QVC Network, Inc.*,[197] in which the Delaware Supreme Court invalidated a deal protection device in a merger agreement. In that case, the board of directors of Paramount Communications, Inc. approved the device to protect a merger agreement between their company and Viacom from any hostile interventions by QVC Network, Inc. The court held that the "Paramount directors could not contract away their fiduciary obligations."[198]

In similar fashion, the court in *CA, Inc.* also cited *Quickturn Design Systems, Inc. v. Shapiro*,[199] in which the Delaware Supreme Court invalidated a "delayed redemption provision" in a poison pill. According to the *Quickturn* court, the delayed redemption provision was invalid because it "prevent[ed] a newly elected board of directors from *completely* discharging its fundamental management duties to the corporation and its stockholders for six months."[200]

The *CA, Inc.* court recognized the obvious distinction between these two cases and the case at bar, namely, that *QVC* and *Quickturn* both involved actions by the board of directors to limit their own authority, whereas *CA, Inc.* involved an action by shareholders to limit the board's authority. But the court called this distinction "one without a difference":

> The reason is that the internal governance contract—which here takes the form of a bylaw—is one that would also prevent the directors from exercising their full managerial power in circumstances where their fiduciary duties would otherwise require them to deny reimbursement to a dissident slate. That this limitation would be imposed by a majority vote of the shareholders rather than by the directors themselves, does not, in our view, legally matter.[201]

It is hard to imagine how the court found this argument persuasive. The form of the argument is transparently circular, and, if taken seriously, would *prohibit all bylaws*. After all, as the court recognized earlier in its opinion, *every* bylaw impinges to some extent on the power of the board of

195. *CA, Inc.*, 953 A.2d at 238.
196. *See supra* notes 180–81 and accompanying text.
197. 637 A.2d 34 (Del. 1994).
198. *Id.* at 51.
199. 721 A.2d 1281 (Del. 1998).
200. *Id.* at 1291.
201. CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 239 (Del. 2008).

directors,[202] thus "prevent[ing] the directors from exercising their full managerial power in circumstances where their fiduciary duties would otherwise require them to [act]."[203] The court had properly framed the issue as requiring it to decide "what is the scope of shareholder action that Section 109(b) permits yet does not improperly intrude upon the directors' power to manage corporation's business and affairs under Section 141(a),"[204] but its conclusory resolution of that issue is unsatisfactory because it unwittingly concluded that there is *no scope* of shareholder action that does not improperly intrude upon a director's powers.

4. *Bebchuk v. Electronic Arts, Inc.*

Scarcely five months after the *CA, Inc.* decision, Professor Bebchuk returned to the courtroom with another dispute, this time on the proper scope of Rule 14a-8 and, by implication, the role of shareholders in corporate governance. The conclusion reached by the judge in that case reinforced the faulty judicial premise that directorial discretion on how to manage a corporation is somehow sacrosanct and that shareholders must make do with whatever scraps of power remain after the directors are finished.

In November 2008, the Southern District of New York weighed in on the issue of shareholder power to adopt, alter, and amend bylaws.[205] At issue was a bylaw proposed by Professor Bebchuk limiting the Electronic Arts (EA) board's discretion in excluding bylaw proposals under Rule 14a-8.[206] In essence, the precatory proposal asked the EA board to propose an amendment to EA's Certificate of Incorporation (or bylaws) that would require directors to include all shareholder proposals on its proxy materials submitted by a shareholder except those determined to be invalid or improper under state law or those relating to EA's ordinary business operations.[207] Such an amendment, if passed, would create a new excludability scheme that would require EA's directors to include numerous proposals that would otherwise be excludable under Rule 14a-8 (such as proposals relating to elections and proposals in conflict with the company's proposals on the same ballot).[208]

The issue raised in the motion to dismiss was whether such an amendment would, if passed, improperly or unduly restrain the board's

202. The court reasoned, "Bylaws, by their very nature, set down rules and procedures that bind a corporation's board and its shareholders. In that sense, most, if not all, bylaws could be said to limit the otherwise unlimited discretionary power of the board." *Id.* at 234.

203. *Id.* at 239.

204. *Id.* at 234.

205. *See* Transcript of Record, Bebchuk v. Elec. Arts, Inc., No. 08-cv-03716 (S.D.N.Y. Nov. 12, 2008).

206. Lucian Bebchuk, Electronic Arts Proposal Concerning Bylaw Amendments, *available at* http://www.law.harvard.edu/faculty/bebchuk/pdfs/2008_Electronic-Arts-Precatory-Proposal.pdf.

207. *See id.*

208. *See* 17 C.F.R. § 240.14a-8 (2011).

discretion to exclude shareholder proposals.[209] Arguing against EA's motion to dismiss, counsel for Professor Bebchuk suggested that the proposal was not properly excluded under Rule 14a-8 for at least the following three reasons: first, Rule 14a-8 "provides the minimum of what has to go in a proxy statement, not the maximum";[210] second, according to the *CA, Inc.* decision, shareholder-proposed bylaws could "be very restrictive on procedural matters addressed by the board of directors";[211] and third, even if the bylaw was a "bad idea for a corporation" and a "bad idea for shareholders to restrict the board's discretion," it was still a valid and legal proposal and not excludable under any of the bases for exclusion laid out in Rule 14a-8.[212]

In response, and in support of the motion to dismiss, counsel for EA argued that the proposal "attempt[ed] to use the 14a-8 right of access process to effectuate an opt-out of the 14a-8 regime" and that such a proposal would be excludable under Rule 14a-8(i)(3), which allows a corporation to exclude any proposal contrary to Rule 14a-8.[213] Essentially, EA argued that the SEC had already created the "right" system of checks and balances whereby boards were given the proper level of discretion and that Professor Bebchuk's proposal sought to alter and distort that framework and, as such, was properly excludable.[214]

Of course, we readily agree with Professor Bebchuk's analysis and arguments. Strangely enough, however, so did EA. Early on in the case, EA made a significant concession that, if properly understood, should have easily given the case to Professor Bebchuk. EA conceded:

> If the board, in the exercise of its fiduciary duties, voluntarily decides that it wants to opt out, or not enforce any of these enumerated provisions [in Rule 14a-8] . . . it can do that. . . . And if the shareholders decide, through a proxy solicitation, that . . . they want to amend the bylaws to opt out of the 14a-8 process, they could do that as well. . . . [I]n other words, they could adopt this proposal.[215]

In light of this concession, it is hard to see what could remain to impede adoption of the bylaw. However, EA went on to suggest that it was concerned not with the *substance* of the bylaw, but with the *procedure* for enacting it. As Professor Bebchuk argued (in light of EA's concession), the "entire discussion [about] . . . the supposedly sacrosanct careful

209. *See* Transcript of Record, *supra* note 205, at 3–4.

210. *Id.* at 10–12 ("[T]here is nothing in 14a-8 or anywhere else in the proxy rules that says the discretion afforded to a company to decide whether or not to include or exclude a proposal must be decided, unencumbered, within the discretion of a board of directors.").

211. *Id.* at 8.

212. *Id.* at 32–33.

213. *Id.* at 12.

214. *Id.* at 14–15; *see also* Gordon Smith, Bebchuk v. Electronic Arts*: Dismissed*, THE CONGLOMERATE (Nov. 18, 2008), http://www.theconglomerate.org/2008/11/bebchuk-v-elect.html.

215. Transcript of Record, *supra* note 205, at 12–13.

balancing . . . is [now] irrelevant. They have just admitted that you can [adopt this bylaw]. They just caution how you do it."[216]

Unfortunately for Professor Bebchuk, Judge Alvin Hellerstein could not let go of a fundamental misconception within corporate law: the belief that directors must have absolute, unchecked power to manage a corporation and that any attempt to tamper with the directors' discretion should receive direct judicial condemnation. As the judge noted:

> [I]f it is wrong to strip the directors of a discretion that is found to be necessary, [it] doesn't seem to me it makes any difference whether it is the company that initiated the proposal or the stockholder that initiated the proposal. . . . There can't be a stripping away of a company of discretion in some governing body to make that decision. That's [Rule 14-a(i)(8)].[217]

Thus, EA held the day. In granting the motion to dismiss, Judge Hellerstein went on to hold that Professor Bebchuk's proposal was properly excluded under Rule 14a-8(i)(3) because

> once the recommendation is made, if it's made, the inevitable effect of this proposal is to do away with the careful limitation on the part of 14a-8, to eliminate the discretion of the company, because there will be nobody to exercise it, and to have all of these questions submitted as a matter of law, federal law, to the shareholders.[218]

Apparently, Judge Hellerstein believes that Rule 14a-8—and only Rule 14a-8—defines the scope of director discretion with respect to a company's proxy ballot. Thus, the Judge implicitly granted the proposition that Rule 14a-8 preempts state law on the issue of access to the issuer's proxy statement. However, this proposition reflects a significant (and classic) federalism problem: "[W]here in the complex realm of corporate internal governance does the federal regime end and the state regime begin?"[219] Failure to draw the line properly has led to many misunderstandings in federal courts (where judges must walk a fine line).

Though Judge Hellerstein's decision has received some positive commentary,[220] it remains a clear example of what happens when courts enshrine the principle of nearly-absolute directorial power at the expense of shareholders, even though there is practically no need (or precedent) for doing so.

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216. *Id.* at 20.

217. *Id.* at 25–26.

218. *Id.* at 49.

219. Larry Ribstein, Bebchuk v. Electronic Arts, IDEOBLOG (Sept. 11, 2008, 11:46 AM), http://busmovie.typepad.com/ideoblog/2008/09/bebchuk-v-elect.html.

220. *See, e.g.*, *id.* Professor Ribstein argues that even if the proposal is not within a specific 14a-8 exclusion, it would essentially undermine the careful limitations on mandated proposals under 14a-8. *Id.* ("This strikes me as really an argument that the proposal is substantially inconsistent with 14a-8 even if it doesn't fall within a specific exclusion category. And that argument makes some sense."). Professor Ribstein suggests that the proposal was properly excluded because even though the proposal does not fall "within a specific" 14a-8 exclusion, if passed it "would essentially undermine the careful limitations on mandated proposals under 14a-8." *Id.*

C. Amendments to the DGCL

On February 28, 2009, the Council of the Corporation Law Section of the Delaware State Bar Association released the proposed 2009 amendments to the DGCL.[221] In a surprising move, as part of these amendments, the Council proposed two new sections favoring shareholder proxy access and greater participation by shareholders in board elections, both of which were subsequently adopted by the Delaware General Assembly.[222] Section 112 "expressly authoriz[es] a Delaware corporation to adopt a bylaw that grants stockholders the right to include within the corporation's proxy solicitation materials stockholders' nominees for the election of directors, subject to any lawful conditions the bylaws may impose."[223] This section goes to the heart of the director election problem.

Additionally, section 113 "permits Delaware corporations to adopt a bylaw providing for the reimbursement by the corporation of expenses incurred by a stockholder in soliciting proxies in connection with an election of directors, subject to such procedures or conditions as the bylaw may prescribe."[224] This section addresses the proposal at issue in *CA, Inc.* However, unlike the Delaware Supreme Court in that case,[225] section 113 does not expressly require that such a bylaw contain any type of fiduciary out for directors.[226] Although a court interpreting this section may decide that some type of fiduciary out is implicitly required, we argue that the failure by the Delaware General Assembly to explicitly recognize such a right suggests a more expansive view of shareholder power than has previously existed in Delaware.

Commentators have described Delaware's adoption of sections 112 and 113 as both "'the most significant change [of the year's proposed corporate law updates]'"[227] and, conversely, as merely "purport[ing] to confer rights that already existed under Delaware state law."[228] In the lone case to mention the amendments thus far, *Yucaipa American Alliance Fund II, L.P. v. Riggio*,[229] Vice Chancellor Strine opined on their impact in an incisive footnote.[230] There, the Vice Chancellor addressed the amendments while

221. Michael Tumas & John Grossbauer, *Amendments to the Delaware Corporation Code*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (Feb. 28, 2009, 4:24 PM), http://blogs.law.harvard.edu/corpgov/2009/02/28/proposed-amendments-to-the-delaware-general-corporation-law-2/.

222. *See* DEL. CODE ANN. tit. 8, §§ 112, 113 (2011).

223. *Id.*

224. *Id.*

225. CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 238 (Del. 2008).

226. DEL. CODE ANN. tit. 8, § 113.

227. Mark J. Roe, *Delaware's Shrinking Half-Life*, 62 STAN. L. REV. 125, 151 (2009) (alterations in original) (quoting Joseph A. Giannone, *Proposed Delaware Law Changes Expand Proxy Access*, REUTERS, Feb. 27, 2009, *available at* http://www.reuters.com/article/2009/02/27/us-corporategovernance-delaware-smbiz-idUSTRE51Q5RT20090227).

228. Fairfax, *supra* note 107, at 108.

229. 1 A.3d 310 (Del. Ch. 2010).

230. *See id.* at 356 n.244. Vice Chancellor Strine has also commented on the amendments in his article, *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also*

rejecting the shareholder plaintiff's argument that sections 112 and 113 represented a policy shift that should have invalidated a poison pill that was at issue in the case.[231] Notably, he explained that the new sections did not redefine or reshape Delaware corporate law, but rather they simply "ma[de] plain that which had always been understood by most Delaware corporate lawyers."[232]

Professor Lisa Fairfax also contends that the amendments "did not actually confer any new rights on shareholders or directors."[233] While she acknowledges that the Delaware General Assembly may have enacted them to merely clarify the law, or even expand shareholder rights,[234] she posits an additional reason that may have greater impact—namely, that they were adopted as part of Delaware's ongoing competition with the federal

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Act and Think Long Term, 66 BUS. LAW. 1 (2010). In that article, Vice Chancellor Strine criticized institutional investors for thinking "short term" when it is in the best interest of those "whose money they manage," and the corporation as a whole, to focus "on the creation of durable, long-term wealth." *Id.* at 1. In considering proxy contests, the Vice Chancellor acknowledged the difficulties that investors face, and the advantages that incumbent management have, in campaigning for board seats. *See id.* at 6–7. Further, he seemed to commend the "private ordering" fostered by DGCL section 112, but also recommended "an enhanced and more flexible Rule 14a-8 to adopt bylaws that shape a more open election system, using techniques such as reimbursement for insurgent slates receiving a certain level of support or access to the company's proxy statement." *See id.*

231. *See Yucaipa*, 1 A.3d at 356 n.244. The shareholder plaintiff in the case (Yucaipa) contended that if the court allowed the defendant (the Barnes & Noble directors) to maintain its poison pill, the "court [would] be undermining the recent amendments to the DGCL." *Id.* The Barnes & Noble pill prevented Yucaipa from making an agreement with another large shareholder in a proxy campaign for board seats. *See id.* at 312–13. Together the two shareholders would have comprised "nearly 40% of the vote" in the coming election. *Id.* at 356 n.244.

232. *Id.* at 356 n.244. Vice Chancellor Strine asserted that Delaware stockholders already had "the authority to adopt potent bylaws shaping a more competitive election process." *Id.* He argued that if the DGCL amendments demonstrated anything about that specific pill, it was that it was not overly injurious to the shareholder franchise. *See id.* The Vice Chancellor reasoned:

> For starters, the very premise of a reimbursement bylaw, if adopted, undercuts the idea that a 20% holder needs to club up to fund a proxy contest, as the reimbursement feature would minimize any cost justification. Moreover, . . . the idea [behind the amendments] has been to give smaller holders an ability to run proxy contests because of the reality that their small holdings may make it unjustifiable to do so.

Id. Yucaipa was not such a "small holder." *See id.* Accordingly, the Vice Chancellor concluded that there was "no evident clash between these statutes and the Barnes & Noble Rights Plan." *Id.*

233. Fairfax, *supra* note 107, at 106. Professor Fairfax argues that while the amendments may have been enacted to "buttress[] shareholders' voting rights," they did little more than "clarif[y] and better define[] the scope of proxy access and expense reimbursement rights." *Id.* at 91, 106.

234. Professor Fairfax explains the "pivotal" role that proxy statements play in "effectuating [shareholders'] rights . . . and ensuring managerial accountability," and considers that the purpose for the amendments could have been merely to allow "for greater access to the proxy statement," and "to have a vital impact on shareholders' ability to participate in elections and influence corporate conduct." *Id.* at 89. However, she ultimately concludes that they "do very little in the way of directly advancing shareholder rights." *Id.* at 91.

government.[235] She argues that the DGCL amendments may have been an attempt "to head off federal regulation in this area."[236] However, Professor Fairfax did not dismiss the alternative possibility that the amendments were actually intended to—and, if not so intended, inadvertently might—give momentum toward the adoption of the subsequently promulgated SEC proxy rules.[237]

Professor Bebchuk and Scott Hirst also minimize the impact of the DGCL amendments in their article advocating for "access default" proxy reform.[238] They contend that although the amendments clarify Delaware's stance, "the permissibility of such bylaws was generally recognized prior to the enactment of section 112."[239] However, they criticize the "private-ordering" approach of the DGCL amendments and reject the idea that the "marketplace [will] effectively produce access arrangements whenever they are efficient."[240] They contend that "companies have had many years to adopt access bylaws and have not chosen to do so."[241] Consequently, they argue for a change from the "no-access default" provided for in the DGCL (and prior Delaware corporate law).[242]

Although we agree that the DGCL amendments may not have greatly diverged from prior Delaware corporate law, we nevertheless argue that their enactment (and the potential motivations behind such enactment) has added an interesting new dimension to the discussion concerning increased

235. *Id.* ("Delaware's recent actions thus may be viewed as having the twin goals of buttressing shareholders' voting rights and reaffirming Delaware's position in the corporate governance lexicon.").

236. *Id.* at 89. Professor Fairfax argues that Delaware may have acted "to prevent or curtail further federal encroachment into [the corporate governance arena], since such encroachment necessarily undercuts [Delaware's role as a leader]." *Id.* at 90; *see also* Roe, *supra* note 227, at 151 n.65 (arguing that, in enacting the amendments, Delaware was not acting in step with the "SEC's agenda" or trying to require greater proxy access, but, rather, that Delaware was merely "reacting and competing" with its "competition," namely the SEC).

237. *See* Fairfax, *supra* note 107, at 103–04 ("Indeed, it is possible that Delaware's actions may have been designed to, or at least may in effect, emphasize the importance of removing the federal impediments to proxy access proposals. Accordingly, the Delaware law may serve an important signaling function, indicating to the federal government Delaware's willingness to look favorably on shareholder-submitted proxy access proposals, and hence Delaware's willingness to look favorably on a federal law that sanctions such proposals."). Professor Fairfax further contends that the amendments may have "made such reform palatable to members of the business community," and that if they did have that effect, then "Delaware may have increased the likelihood that the SEC will adopt such reform." *Id.* at 103. However, she concludes that "Delaware's actions appear to have had no impact on the SEC's decision to move forward with a proxy access proposal." *Id.* at 107.

238. Bebchuck & Hirst, *supra* note 12, at 339–40. In their article, the professors reject two arguments that they label as "meta issues" in the debate over federal proxy access reform. *See id.* at 331. One of their contentions is that if proxy access rules have an "opt-out" provision, the default should be "access default" rather than the current "no-access" default, where a corporation has to choose to adopt proxy access bylaws. *See id.* at 332–33.

239. *Id.* at 340 n.47.

240. *Id.* at 339.

241. *Id.* at 339–40 ("[O]nly three companies have put in place a proxy access arrangement, and each of these three instances is peculiar because of either the nature of the company or the circumstances surrounding its adoption of proxy access.").

242. *See id.*

shareholder power in corporate elections. Moreover, it seems the amendments played a significant part in the vigorous debate that surrounded the SEC's recent attempt to enact new proxy access rules.

III. Shareholder Bylaws in the SEC

The SEC adopted new proxy access rules in November 2010. The most important of those rules, Rule 14a-11, was vacated by a three-judge panel of the D.C. Circuit in July 2011.[243] We discuss that opinion below, but we begin with a brief history of proxy access in the SEC. The latest rules were the product of a debate that began years before and promises to continue for the foreseeable future. The momentum towards the 2010 rules most recently began in October of 2003, when the SEC first proposed direct shareholder proxy access amendments to its proxy rules.[244] Although the SEC had considered adopting somewhat similar rules as far back as 1942,[245] the 2003 amendments were the first time that the SEC actually proposed rules that would have allowed shareholders direct access to the proxy statements.[246] However, those proposed amendments incurred strong opposition, and the SEC abandoned any effort to adopt them.[247]

The issue of proxy access resurfaced in the 2006 Second Circuit case, *American Federation of State, County and Municipal Employees v. American International Group, Inc.* (*AFSCME*).[248] In *AFSCME*, the court held that a corporation could not exclude a "shareholder proposal that seeks to amend the corporate bylaws to establish a procedure by which shareholder-nominated candidates may be included on the corporate ballot," because such a proposal "does not relate to an election within the meaning of [Rule 14a-8]"—the "election exclusion."[249] The court's holding came in response to AFSCME's request that AIG include such a bylaw proposal in its proxy materials.[250]

Notably, the *AFSCME* holding directly contradicted an interpretation of the election exclusion offered by the SEC. In fact, before the suit was filed, the SEC issued a no-action letter to AIG in response to its inquiry regarding this request and "indicated that it would not recommend an enforcement action against AIG should the Company exclude the proposal."[251]

243. Bus. Roundtable v. SEC, No. 10-1305, 2011 WL 2936808 (D.C. Cir. July 22, 2011).

244. Security Holder Director Nominations, 68 Fed. Reg. 60,784 (Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 274); *see also* Lisa M. Fairfax, *The Future of Shareholder Democracy*, 84 IND. L.J. 1259, 1275 (2009) (describing the October 2003 proposal and the "corporate governance scandals of 2002 [that] spurred renewed consideration of proxy access").

245. *See* Fairfax, *supra* note 244, at 1273–74 (noting that the SEC considered proxy access rule changes in 1942, 1977, and 1982).

246. Nell Minow & John F. Olson, *The Future of Corporate Governance*, *in* CORPORATE GOVERNANCE: LAW & PRACTICE § 2.01(4) (Bart Schwartz & Amy L. Goodman eds., 2010).

247. *See* Fairfax, *supra* note 244, at 1274 (noting that the weight of the commentary on the Rule influenced the SEC's decision to abandon efforts to adopt the amendments).

248. 462 F.3d 121 (2d Cir. 2006); *see* Fairfax, *supra* note 244, at 1275–76.

249. *AFSCME*, 462 F.3d at 123.

250. *Id.* at 124.

251. *Id.*

Furthermore, when the case came to the Second Circuit on appeal, the SEC filed an amicus brief that interpreted Rule 14a-8(i)(8)'s election exclusion as applying to proxy access bylaw proposals.[252] Nonetheless, the Second Circuit concluded that the election exclusion applied only to shareholder proposals seeking to contest management nominees for a specific election and not to proposed proxy access amendments that would affect "the procedural rules governing elections generally."[253]

Not long after the *AFSCME* decision, the SEC responded by publishing two new proposals regarding proxy access.[254] First, the SEC proposed an amendment to Rule 14a-8(i)(8).[255] This amendment, which was ultimately adopted in November 2007, codified the SEC's long-standing interpretation that all shareholder proposals for proxy access are excludable under the Rule.[256] The second proposal would have amended the Rule to allow for the inclusion of proxy access proposals from certain qualifying shareholders who met additional disclosure requirements.[257] However, the SEC did not adopt this second proposal.[258]

The momentum toward more rule changes increased in 2009 when Mary L. Schapiro was appointed to serve as the Chairman of the SEC.[259] In her nomination speech, Chairman Schapiro emphasized her belief that the current financial crisis highlighted the need to address the proxy access issue.[260] It was in May 2009 that Schapiro and the SEC approved the publication of the proposed rules that—after much commentary and some changes—were adopted on August 25, 2010.[261]

Another important development came after the SEC published its proposed rules in May 2009—the passing of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[262] In the Dodd-Frank Act, Congress explicitly gave the SEC authority to issue rules requiring corporations to

252. *Id.* at 126. The SEC asserted that such proposals "would result in contested elections." *Id.* at 127.

253. *Id.* at 128–30.

254. Shareholder Proposals, 72 Fed. Reg. 43,466 (Aug. 3, 2007) (to be codified at 17 C.F.R. pt. 240); Shareholder Proposals Relating to the Election of Directors, 72 Fed. Reg. 43,488 (Aug. 3, 2007) (to be codified at 17 C.F.R. pt. 240).

255. Shareholder Proposals Relating to the Election of Directors, 72 Fed. Reg. 43,488.

256. *Id.*; Press Release, Sec. & Exch. Comm'n, SEC Votes to Codify Longstanding Policy on Shareholder Proposals on Election Procedures (Nov. 28, 2007), http://www.sec.gov/news/press/2007/2007-246.htm.

257. Shareholder Proposals, 72 Fed. Reg. 43,466.

258. Press Release, *supra* note 256.

259. *See* Minow & Olson, *supra* note 246, § 2.01(4).

260. *See id.* Chairman Schapiro later stated: "'This crisis has led many to raise serious questions and concerns about the accountability and responsiveness of some companies and boards of directors, to the interests of the shareholders.'" *Id.* (quoting Mary L. Schapiro, Chairman, Sec. & Exch. Comm'n, Statement at SEC Open Meeting on Facilitating Director Nominations (May 20, 2009), *available at* http://www.sec.gov/news/speech/2009/spch052009mls.htm.

261. Press Release, Sec. & Exch. Comm'n, SEC Votes to Propose Rule Amendments to Facilitate Rights of Shareholders to Nominate Directors (May 20, 2009), http://www.sec.gov/news/press/2009/2009-116.htm.

262. Pub. L. No. 111-203, § 971, 124 Stat. 1376 (2010).

include shareholder director nominees in their proxy materials.[263] Although maintaining the position that it already had authority to adopt its new proxy access rule, the SEC pointed to these provisions of the Dodd-Frank Act as confirmation of that authority.[264]

A. The SEC's 2010 Proxy Access Rules

The SEC's 2010 amendments to its proxy rules provided two ways for shareholders "to more fully exercise their right to nominate directors."[265] First, the SEC adopted a new proxy access rule—Rule 14a-11[266]—under which companies would have been required to include shareholder-nominated directors in their proxy materials, as long as the nominating shareholders met certain requirements.[267] Second, the SEC amended Rule 14a-8 to require companies to include in their proxy materials proposals from qualifying shareholders for new procedures in the companies' governing documents that would include shareholder director nominees in the company's proxy statements.[268] The SEC stayed the implementation of both Rules on October 4, 2010[269] following the filing of a lawsuit by the Business Roundtable and Chamber of Commerce of the United States of America. The D.C. Circuit vacated Rule 14a-11 on July 22, 2011,[270] leaving the amended Rule 14a-8 in place. At the time of this writing, the SEC has not lifted the stay on the new Rule 14a-8, and the future of proxy access is uncertain. Nevertheless, we believe that a brief description of the 2010 Rules is helpful in placing our proposals in context.

One driving force behind the SEC's adoption of the 2010 Rules was its acknowledgment that the financial crisis had "heightened the serious concerns of many shareholders about the accountability and responsiveness of some companies and boards of directors to shareholder interests, and that these concerns had resulted in a loss of investor confidence."[271] Accordingly, the rule changes were aimed, in large part, at restoring shareholder confidence in boards of directors.[272]

Far from granting any form of universal proxy access to shareholders, however, the new proxy access rules, even if enacted, would have included significant additional hurdles to shareholders. For instance, Rule 14a-11 required that shareholders "hold a significant, long term interest in the

263. *See id.* § 971(a)–(b).

264. *See* Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249).

265. *Id.* at 56,677.

266. *Id.*

267. *Id.*

268. *Id.*

269. *See* Business Roundtable and the Chamber of Commerce of the United States of America, Order Granting Stay, No. S7-10-09 (Oct. 4, 2010), *available at* http://www.sec.gov/rules/other/2010/33-9149.pdf.

270. Bus. Roundtable v. SEC, No. 10-1305, 2011 WL 2936808 (D.C. Cir. July 22, 2011).

271. Facilitating Shareholder Director Nominations, 75 Fed. Reg. at 56,669.

272. *See id.* at 56,670.

company,"[273] which the SEC specifically defined as holding at least 3 percent of the total voting power of the company's securities that would be entitled to vote at the annual shareholders' meeting for at least three continuous years.[274] In addition, Rule 14a-11 required the shareholder to hold that amount through the date of the meeting[275] and specified that the nominating shareholders could not be holding the company's securities for the purpose or effect of changing control of the company, nor could the shareholders have made "an agreement with the company regarding the nomination."[276]

Furthermore, Rule 14a-11 required that shareholder nominees meet certain requirements to be eligible for nomination. First, their candidacy, and ultimately their board membership, could not violate applicable federal law, state law, or regulations.[277] Second, the nominees needed to meet the objective independence criteria set forth by a national securities exchange or national securities association.[278] Finally, neither the nominee nor the nominators could have made an agreement with the corporation's management regarding the nominee's candidacy.[279]

Finally, under the Rule, companies were "required to include no more than one shareholder nominee or the number of nominees that represents 25 percent of the company's board of directors, whichever is greater."[280] By including these provisos and additional requirements, the SEC made Rule 14a-11 consistent with its desire to avoid making the Rule a venue for shareholders that are "seeking to change the control of the company or to gain more than a limited number of seats on the board."[281] Accordingly, shareholder nominees who first gave "timely notice of intent to nominate a director pursuant to the rule" would have been granted effective priority "up to and including the total number of shareholder nominees required to be included by the company."[282]

In contrast to these limitations, however, the new proxy access rules also created mechanisms which granted shareholders a greater ability to communicate with each other, thus aiding proxy access. For instance, under the new rules, shareholders could have "engage[d] in communications with other shareholders in an effort to form a nominating shareholder group to aggregate their holdings to meet the . . . ownership threshold."[283] Normally, such communications would have been banned as solicitations under the general proxy rules, so the SEC created a new

273. *Id.* at 56,688.
274. *Id.* The Rule allowed for a group of shareholders to aggregate holdings to meet this requirement. *Id.*
275. *Id.*
276. *Id.*
277. *See id.* at 56,702.
278. *See id.* at 56,702–03.
279. *See id.* at 56,705.
280. *Id.* at 56,706.
281. *See id.* at 56,707.
282. *Id.* at 56,710.
283. *Id.* at 56,725.

exemption "for written communications made in connection with using proposed Rule 14a-11."[284] The SEC also created an exemption from the rules for "solicitations by or on behalf of a nominating shareholder or group in support of its nominee who is included in the company's proxy statement and form of proxy."[285] The rules also required that shareholders availing themselves of this exemption must not be seeking proxy authority and must include specific disclosures set forth in the Rule as part of the written communications.[286]

Before the adoption of these new amendments, Rule 14a-8(i)(8)—the election exclusion—allowed companies to exclude shareholder proposals relating to nominating or electing directors, or to the procedure for nominating or electing directors, from the company's proxy statements.[287] Under the newly amended Rule 14a-8(i)(8), however, the SEC had narrowed the election exclusion.[288] "As adopted, companies [would] no longer [have been] able to rely on Rule 14a-8(i)(8) to exclude a proposal seeking to establish a procedure in a company's governing documents for the inclusion of one or more shareholder nominees for director in the company's proxy materials."[289] The new rule did, however, provide a few circumstances in which a company would be able to exclude a proposed shareholder procedure.[290] Each of those circumstances covered situations in which the proposal would have had an effect on current directors' standing or specific influence on nominees in an upcoming election.[291]

B. Response to the 2010 Rules

Not surprisingly, the 2010 Rules met with a mixed reaction. The SEC noted this divergent response in referencing the comments it received regarding the proposed amendments.[292] As the SEC explained, supporters of the amendments have generally asserted that the changes will "provide meaningful opportunities to effect changes in the composition of the board" and "lead to more accountable, responsive, and effective boards."[293] It also cited many commentators as connecting the "recent economic crisis [with] shareholders' inability to have nominees included in a company's proxy materials."[294] Conversely, commentators opposed to the amendments often argued that other corporate governance developments—particularly using majority voting instead of plurality voting in director elections and the

284. *Id.*
285. *Id.* at 56,727.
286. *Id.*
287. *See id.* at 56,730.
288. *See id.* at 56,730–32.
289. *Id.* at 56,732.
290. *See id.*
291. *See id.*
292. *See id.* at 56,670 ("We received significant comment on the proposed amendments. Overall, commenters were sharply divided on the necessity for, and the workability of, the proposed amendments.").
293. *Id.*
294. *Id.*

implementation of optional proxy access rules like in Delaware—have given shareholders enough opportunities to actively participate in corporate suffrage, thus rendering these new amendments useless.[295] Moreover, many commentators expressed federalism concerns—worrying that a federal one size fits all rule would inappropriately "intrud[e] into matters traditionally governed by state law"—and concerns that the rules could create short-sighted special interest directors who would neglect the duty to create long-term value.[296]

The debate has continued after the adoption of the amendments, as various scholars and commentators weighed in during the days following the SEC's announcement. The new rules were both lauded as "a welcome and long overdue development"[297] and bemoaned as something that "has never been a good idea."[298] The divergence of opinion in this debate, though heated, nevertheless gave way to a strong sentiment that, due to the lack of any empirical data, the real effects of these changes were yet to be determined.[299] Unfortunately, in light of the D.C. Circuit's recent decision, it may be some time before anyone will see the real effects of expanded proxy access.

The scholars who wrote in favor of the SEC's amendments gave several common reasons for their support. For instance, one recurring argument was that "reducing incumbent directors' insulation from removal" would improve director accountability towards shareholders and, in turn, increase value for shareholders.[300] Another argument was that a lack of director

295. *See id.* at 56,670–72.

296. *Id.; see also* Lucian A. Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 59 (2003) (arguing that if "[o]ne size . . . does not fit all" then "the adopted SEC rule should leave firms free to opt out of the rule with shareholder approval"); Grundfest, *supra* note 70, at 376 ("'[O]ne size might not fit all: companies differ in their circumstances, attributes, and needs.'" (quoting Lucian A. Bebchuk, *Let the Shareholders Set the Rules*, 119 HARV. L. REV. 1784, 1787 (2006))).

297. Lucian Bebchuk & Scott Hirst, *Proxy Access Is In*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (Aug. 25, 2010, 11:20 AM), http://blogs.law.harvard.edu/corpgov/2010/08/25/proxy-access-is-in; *see also* Nell Minow, *Proxy Access Forum: Nell Minow*, THE CONGLOMERATE (Aug. 26, 2010), http://www.theconglomerate.org/forum-proxy-access/ ("The SEC's new proxy access rule is a modest and most welcome step forward.").

298. Stephen Bainbridge, *SEC Adopts Proxy Access*, PROFESSORBAINBRIDGE.COM (Aug. 25, 2010, 1:39 PM), http://www.professorbainbridge.com/professorbainbridgecom/2010/08/sec-adopts-proxy-access.html.

299. *See, e.g.*, Eric Talley, *Proxy Access Forum: Eric Talley (UC Berkeley)*, THE CONGLOMERATE (Aug. 26, 2010), http://www.theconglomerate.org/forum-proxy-access/ ("Given the stock of empirical knowledge we have today, I submit that the only responsible answer to [what the amendments mean for investors] is a cautious combination of 'it depends,' or 'we don't fully know.'").

300. Bebchuck & Hirst, *supra* note 297; *see also* J. Robert Brown, Jr., *The Arrival of Access*, THE RACE TO THE BOTTOM (Aug. 25, 2010, 10:25 AM), http://www.theracetothebottom.org/shareholder-rights/the-arrival-of-access.html ("If these directors want to remain on the board, they have to act in the best interests of shareholders rather than management."); Brett McDonnell, *Proxy Access Forum: Brett McDonnell*, THE CONGLOMERATE (Aug. 26, 2010), http://www.theconglomerate.org/forum-proxy-access/. Although ultimately arguing that the amendments are too stringent because they do not allow

accountability exacerbated—and perhaps contributed significantly to—the financial crisis and that expanded proxy access would have made directors more accountable.[301] In addition, some have argued that the SEC's decision to amend Rule 14a-8 was appropriate because the election exclusion as it was understood was never justified.[302] Understandably, some of the scholars in favor of the amendments—including the authors—believe that the limits the SEC placed on shareholders in Rule 14a-11, particularly the ownership threshold, would have been too restrictive.[303]

Those opposing the amendments also expressed some common themes. One major and recurring concern was federalism. Contrary to the SEC's assertion that proxy access would "facilitate" state rights, these scholars noted that "it preempts them."[304] Another concern was that the mandatory nature of the Rule is counterproductive and it would be better served if companies were able to opt-out of the Rule.[305] As Professor McDonnell points out, "[i]f we trust shareholders to choose among competing slates of nominees, why not trust them to choose the best proxy access regime?"[306] Furthermore, some have argued that it is disingenuous to claim that proxy access is a legitimate response to the economic crisis.[307]

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for corporations to opt out, Professor McDonnell acknowledges the benefits of proxy access as a possibility. *See id.*; Minow, *supra* note 297.

301. *See, e.g.*, Minow, *supra* note 297 ("Market forces will operate far more efficiently if board members are subjected to even the very small market test of a very limited ability for shareholders to put alternate candidates to a vote.").

302. *See* Bebchuck & Hirst, *supra* note 297.

303. *See id.*

304. Bainbridge, *supra* note 298; *see also* Troy A. Paredes, Comm'r, Sec. & Exch. Comm'n, Speech by SEC Commissioner: Statement at Open Meeting to Adopt the Final Rule Regarding Facilitating Shareholder Director Nominations ("Proxy Access") (Aug. 25, 2010), *available at* http://www.sec.gov/news/speech/2010/spch087510tap.htm ("The tradition of state corporate law has been not to regulate by mandate. To the contrary, in regulating the internal affairs of corporations, states have adhered to a so-called 'enabling' approach as opposed to a 'mandatory' approach."); Christopher Bruner, *Proxy Access Forum: Christopher Bruner*, THE CONGLOMERATE (Aug. 26, 2010), http://www.theconglomerate.org/forum-proxy-access/ ("[T]he SEC effectively says that shareholder nominations in public companies work our way, or not at all—a near-total federalization of a process pretty close to the heart of corporate governance, which cannot coherently be described as merely facilitating state law.").

305. *See* McDonnell, *supra* note 300 (arguing that having some degree of proxy access as a default is helpful, but the inability for corporations to opt-out of the rule is "too inflexible"); J.W. Verret, *Proxy Access Forum: J.W. Verret (George Mason Law School)*, THE CONGLOMERATE (Aug. 26, 2010), http://www.theconglomerate.org/forum-proxy-access/. Even though there is not an explicit "opt-out" provision in the rules, at least two professors have discussed ways that corporations will be able to avoid the impositions of the new rules. *See* Larry Ribstein, *Proxy Access Arrives. Now What?*, TRUTH ON THE MARKET (Aug. 26, 2010, 4:52 AM), http://truthonthemarket.com/2010/08/26/proxy-access-arrives-now-what/ (noting that the rules could increase IPOs abroad, firms "uncorporating," and other unpredictable corporate governance in an effort to avoid the rules); Verret, *supra* (presenting sixteen defenses that could be available to companies to "thwart shareholders from using their new federal proxy access right").

306. McDonnell, *supra* note 300.

307. *See* Bruner, *supra* note 304 ("Offering up proxy access and other forms of shareholder empowerment as a response to corporate governance problems precipitating the financial crisis is absurd.").

An interesting—albeit for the moment unanswerable—question is to what extent director independence would have been encouraged or hindered by the amendments.[308] On one side of the debate, proponents of the amendments argued that shareholder-nominated directors would be independent from incumbent management and directors, giving fresh, needed perspective.[309] On the other hand, opponents argued that this can disrupt the board and undermine good governance.[310] Moreover, opponents expressed great concern that directors may be beholden to the interests of the shareholders that nominated them.[311] However, proponents countered that fiduciary duty limitations would constrain a director's actions, regardless of who nominated the director to that position.[312] Additionally, as Professor Fairfax observed, management-nominated directors may equally "feel beholden to those who nominate them."[313]

Regardless of their position on proxy access, several commentators echoed a similar sentiment: uncertainty about the ultimate effect of the changes.[314] Such uncertainty may continue for some time in the wake of *Business Roundtable v. SEC*, which is discussed briefly in the following section.

C. Business Roundtable v. SEC

In the *Business Roundtable* decision, a unanimous panel of the D.C. Circuit held that the SEC was "arbitrary and capricious in promulgating Rule 14a-11."[315] According to the court, the SEC has a unique obligation to consider the effect of any new rule upon "efficiency, competition, and capital formation,"[316] and the SEC failed "adequately to assess the economic effects of [the] new rule.[317] Relying on the Administrative Procedure Act,[318] the holding in *Business Roundtable* is not particularly interesting to the problem of shareholder empowerment presented in this Article. Nevertheless, some aspects of the opinion are relevant to the shareholder empowerment debate and to our proposals in Part IV.

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308. *See* Lisa Fairfax, *Proxy Access Forum: Proxy Access and Director Independence*, THE CONGLOMERATE (Aug. 27, 2010), http://www.theconglomerate.org/forum-proxy-access/.

309. *See id.*

310. *See id.*

311. *See id.*

312. *See id.*

313. *Id.*

314. *See, e.g.*, McDonnell, *supra* note 300 ("I suspect this is not the last word from the SEC on this subject."); Usha Rodrigues, *Proxy Access Forum: The Weirdo Shareholder Problem*, THE CONGLOMERATE (Aug. 27, 2010), http://www.theconglomerate.org/forum-proxy-access/ ("Like Eric, in the end I think the sensible response is: 'Let's see how this thing plays out.'"); Talley, *supra* note 299.

315. Bus. Roundtable v. SEC, No. 10-1305, 2011 WL 2936808, at *11 (D.C. Cir. July 22, 2011).

316. *Id.* at *1 (citing 15 U.S.C. §§ 78c(f), 78w(a)(2), 80a-2(c) (2006)).

317. *Id.* at *3.

318. 5 U.S.C. §§ 551–559.

Under the Administrative Procedure Act, a court may set aside agency action that is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."[319] In reviewing an agency decision to determine whether it is arbitrary and capricious, however, a court may not substitute its own judgment for that of the agency.[320] Moreover, a court generally can strike down an agency decision only if that decision is decidedly "irrational."[321]

In *Business Roundtable*, the court did not conclude that Rule 14a-11 was irrational, but held that the SEC did not adequately account for the direct costs of the new rule, including the potentially high expenditures that companies would incur in opposing shareholder nominees.[322] The SEC failed to even attempt to quantify these costs, even though historical data on the costs of proxy contests is available.[323] Importantly, the costs of opposing shareholder nominees might not be discretionary or self-serving, as the incumbent directors would feel obliged by their fiduciary duty to oppose unqualified nominees.[324]

The SEC also failed to quantify the benefits of the Rule, which include improved corporate performance from the election of dissident directors.[325] The court concluded that the SEC did not adequately evaluate the empirical evidence on this issue.[326] In the face of "mixed" empirical evidence, the SEC was not entitled to claim benefits from the Rule.[327]

For our purposes, the most interesting part of the opinion is where the court considered the possibility that union and state pension funds might use Rule 14a-11 for personal gain.[328] The court observed, "By ducking serious evaluation of the costs that could be imposed upon companies from use of the Rule by shareholders representing special interests, particularly union and government pension funds, we think the Commission acted arbitrarily."[329]

Finally, the court challenged the SEC's conclusions about the frequency of shareholder nominations: "[T]he Adopting Release does not address

319. *Bus. Roundtable*, 2011 WL 2936808, at *2 (citing 5 U.S.C. § 706(2)(A) (2006)).

320. *See* FCC v. Fox Television Stations, Inc., 129 S. Ct. 1800, 1810 (2009) ("We have made clear, however, that 'a court is not to substitute its judgment for that of the agency,' and should 'uphold a decision of less than ideal clarity if the agency's path may reasonably be discerned.'" (quoting Bowman Transp., Inc. v. Ark.-Best Freight Sys., Inc., 419 U.S. 281, 286 (1974)).

321. Allentown Mack Sales & Serv., Inc. v. NLRB, 522 U.S. 359, 364 (1998) ("While the Board's adoption of a unitary standard for polling, RM elections, and withdrawals of recognition is in some respects a puzzling policy, we do not find it so irrational as to be 'arbitrary [or] capricious' within the meaning of the Administrative Procedure Act.").

322. *Bus. Roundtable*, 2011 WL 2936808, at *3–6.

323. *Id.* at *5.

324. *Id.* at *4.

325. *Id.* at *5.

326. *Id.*

327. *Id.*

328. *Id.* at *6–7.

329. *Id.* at *7.

whether and to what extent Rule 14a-11 will take the place of traditional proxy contests."[330]

By vacating Rule 14a-11, *Business Roundtable* set back the clock on shareholder empowerment, and we believe that the need for legal reform is now stronger than ever. In the next section, we propose several modest reforms that would enable private ordering by shareholders. We also would be in favor of the SEC lifting the stay on the new Rule 14a-8, which was not targeted by the *Business Roundtable* decision.

IV. In Defense of Private Ordering with Shareholder Bylaws

Despite the recent moves facilitating shareholder empowerment with respect to director elections, both Delaware and the SEC continue to rely on "director primacy" as a foundational principle of corporate governance.[331] In the near future, therefore, shareholders may have more voice in the composition of the board of directors, but the board of directors will retain exclusive control over most decisions "relating to the business of the corporation, [and] the conduct of its affairs."[332] We would empower shareholders to adopt bylaws that limit the managerial authority of the board of directors.

In this Part, we develop the argument in favor of private ordering in public corporations. We begin with the affirmative case for private ordering, which rests in part on the benefits of private ordering to a particular firm (micro-benefits) and in part on the benefits of private ordering to the corporate governance system as a whole (macro-benefits). We proceed to describe the legal and market constraints on private ordering that limit the downside potential of our proposed reforms. We conclude with a description of the technical legal reforms that we propose to facilitate private ordering in public corporations.

A. The Affirmative Case for Private Ordering

Recent scholarship has produced a standard set of arguments in favor of shareholder empowerment. Most of these arguments focus on the micro-benefits of shareholder activism. We contend that different firms accrue these micro-benefits in different ways and to varying degrees, depending on myriad factors, such as firm size, product market maturity, and industry regulations. We argue that private ordering would enable firms to tailor the mechanisms of shareholder activism to their particular circumstances, thus maximizing these micro-benefits.

Shareholder activism also has effects beyond the particular firms in which shareholders become active. Corporate executives, capital market investors, banks, employees, regulators, and other groups that are affected by or interact with corporations gather information by observing shareholder activity in the broader market. In this Article, we focus on

330. *Id.* at *8.
331. *See, e.g.*, Bainbridge, *supra* note 62, at 1735–36 .
332. Del. Code Ann. tit. 8, § 109(b) (2005).

information about corporate governance practices and procedures as the information that is especially valuable beyond a particular firm. Each firm that relies on private ordering to conduct its affairs is performing an experiment of sorts, and that experiment produces information for the corporate governance system as a whole. We refer to this information as a macro-benefit of private ordering.

1. Micro-benefits of Private Ordering

Shareholders value empowerment. The empirical evidence is ambiguous, but a recent event study of the SEC's unexpected decision to delay implementation of the proxy access rule in response to the Business Roundtable's legal challenge offers strong evidence that "financial markets placed a positive value on shareholder access" as implemented in that rule.[333] While the authors of this study do not attempt to discern the source of this added value, most proponents of shareholder empowerment argue that shareholders add value through effective monitoring of corporate managers.[334]

In a previous era, shareholders participated in monitoring by deciding when to sell the firm[335] or by suing corporate managers for misconduct. In recent years, as institutional investors have shown an increased inclination toward participation in corporate governance, the monitoring role of shareholders has focused on director elections.[336] In addition to proxy

333. Bo Becker et al., *Does Shareholder Proxy Access Improve Firm Value? Evidence from the Business Roundtable Challenge* 4–5 (Harvard L. & Econ. Discussion Paper No. 685, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1695666 ("Using a 1-day event window around October 4, 2010, we find that share prices of companies that would have been most exposed to shareholder access declined significantly compared to share prices of companies that would have been most insulated from the rule."). Two other event studies find reductions in shareholder wealth from proxy access, but there are good reasons to be skeptical of these findings. *Id.* at 13–17.

334. *See generally* Paul Rose, *Common Agency and the Public Corporation*, 63 VAND. L. REV. 1355, 1381–85 (2010).

335. *See* Easterbrook & Fischel, *supra* note 102, at 1170; Ronald J. Gilson, *The Case Against Shark Repellant Amendments: Structural Limitations on the Enabling Concept*, 34 STAN. L. REV. 775, 807 (1982); *see also* Thompson & Smith, *supra* note 99, at 307 ("[S]hareholders should be able to use their antidote power even earlier than the annual meeting to remove director-installed defensive tactics that would block the shareholders' right to exercise their power to vote or to sell their shares.").

336. *See, e.g.*, Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 680 (2007) (arguing that the shareholder power to replace directors is important because "the fear of replacement is supposed to make directors accountable and provides them with incentives to serve shareholder interests"); Bebchuk, *supra* note 296, at 66 ("[A] well-designed shareholder access regime . . . would contribute to making directors more accountable and would improve corporate governance."); Lee Harris, *Shareholder Campaign Funds: A Campaign Subsidy Scheme for Corporate Elections*, 58 UCLA L. REV. 167, 167 (2010) ("The corporate election system is . . . broken, anticompetitive, and in need of significant reform."). For opposing views on the value of shareholder empowerment in director elections, see Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733, 742–43 (2007) (concluding that *The Myth of the Shareholder Franchise* "never demonstrates that an increase in contested directorial elections will increase corporate performance or yield any other quantifiable good"); Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 VA. L. REV. 789, 809 (2007) ("Rather than being driven by data,

access, discussed above, shareholders have created various other means of making director elections more meaningful, including withhold-the-vote campaigns,[337] majority voting,[338] and the abolition of cumulative voting[339] and classified boards.[340]

Although the SEC has suspended implementation of its recently adopted proxy access rules, many commentators argue that proxy access is essential to the corporate governance system.[341] Even if proxy access is inevitable, the ultimate structure of proxy access rules remains to be decided. The SEC has opted for one-size-fits-all mandatory rules, whereas Delaware has enacted enabling statutes to facilitate private ordering. We favor private ordering for the simple reason that it enables firms to tailor the rules to their particular circumstances.

Of course, this result adheres only if the shareholders are allowed to participate in the framing of those rules. Under the current web of shareholder regulations, private ordering is effectively thwarted. In the event study cited above, the authors considered why the firms that would benefit from proxy access did not implement it through private ordering.[342] The authors speculate that "some friction prevents firms from achieving the optimal degree of shareholder democracy on their own."[343] This speculation was supported by a "muted effect for Delaware," where proxy access through private ordering has been enabled by the DGCL.[344]

Another issue that arises in structuring proxy access rules is whether those rules should have "no access" as the default rule. Professor Bebchuk and Scott Hirst observe: "There is no reason to assume . . . that private ordering should begin from a no-access default. A preference for private ordering merely implies a preference for allowing opting out from whichever default is set, and does not imply that the ideal default is no-access."[345] Even with the proposals we offer below, default rules relating to proxy access may remain sticky.[346] Thus, we endorse the access default rule proposed by Bebchuk and Hirst. We aspire to improve corporate governance through private ordering, and setting the right default rules is an

calls for greater shareholder control over public corporations seem driven by sentiment and the unspoken assumption that shareholder democracy, like Mom and apple pie, must be a good thing.").

337. *See generally* Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857 (1993).

338. *See generally* William K. Sjostrom, Jr. & Young Sang Kim, *Majority Voting for the Election of Directors*, 40 CONN. L. REV. 459 (2007); J.W. Verret, *Pandora's Ballot Box, or a Proxy with Moxie? Majority Voting, Corporate Ballot Access, and the Legend of Martin Lipton Re-examined*, 62 BUS. LAW. 1007 (2007).

339. *See generally* Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124 (1994).

340. Rivka Weill, *Declassifying the Classified*, 31 DEL. J. CORP. L. 891 (2006).

341. Fairfax, *supra* note 244, at 1288–95.

342. Becker et al., *supra* note 333, at 6.

343. *Id.*

344. *Id.*

345. Bebchuck & Hirst, *supra* note 12, at 334.

346. Brett H. McDonnell, *Sticky Defaults and Altering Rules in Corporate Law*, 60 SMU L. REV. 383, 392–93 (2007).

important part of the project. Determining the right default rules is a complex undertaking[347] that involves consideration of not only the substantive default rules, but also the "altering rules," which "tell private parties the necessary and sufficient conditions for contracting around a default."[348]

Even if all of the rules relating to shareholder empowerment were changed in accordance with our proposals below, several features of the corporate voting system could undermine private ordering. Professors Marcel Kahan and Edward Rock have detailed the ways in which the back office rules governing corporate voting can produce "various pathologies that infect the shareholder voting system."[349] They conclude with this warning and exhortation: "[G]iven the problems with the existing system, one should not rush to expand the opportunities for shareholder voting in corporate governance . . . . If we want shareholders to vote on more things, we need to improve the system. . . ."[350]

A similar concern about the integrity of shareholder voting arises with respect to "new vote buying" or "decoupling," which Henry Hu and Bernard Black have discussed in two recent articles.[351] "New vote buying" includes both "empty voting," where shareholders "hold more votes than shares,"[352] and "hidden (morphable) ownership," where shareholders have "the combination of undisclosed economic ownership plus probable informal voting power."[353] New vote buying could bear on our proposed solutions to the extent that it can affect outcomes of shareholder bylaw proposals. Because new vote buying enables the separation of "the economic return on shares . . . from the related voting rights,"[354] it can cause deviation from the traditional contractarian notions of the firm in which shareholders retain voting power proportional to their economic interests and, accordingly, use those votes to monitor management and further their common goal of wealth maximization.[355] Decoupling can skew votes through things like "record date capture"—where shareholders try to amass large voting power just prior to a shareholder meeting and relinquish it shortly thereafter[356]—and by increasing the voting power of "investors with negative economic interests, who would profit if the

347. *See* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 108–16 (1989) (applying an economic analysis to determine appropriate default rules).

348. Ian Ayres, *Menus Matter*, 73 U. CHI. L. REV. 3, 6 (2006).

349. Marcel Kahan & Edward Rock, *The Hanging Chads of Corporate Voting*, 96 GEO. L.J. 1227, 1231 (2008).

350. *Id.* at 1280–81.

351. *See, e.g.*, Henry T. C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625 (2008); Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006) [hereinafter Hu & Black, *The New Vote Buying*].

352. Hu & Black, *The New Vote Buying*, *supra* note 351, at 815.

353. *Id.* at 816.

354. *Id.* at 823.

355. *See id.* at 850.

356. *See id.* at 832.

companies' share prices go down."[357] Certainly this phenomenon can give power to both shareholder activists[358] and corporate insiders seeking entrenchment,[359] creating a new dynamic in the market for corporate control.

While all of the foregoing issues must be considered in developing the framework for private ordering, none of these technical concerns should take shareholder empowerment off the table. Indeed, shareholder empowerment would likely serve as an impetus to mitigating some of the problems already identified. In the final analysis, we should not allow the perfect to be the enemy of the good.

2. Macro-benefits of Private Ordering

The current system of corporate governance in the United States limits shareholder participation in corporate decision making, producing a one-size-fits-all conception of shareholder participation. We believe that this system does not adequately serve the needs of diverse organizations. While some corporations thrive with (mostly) passive shareholders, other corporations would benefit from varying degrees of shareholder participation. By facilitating private ordering, we would expect each corporation to become a laboratory of corporate governance, experimenting with different models of shareholder participation and ultimately producing a diversity of governance forms and practices.

Corporations learn by transacting,[360] both directly and vicariously.[361] In a system in which private ordering is encouraged, corporate bylaws, through experience and adaptation, become solutions to common governance problems faced by corporations. The bylaws then serve as "repositories" of governance provisions,[362] which (via mandatory disclosure to the SEC) can be disseminated throughout the corporate governance system. Thus, firms innovate and imitate, producing a vibrant exchange of governance solutions. While this "population-level learning"[363] might be subject to some of the same inertial forces that afflict

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357. *Id.* at 907. Of course, there are also arguable benefits to decoupling. *See id.* at 907–08.

358. *See id.* at 824.

359. *See id.* at 856.

360. D. Gordon Smith & Brayden G. King, *Contracts as Organizations*, 51 ARIZ. L. REV. 1, 29 (2009); *cf.* Dennis Epple et al., *An Empirical Investigation of the Microstructure of Knowledge Acquisition and Transfer Through Learning by Doing*, 44 OPERATIONS RES. 77 (1996).

361. Armen A. Alchian, *Uncertainty, Evolution, and Economic Theory*, 58 J. POL. ECON. 211, 214 (1950); Barbara Levitt & James G. March, *Organizational Learning*, 14 ANN. REV. SOC. 319, 321 (1988).

362. Kyle J. Mayer & Nicholas S. Argyres, *Learning to Contract: Evidence from the Personal Computer Industry*, 15 ORG. SCI. 394, 405 (2004).

363. Anne S. Miner & Philip Anderson, *Industry and Population-level Learning: Organizational, Interorganizational, and Collective Learning Processes*, 16 ADVANCES STRATEGIC MGMT. 1 (1999); Anne S. Miner & Pamela R. Haunschild, *Population Level Learning*, 17 RES. ORG. BEHAV. 115 (1995).

boilerplate contracting,[364] we believe that it would be a significant advance over the current system.

B. Constraints on Private Ordering in Public Corporations

When enabled and emboldened to act, shareholders are self-interested. The primary concern of those who oppose an expanded space for shareholder action, therefore, is that shareholders will act opportunistically. Of course, the problem of opportunistic shareholders is not new, and courts and legislatures have imposed various express limits on shareholders. In this section, we respond to these arguments against shareholder empowerment and show how various legal and market constraints on the adoption of shareholder bylaws create the appropriate balance of authority between shareholders and directors without unnecessary judicial intervention.

1. "Any provision not inconsistent with . . ."

Section 109(b) limits the scope of bylaws to provisions that are "not inconsistent with law."[365] We have seen this phrase at work in connection with section 141(a), but the reach of this limitation extends well beyond that context. Consistent with the plain language of the statute, the Delaware Supreme Court has confirmed bylaws may not run afoul of any provision of the DGCL.[366] We presume, though no cases on the issue have been decided, that bylaws may not conflict with law generally.[367] This provision ensures that unrestrained shareholders would not be able to wield their power to engage in any illegal activity no matter how profitable.

In addition to prohibiting inconsistency with "law," section 109(b) prohibits any provision inconsistent with the certificate of incorporation.[368] Accordingly, several Delaware cases (and cases from other jurisdictions applying Delaware law) have invalidated bylaw provisions that have been inconsistent with certificates of incorporation.[369] We view the hierarchical

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364. Stephen J. Choi & G. Mitu Gulati, *Innovation in Boilerplate Contracts: An Empirical Examination of Sovereign Bonds*, 53 EMORY L.J. 929, 937 (2004) ("Change not only takes time, but also comes in stages—as we describe it, there is first an interpretive shock, then a lengthy period of adjustment, and only then a big shift in terms.").

365. DEL. CODE ANN. tit. 8, § 109(b) (2005).

366. *See, e.g.*, Crown EMAK Partners, LLC v. Kurz, 992 A.2d 377, 402 (Del. 2010) (invalidating a bylaw amendment because it conflicted with statutorily mandated procedure for removing directors and holding annual meetings for the election of directors as provided in sections 141(b),141(k), and 211(b)).

367. We believe that "[t]he duty to maximize value for the shareholders will be limited by the duty to obey the law." Kent Greenfield, *Ultra Vires Lives! A Stakeholder Analysis of Corporate Illegality (with Notes on how Corporate Law Could Reinforce International Law Norms)*, 87 VA. L. REV. 1279, 1282 (2001).

368. DEL. CODE ANN. tit. 8, § 109(b).

369. *See, e.g.*, Nord Serv., Inc. v. Palter, 548 F. Supp. 2d 366, 376 n.9 (E.D. Tex. 2008) (applying Delaware law and concluding that a bylaw purporting to "issue[] 200,000 shares would be ineffective, as it conflicts with the certificate of incorporation" (citing DEL. CODE ANN. tit. 8, § 109(b))); Centaur Partners, IV v. Nat'l Intergroup, Inc., 582 A.2d 923, 929 (Del. 1990) (holding that a bylaw amendment that conflicted with the certificate of

relationship between the certificate of incorporation and the bylaws as a useful element of private ordering. Provisions in the certificate of incorporation not only trump bylaw provisions, but the former are also more durable.[370] Thus, a corporation that wanted to channel shareholder actions might adopt charter provisions as a means of making a (potentially) lasting commitment to the particular governance provisions.

We recognize the possibility that, under this rule, some corporations will attempt to thwart the adoption of shareholder bylaws through charter provisions, but we are comforted by three features of the present system. First, charter provisions must, at some point, receive the approval of shareholders.[371] Second, even if charter provisions were inserted prior to an initial public offering, the provisions would be priced by the market, meaning that the founders or promoters of the company would bear the costs associated with limiting shareholder power. Third, although there are no cases on this point, DGCL section 109(a) expressly forbids corporations from depriving shareholders of the power to change adopt, amend, or repeal bylaws.[372] Taken together, these three features of the bylaw process provide a meaningful check on managerial attempts to undermine our proposal.

2. Majority Vote Requirement

We acknowledge that some shareholders will have idiosyncratic views on corporate governance, and under our proposals, such shareholders might have a platform that would be denied them under the current rules. Nevertheless, we expect many issues relating to such shareholders to be resolved by the other constraints discussed in this section. In the end, however, any shareholder action must be approved by a majority of the shares present and voting at a properly called meeting of the shareholders,

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incorporation's provision that the "number of directors of the Corporation . . . may from time to time be altered as provided in the By-Laws" was invalid because "[w]here a by-law provision is in conflict with a provision of the charter, the by-law provision is a 'nullity'" (quoting Burr v. Burr Corp., 291 A.2d 409, 410 (Del. Ch. 1972))); Sun-Times Media Grp., Inc. v. Black, 954 A.2d 380, 407 (Del. Ch. 2008) (invalidating a director indemnification provision in a bylaw because it was "more restrictive than and inconsistent with the Certificate"); *see also* Vergopia v. Shaker, 922 A.2d 1238, 1249 (N.J. 2007) (applying Delaware law and acknowledging a "'gradation of authority'" requiring the bylaws to "succumb to the superior authority of the charter; the charter . . . [to] the statute . . . ; and the statute, . . . [to] the constitution" (quoting Gaskill v. Gladys Belle Oil Co., 146 A. 337 (Del. Ch. 1929))). *But see* Di Loreto v. Tiber Holding Corp., No. CIV.A.16564, 1999 WL 1261450, at *4 n.12 (Del. Ch. June 29, 1999) ("Deleting a bylaw provision required by the certificate does not run afoul of [109(b)].").

370. Amending the certificate of incorporation requires action by the board of directors and the shareholders. DEL. CODE ANN. tit. 8, § 242(b)(2). Amending the bylaws generally requires action by either the board of directors or the shareholders. *Id.* § 109(a). Obviously, amending the certificate of incorporation is more difficult than amending the bylaws, making the provisions of the certificate of incorporation more durable in most corporations.

371. *Id.* § 242(b)(4).

372. *Id.* § 109(a) ("[T]he power to adopt, amend, or repeal bylaws shall be in the stockholders entitled to vote . . . .").

and this majority vote requirement is a meaningful obstacle to unsound shareholder proposals.[373]

Shareholder voting in Delaware corporations is governed by DGCL section 216, which allows corporations to set, in the "certificate of incorporation or bylaws," the number of voting shareholders required to be present "in order to constitute a quorum" and the number of "votes that shall be necessary" to pass bylaws.[374] Despite this freedom to contract, the requirement for a quorum cannot "consist of less than one-third of the shares entitled to vote at that meeting."[375] The default rule, which arises "[i]n the absence of such specification," provides that a quorum is formed by a "majority of the shares entitled to vote, present in person or represented by proxy," and the number of votes necessary to approve a bylaw would be "the affirmative vote of the majority of shares present in person or represented by proxy at the meeting and entitled to vote on the subject matter."[376] By requiring a majority of voting shareholders to be present or represented to constitute a quorum, and requiring a majority of the shares to pass a bylaw, the voting rules in Delaware provide a strong check on frivolous bylaws.

3. Director Counter-Bylaws

Another constraint on shareholder bylaws is the potential for director-adopted counter-bylaws. Directors could theoretically respond to and constrain unwanted shareholder bylaws in two ways: (1) they could attempt to amend or repeal the bylaws;[377] or (2) they could push for their own

373. When a controlling shareholder is engaged in a transaction with the corporation, the Delaware courts impose a duty of loyalty on the controlling shareholder to protect the other shareholders. *See, e.g.*, Williamson v. Cox Commc'ns, Inc., No. Civ.A. 1663-N, 2006 WL 1586375, at *4 (Del. Ch. June 5, 2006) ("A shareholder is a 'controlling' one if she owns more than 50% of the voting power in a corporation *or* if she 'exercises control over the business and affairs of the corporation.'" (quoting Kahn v. Lynch Commc'n Sys., Inc., 683 A.2d 1110, 1113–14 (Del. 1994))). In this circumstance, the controlling shareholder's conduct is measured by the "entire fairness" standard, but the controlling shareholder can shift the burden of proving fairness to the plaintiff by obtaining a vote of a "majority of the minority" shareholders. *In re* Wheelabrator Techs., Inc. S'holders Litig., 663 A.2d 1194, 1203 (Del. Ch. 1995). Thus, even in controlling shareholder transactions, majority voting may be meaningful.

374. DEL. CODE ANN. tit. 8, § 216.

375. *Id.*

376. *Id.*

377. *See* Hamermesh, *supra* note 109, 467–68. Notably, this is not an option that is clearly available to directors in any state, and it is explicitly precluded in some states. *See id.* at 467. In most states that follow the Model Business Corporation Act, the "statutes altogether preclude director amendment of stockholder-adopted by-laws, at least where the stockholders' by-law expressly precludes such amendment, and sometimes even if the stockholder by-law is silent on the point." *Id.* However, such is not the case in Delaware, where the DGCL does not definitively give an answer on this issue, but it does not "expressly permit a stockholder-adopted by-law to include a provision prohibiting subsequent amendment by the board of directors." *Id.* at 467–68.

"alternative proposals."[378] We now address both of these possible checks on shareholder bylaws.

First, directors could act to amend or repeal bylaws that they oppose. Although Delaware law is not settled as to whether shareholders can prohibit directors from subsequently amending their adopted bylaws,[379] it is possible that directors have some authority to amend or repeal sufficiently egregious shareholder-enacted bylaws, despite the bylaws' own provisions to the contrary.[380] Currently, there is no dispositive Delaware case law addressing this recourse, and to complicate matters, the courts have published conflicting dicta on the subject.[381] Certainly it is an issue that would need to be flushed out in the courts to become a legitimate check on shareholder power, but even the mere threat of director repeal or amendment could itself now be a force that constrains ill-advised shareholder bylaws.[382]

The second, and less controversial, recourse available to directors is to simply propose their own bylaws in contrast to shareholder proposals.[383]

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378. *See* Bebchuk, *supra* note 84, at 839; Hamermesh, *supra* note 109, at 491; McDonnell, *supra* note 116, at 262.

379. *See* Hamermesh, *supra* note 109, at 470; McDonnell, *supra* note 116, at 261 ("It is an open, and rather puzzling, question in Delaware whether the board may amend a shareholder-passed bylaw where the bylaw on its own terms states that the board may not do so."). Professor Hamermesh notes that there is no limiting language in section 109(a) that would constrain "directors' power to amend any by-law, . . . as long as the certificate of incorporation confers upon the directors unlimited power to adopt and repeal the by-laws." Hamermesh, *supra* note 109, at 469. However, Professor Hamermesh interestingly recounts legislative history from section 109, which included three proposals: (1) giving directors "unlimited authority" to amend shareholder by-laws; (2) conclusively prohibiting such amendments; (3) allowing for amendments, but only after meeting certain requirements. *See id.* at 469 n.249. None of these proposals were adopted, however, so we are left with nothing more than the language of the statute. *See id.*

380. *See* Hamermesh, *supra* note 109, at 475. Professor Hamermesh argues that "a by-law purporting to limit authority conferred upon the directors by charter provision should be suspect, to say the least." *Id.* at 470. Accordingly, he concludes that "[o]n balance, then, it is most probable that the Delaware courts would not give absolute, literal effect to a prohibition in a stockholder-adopted by-law against amendment of the by-law by the board of directors." *Id.* at 475. *But see* McDonnell, *supra* note 116, at 262 ("Even if Delaware courts hold that boards have the power to repeal such shareholder bylaws, there are legal and practical limits to that board power.").

381. *See* Hamermesh, *supra* note 109, at 470–72; McDonnell, *supra* note 116, at 261–62. Professor Hamermesh cites to two cases that touch on the matter: *American International Rent-a-Car, Inc. v. Cross,* No. 7583, 1984 WL 8204, at *3 (Del. Ch. May 9, 1984), and *Centaur Partners, IV v. National Intergroup, Inc.*, 582 A.2d 923, 929 (Del. 1990). Hamermesh, *supra* note 109, at 475. In *Cross*, the Chancery Court "asserted that the stockholders could adopt [an amendment-precluding provision]." *See id.* at 469. Conversely, in *Centaur*, the Delaware Supreme Court rejected such a provision. *See id.* at 470–71. Both courts made those assertions in dicta. *See id.* at 469–71.

382. However, a notable dynamic is also the pressure that directors would receive to not repeal or amend a shareholder adopted bylaw. *See* Hamermesh, *supra* note 109, at 416 n.24 ("The public relations consequences of such a repudiation by the directors, on the other hand, could be highly significant."); McDonnell, *supra* note 116, at 262 ("Practically, I doubt whether boards would want so blatantly to counter shareholder desires as to repeal a board-limiting bylaw that shareholders had recently passed.").

383. *See* Hamermesh, *supra* note 109, at 491 ("Directors who fear that stockholders might adopt a by-law strictly limiting use of rights plans, for example, might concurrently submit

Professor Hamermesh suggests these "counterinitiatives" and accompanying "contests over by-law proposals" are an "inevitable" result of a rise in shareholder proposals, particularly if "statutes or court decisions significantly limit the directors' ability to supersede such by-laws by post hoc amendments."[384] Professor Bebchuk has described management counter-proposals as "expand[ing] shareholders' set of choices and thus increas[ing] the chances that the most value-increasing change in rules will be chosen."[385] He argues that this check will remedy potential problems that might arise from shareholder bylaw proposals, such as "disruptive cycling."[386] We agree that management counter-bylaws will increase the likelihood that "the menu offered to shareholders would include the value-maximizing option"[387] and thus provide an adequate constraint on shareholders' unlimited power.

4. The Limits of Rule 14a-8

All of the foregoing constraints are embedded in Delaware corporate law. Most shareholders who wish to change the bylaws must also traverse Rule 14a-8, which imposes significant procedural constraints on shareholder proposals. If shareholders do not meet the requirements of Rule 14a-8 then management can exclude their proposals and supporting statements from the company's proxy materials.[388] As gatekeeping requirements, the Rule imposes standards for both ownership of shares and timing of the proposal. Accordingly, shareholder proponents must have continuously owned at least \$2,000 in stock or 1 percent of the company's voting shares, whichever is less, for at least one year before submitting a proposal.[389]

for stockholder approval a less stringent plan."). Professor Hamermesh calls this a "counterinitiative." *See id.* It is also referred to as a "counter-proposal." *See, e.g.*, Bebchuck, *supra* note 84, at 839.

384. Hamermesh, *supra* note 109, at 491 ("In sum, as stockholder activists come increasingly to rely on the stockholders' power to adopt by-laws in their efforts to exercise influence over corporate policy, one can expect managers to become increasingly aggressive in developing and testing mechanisms to resist such efforts."). He analogizes this possibility with the "opponents of ballot initiatives in the political arena." *Id.* However, he notes that, unlike in the political arena, "[c]orporate managers are encumbered neither by petition signature requirements . . . nor by advance notice requirements generally applicable to stockholder proposals, and managers are free to use corporate resources to present competing proposals." *Id.* at 461. While Professor Hamermesh notes this to demonstrate potential for "voter confusion," *see id.* at 459, it also emphasizes how ready of a check this can be on shareholder bylaws.

385. Bebchuck, *supra* note 84, at 872 (This is in reference to shareholder "proposal[s] to amend the charter or reincorporate," but we contend that the check that these counter-proposals would serve in this context would be the same in the context of bylaws.).

386. *See id.* at 886–87 ("Thus, concerns about cycling at most require providing management with the power to place counter-proposals on the agenda. Such power would be sufficient to enable management to break any cycles that might arise.").

387. *Id.* at 839.

388. 17 C.F.R. § 240.14a-8 (2011). Notably, if management successfully excludes a shareholder proposal, the proponents can still use Rule 14a-7 to obtain the shareholder list and mail their proposal out separately. *See id.* § 240.14a-7(a). However, the significant cost imposed by mailing the proposals greatly deters shareholders from pursuing this avenue.

389. *Id.* § 240.14a-8(b).

Furthermore, they must ensure that the company receives the proposal "120 calendar days before the date of the company's proxy statement released to shareholders in connection with the previous year's annual meeting."[390] This time period is critical because it allows the company to seek a no-action letter from the SEC.[391]

In addition to these procedural constraints, the Rule imposes several limitations on the subject matter of the proposals.[392] For example, management can exclude any proposals that are "[i]mproper under state law"[393] or that amount to nothing more than a "[p]ersonal grievance" of the proponent.[394] Management also has discretion to exclude proposals that are not relevant, meaning proposals that do not relate to at least "5 percent of the company's total assets" or "5 percent of its net earnings and gross sales" or that are "not otherwise significantly related to the company's business."[395] Moreover, management can exclude proposals that "directly conflict[] with one of the company's own proposals to be submitted . . . at the same meeting"[396] or that are no more than a duplicate[397] or a resubmission of a previous proposal.[398] In sum, these provisions considerably constrain shareholders from proposing errant or outlandish bylaws.

5. Self-Interest

The legal rules examined in the foregoing sections almost certainly impede many frivolous or unwise shareholder bylaw proposals, but many more are thwarted by self-interest. We assume that shareholders are self-interested. While a shareholder may attempt to serve its self-interest by acting opportunistically, that shareholder can also serve its self-interest by improving the governance of the corporation. We recognize that shareholders cannot capture all of the gains from their effort, but institutional shareholders capture a great deal of value by proposing value-

390. *Id.* § 240.14a-8(e)(2).

391. The threat of a no-action letter, in and of itself, serves as an additional deterrent for outlandish bylaw proposals.

392. Among these requirements is the "ordinary business" exclusion. 17 C.F.R. § 240.14a-8(i)(7). We do not discuss that exclusion here, however, because we advocate for its removal below.

393. *Id.* § 240.14a-8(i)(1). Proposals must be "a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization." *Id.*

394. *Id.* § 240.14a-8(i)(4). Proposals are excludable if they "relate[] to the redress of a personal claim or grievance against the company or any other person, or if [they are] designed to result in a benefit to [the proponent], or to further a personal interest, which is not shared by the other shareholders at large." *Id.*

395. *Id.* § 240.14a-8(i)(5); *see, e.g.*, Lovenheim v. Iroquois Brands, Ltd., 618 F. Supp. 554, 558–61 (D.D.C. 1985) (holding that a resolution was relevant that did not meet the 5 percent threshold because it dealt with the ethical treatment of geese that the company used to produce pate de fois gras).

396. 17 C.F.R. § 240.14a-8(i)(9).

397. *Id.* § 240.14a-8(i)(11).

398. *Id.* § 240.14a-8(i)(12). Proposals are excludable if they "deal[] with substantially the same subject matter as another proposal . . . that has . . . been previously included in the company's proxy materials within the preceding 5 calendar years." *Id.*

enhancing changes across the whole of their portfolios. The goal of corporate governance is to increase the value of the firm, and we believe that most shareholders will pursue that goal when proposing shareholder bylaws.

C. Facilitating Private Ordering in Public Corporations

We have endorsed private ordering in public corporations, and the purpose of this section is to propose changes to the relevant laws to facilitate that private ordering. The changes proposed below are technically modest, but conceptually ambitious. First, we would resolve the recursive loop between DGCL sections 109(b) and 141(a) to enable shareholder bylaws that are not "limited by the board's management prerogatives under Section 141(a)."[399] Second, we would abolish the unfounded distinction between procedural and substantive bylaws invented by the Delaware Supreme Court in *CA, Inc*. Third, we would encourage the Delaware courts to reconsider *CA, Inc.* in light of the foregoing changes to the DGCL, abandoning the notion that the board of directors could somehow "breach their fiduciary duties [by] compl[ying] with the [shareholder's] Bylaw."[400] Fourth, we would amend Rule 14a-8 to permit proposals relating to "ordinary business operations,"[401] thus enabling shareholders to work out for themselves which issues merit shareholder attention. We believe that the combined effect of the adoption of these proposals would be to facilitate private ordering, creating laboratories of corporate governance in U.S. public corporations.

1. Amending DGCL Section 141(a)

The limitations on shareholder power under Delaware law do not derive from the DGCL, but rather from the common law decisions of the Delaware courts. Having first embraced the concept of director primacy as a matter of common law,[402] the Delaware courts interpreted DGCL section 109(b) narrowly to deprive shareholders of power. We would empower shareholders to adopt bylaws that limit the managerial authority of the board of directors. To effect that change, we could strive to persuade the Delaware courts of the correctness of our position. Alternatively, we could persuade the Delaware General Assembly to amend the DGCL, thus encouraging the Delaware courts to reconsider their policy choices. We see greater potential for quick and lasting change in the latter course.

The technical challenge posed by this strategy is to craft an amendment to the DGCL that would enable shareholder bylaws that are not "limited by

399. CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 232 (Del. 2008).

400. *Id.* at 238; *see supra* note 104 and accompanying text.

401. 17 C.F.R. § 240.14a-8(i)(7).

402. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) ("The business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors."); Hollinger Inc. v. Hollinger Int'l, Inc., 858 A.2d 342, 374 (Del. Ch. 2004) ("That approach also adheres to the director-centered nature of our law . . . .").

the board's management prerogatives under Section 141(a)."[403] In other words, we would like the DGCL to create a relationship between shareholders and directors like the one described by Chancellor Chandler in *UniSuper Ltd. v. News Corp.*[404]:

> [W]hen shareholders exercise their right to vote in order to assert control over the business and affairs of the corporation the board must give way. This is because the board's power—which is that of an agent's with regard to its principal—derives from the shareholders, who are the ultimate holders of power under Delaware law.[405]

Although Chancellor Chandler alludes to agency law, he does not view shareholders and directors as literal principals and agents.[406] Agency theory has long exerted a strong metaphorical pull on corporate law scholars and judges.[407] The central focus of agency theory is the conflict created when one person or group (in this instance, the board of directors) acts on behalf of another (the shareholders). While the agency metaphor is far from uncontroversial,[408] it has a well-established pedigree in Delaware,[409] and we believe that it is a useful framework for constructing the relationship between shareholders and the board of directors. In an attempt to emphasize the existence of such a relationship in the language of the DGCL, we propose to amend section 141(a) as follows:

> 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, *or in its bylaws*. If any such provision is made in the certificate of incorporation *or in the bylaws*, 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 *or in the bylaws*.

This "New Section 141(a)" identifies three sources of limitation on the managerial authority of the board of directors: other provisions of the DGCL, the certificate of incorporation, and the bylaws. This is undoubtedly a significant conceptual change in the sense that the board of directors would be less insulated from shareholder influence, but for reasons discussed above, we believe that shareholder empowerment will have positive effects on public corporations.

403. *CA, Inc.*, 953 A.2d at 232.

404. No. 1699-N, 2005 WL 3529317 (Del. Ch. Dec. 20, 2005).

405. *Id.* at *6.

406. *See id.* at *6–8.

407. *See, e.g.*, Rose, *supra* note 334, at 1363–64; Thompson & Smith, *supra* note 99, at 265 ("Agency theory has dominated corporate-law scholarship . . . ."); J.W. Verret, *Treasury Inc.: How the Bailout Reshapes Corporate Theory and Practice*, 27 YALE J. ON REG. 283, 315 (2010) ("Agency theory is the bedrock of corporate law . . . .").

408. *See, e.g.*, Richard Mitchell et al., *Shareholder Value and Employee Interests: Intersections Between Corporate Governance, Corporate Law and Labor Law*, 23 WIS. INT'L L.J. 417, 432 (2005) ("[A]gency theory does not accord particularly well . . . with what we term the legal model of the company.").

409. *See, e.g.*, Rose, *supra* note 334, at 1361–62; Thompson & Smith, *supra* note 99, at 264–66, 268–69; Verret, *supra* note 407, at 315.

Professor McDonnell identified an interpretive quandary with regard to the current DGCL section 141(a) that could bear on New Section 141(a).[410] The quandary stems from the phrase "except as may be otherwise provided in this chapter"[411] and the application of that phrase to DGCL section 102(b)(1), which is similar to section 109(b) in that it expressly allows for provisions in the certificate of incorporation relating to "the management of the business and . . . the conduct of the affairs of the corporation."[412] Professor McDonnell wonders, if such charter provisions are "provided in this chapter," then why would the exception in section 141(a) need to include the language, "or in its certificate of incorporation"?[413] The answer, of course, is that under the stated assumptions, the certificate language in section 141(a)'s exception clause would be superfluous.

Professor McDonnell uses this clever argument as a reason to read section 109(b) narrowly. "If we are to read section 109(b) broadly to allow bylaws to limit board authority," he reasons, "then section 102(b)(1) would have the same effect" because both sections expressly allow for provisions relating to the conduct of the affairs of the corporation.[414] We should not read statutes to make language superfluous, so this broad reading of these sections would be illegitimate.

While Professor McDonnell's reading would make the certificate language in section 141(a)'s exception clause superfluous, a readily available alternative reading would retain the meaning of each part of the exception clause. The alternative reading would hold that provisions in the certificate of incorporation are not "otherwise provided in this chapter," even though the procedures for creating such provisions are "otherwise provided in this chapter." Indeed, it is self-evident that provisions in the certificate of incorporation are not "in this chapter."

We use this alternative reading to support our proposed amendment. Just as provisions in the certificate of incorporation relating to the conduct of the affairs of the corporation are expressly contemplated by DGCL section 102(b)(1), provisions in the bylaws relating to the conduct of the affairs of the corporation are expressly contemplated by DGCL section 109(b). Such provisions are manifestly in the bylaws, not "in this chapter." Thus, the language added in New Section 141(a) would not be superfluous. Indeed, in light of the Delaware Supreme Court's decision in *CA, Inc.* that shareholder-adopted bylaws are "limited by the board's management prerogatives under Section 141(a),"[415] the new language would transform Delaware law, enabling shareholder-adopted bylaws that limit managerial authority of the board of directors.

410. McDonnell, *supra* note 116, at 215.
411. DEL. CODE ANN. tit. 8, § 141(a) (2005).
412. *Id.* § 102(b)(1).
413. McDonnell, *supra* note 116, at 213–14.
414. *Id.* at 215.
415. CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 232 (Del. 2008).

2. Amending DGCL Section 109(b)

As noted above in our analysis of *CA, Inc.*, the distinction between procedural and substantive bylaws was invented by the Delaware Supreme Court out of whole cloth. The purpose of this distinction is to place substantive bylaws beyond the reach of shareholder action, though the policy reasons motivating this effort are misguided. We would empower shareholders to adopt bylaws that limit the managerial authority of the board of directors, whether those limits are procedural or substantive. In an attempt to enable shareholders, we propose to amend section 109(b) as follows:

> The bylaws may contain any provision, *whether procedural or substantive*, 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 or the rights or powers of its stockholders, directors, officers or employees.

This amendment is intended to be a straightforward demolition of the Delaware Supreme Court's framework. Using the opaque words "procedural" and "substantive" in the statute would be troublesome if the Delaware courts were required to define these terms. As used in this section, however, the terms do require definition. Indeed, the purpose of inserting the terms is to prevent the courts from going down that path. These terms are intended to signify that "any provision" truly means *any provision*. Although the plain language of the original statute should have been sufficient to avoid a distinction between procedural and substantive bylaws, the court's decision in *CA, Inc.* necessitates this amendment.

We would retain the enigmatic phrase "not inconsistent with law," because "law" has now been interpreted to include DGCL section 141(a).[416] When this revised section 109(b) is read in conjunction with New Section 141(a), therefore, the result is to allow shareholder bylaws without regard to their effect on the managerial authority of the board of directors. Such bylaws are not inconsistent with New Section 141(a), which expressly allows for limiting bylaws.

3. Revisiting Delaware Precedent

The next step in creating laboratories of corporate governance must be taken by the Delaware courts. As noted above, we disagree with the Delaware Supreme Court's decision in *CA, Inc.* that the directors could "breach their fiduciary duties [by] compl[ying] with the [shareholder's] Bylaw."[417] Our amendments to DGCL sections 109(b) and 141(a) end the "recursive loop" and describe a relationship between shareholders and the board of directors that would not accommodate the court's view of a fiduciary limitation. Obviously, we cannot ensure that the Delaware courts

416. *Id.* at 232 n.7.
417. *Id.* at 238; *see supra* note 101 and accompanying text.

would respond to the amendments in this way, but we believe that the proposed statutory changes would require a reconsideration of *CA, Inc.*

4. Amending Rule 14a-8

In addition to changing Delaware law, we would amend Rule 14a-8 to eliminate the "ordinary business" exclusion.[418] The vagueness of this exclusion fosters contentious litigation, and to what end? According to the SEC, the stated purpose of the exclusion is to reduce inefficiencies, enabling managers to make decisions that are either too mundane or too complex for shareholder votes.[419] We contend that the frictions described above (shareholder self-interest, market forces, majority voting requirements, and director counter-bylaws) will effectively deter many trivial proposals. Moreover, the other limitations in Rule 14a-8 (e.g., "personal grievances," "relevance," "duplication," and "resubmission"[420]) will constrain bylaw proponents. Finally, in a system animated by private ordering, each corporation will be able to devise additional rules governing shareholder proposals. We would expect some experimentation with such rules, and we would expect effective rules to be adopted by many corporations through private ordering.

The SEC's own description of the "ordinary business" exclusion demonstrates how its vagueness can be problematic.[421] The SEC has

418. 17 C.F.R. § 240.14a-8(i)(7) (2011). The Rule currently reads: "(i) *Question 9*: If I have complied with the procedural requirements, on what other bases may a company rely to exclude my proposal? . . . (7) *Management functions*: If the proposal deals with a matter relating to the company's ordinary business operations." *Id.*

We acknowledge that we are not the first to suggest striking this provision. For years, several scholars have advocated removal of this overly subjective exclusion. *See, e.g.*, Alan R. Palmiter, *The Shareholder Proposal Rule: A Failed Experiment in Merit Regulation*, 45 ALA. L. REV. 879, 885 (1994) ("The time has come to jettison 14a-8 merit regulation, a vestige of another time and regulatory attitude. The decision whether a proposal is 'substantially related' to the company's business or an 'ordinary business' matter . . . should be left to the shareholder voting process or, in the unusual case, to dispute resolution under state corporate law."). In fact, the SEC has considered abandoning this exclusion. *See* Notice of Solicitation of Public Views Regarding Possible Changes to the Proxy Rules, 68 Fed. Reg. 24,530, 24,530–01 (May 7, 2003).

419. *See* Amendments to Rules on Shareholder Proposals, 63 Fed. Reg. 29,106, 29,108 (May 28, 1998) ("The general underlying policy of this exclusion is consistent with the policy of most state corporate laws: to confine the resolution of ordinary business problems to management and the board of directors, since it is impracticable for shareholders to decide how to solve such problems at an annual shareholders meeting."). The SEC has identified "two central considerations" that support this policy. First, it contends that "[c]ertain tasks are so fundamental to management's ability to run a company on a day-to-day basis that they could not, as a practical matter, be subject to direct shareholder oversight." *Id.* Second, it fears that shareholders will attempt to "'micro-manage' the company by probing too deeply into matters of a complex nature upon which shareholders, as a group, would not be in a position to make an informed judgment." *Id.*

420. *See* 17 C.F.R. § 240.14a-8(i) (providing for twelve other reasons a board may exclude a proposal).

421. *See supra* note 394.

labeled the test for this exclusion as a "case-by-case analytical approach"[422] that requires staffers to "make reasoned distinctions in deciding whether to furnish 'no-action' relief" that can, in some cases, admittedly be "tenuous."[423] The SEC justifies this approach by reasoning "that on the whole the benefit to shareholders and companies in providing guidance and informal resolutions will outweigh the problematic aspects of the few decisions in the middle ground."[424] Further, the SEC has, "over the years," been willing to "reverse[] its position on the excludability of a number of types of proposals" once it has "gained a better understanding of the depth of interest among shareholders to express their views to company management."[425] We are not persuaded by the benefits of this "case-by-case" approach or its policy justifications, and we do not feel that shareholders should have to wait years for the SEC to pick up on its "depth of interest" and reverse itself. Rather, we propose that this process should be left to private ordering, allowing a corporation, if it so desires, to create its own "ordinary business" type exclusion or, in the alternative, to not have one at all.

The potential for the SEC's fickle usage of this exclusion to produce troublesome outcomes has been demonstrated by several notable no-action letters in which the SEC decided to depart from its earlier positions with regard to this exclusion.[426] For example, the SEC reversed itself on several accounts after the Enron scandal in 2001.[427] Prior to doing so, the staff's position was to exclude "all proposals regarding whether a company's outside auditor could also conduct consulting work for the company."[428] This was followed by several other policy shifts concerning auditing, accounting, and finance.[429] In a more recent example, the SEC issued two contrasting no-action letters, separated by three months, regarding a proposal by shareholders of Tyson Foods, Inc.[430] The SEC first backed Tyson Foods's exclusion of the proposal, which dealt with the company's

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422. Amendments to Rules on Shareholder Proposals, 63 Fed. Reg. 29,106, 29,108 (May 28, 1998). The SEC said that it will "tak[e] into account factors such as the nature of the proposal and the circumstances of the company to which it is directed." *Id.*

423. *Id.* The SEC tries to "use the most well-reasoned and consistent standards possible," but acknowledges "the inherent complexity of the task." *Id.*

424. *Id.*

425. *Id.*

426. *See* Marc H. Folladori, *Shareholder Proposals*, 1855 PLI/CORP. 435, 497 (2010) ("Indeed, the staff's responses to company no-action letter requests . . . under the 'ordinary business operations' exemption . . . has seemed to reflect, in large part, the then-prevailing national mood concerning corporate governance issues at their time of issuance.").

427. *Id.*

428. *Id.* (citing two no-action letters: The Walt Disney Co., SEC No-Action Letter, 2001 WL 1700743 (Dec. 18, 2001); Liz Claiborne, Inc., SEC No-Action Letter, 2002 WL 562180 (Mar. 13, 2002)).

429. *See id.* at 499 (citing USG Corp., SEC No-Action Letter, 2003 WL 942651 (Mar. 5, 2003) ("[P]roposal requests the board of directors to conduct an annual poll of auditor reputation and release the results of the poll to the news media."); Fleetwood Enters. Inc., SEC No-Action Letter, 2002 WL 32078264 (Apr. 24, 2002) ("The proposal requests that [the company] select its independent auditor annually by shareowner vote.")).

430. *See id.* at 500.

usage of "antibiotics as livestock feed," only to then reverse itself and decide that the proposal was not excludable as "ordinary business."[431] The staff reached this decision because of "'the widespread public debate concerning antimicrobial resistance,'" and did so in spite of two earlier no-action letters that held to the contrary.[432]

We are concerned by the burden, as illustrated by the above examples, that this exclusion places on the SEC to keep up with "widespread public debate" and arbitrarily gauge the "depth of shareholder interest." Under our proposed amendments, it would not take large-scale accounting fraud or "antimicrobial resistance" for a shareholder's concern to suddenly rise in significance enough to escape the reach of the "ordinary business" exclusion. Rather, the proponents of any proposal that met the other requirements of 14a-8 would have the opportunity to try and garner a majority vote. And if the shareholders and directors of any given corporation decided that an exclusion akin to this "ordinary business" provision would be beneficial to their corporation, they could arrange it through private ordering.

Our proposal bears a family resemblance to the work of Professor Bebchuk, who has offered the most ambitious proposal for increasing shareholder power.[433] Nevertheless, the proposal to channel shareholder action through corporate bylaws places us somewhat at odds with Professor Bebchuk. Under his proposal, shareholders could initiate two categories of decisions beyond the election and removal of directors: "'rules-of-the-game' decisions to amend the corporate charter or to change the company's state of incorporation [and] specific business decisions of substantial importance."[434] We would not allow shareholders to amend the corporate charter or to change the company's state of incorporation unilaterally because we see value in the current distinction between charter amendments, which must be initiated by the board of directors,[435] and bylaw amendments, which may be initiated by the shareholders.[436] With respect to the second part of Professor Bebchuk's proposal, we believe that attempts to distinguish between business decisions of substantial importance and other business decisions are both frustrating and unnecessary. This is precisely the sort of inquiry made in the "ordinary business" exclusion under Rule 14a-8, and that experience demonstrates the impossibility of drawing meaningful lines. As a result, we would eliminate the "ordinary business" exclusion, and we would not introduce that problem into Delaware corporate law.

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431. *See id.*

432. *See id.* (quoting Tyson Foods, Inc., SEC No-Action Letter, 2009 WL 5149212 (Dec. 15, 2009)).

433. *See generally* Bebchuk, *supra* note 84.

434. *Id.* at 836–37.

435. DEL. CODE ANN. tit. 8, §242(b) (2005); MODEL BUS. CORP. ACT §10.03 (2007).

436. DEL. CODE ANN. tit. 8, §109(a); MODEL BUS. CORP. ACT §10.20(a).

CONCLUSION

We began this Article by describing the *Airgas* case, in which Chancellor Chandler addressed "one of the most basic questions animating all of corporate law . . . . [I]n the context of a hostile tender offer, who gets to decide when and if the corporation is for sale?"[437] This question is merely one manifestation of the larger question: who controls the corporation—the shareholders or the directors? The trivial answer is that *both* shareholders and directors control the corporation. The more nuanced answer recognizes that each has a role, and the difficult task in which Chancellor Chandler was engaged is defining those roles.

This Article is motivated by one of the most important insights from transaction cost economics, namely, that different firms require different governance structures to effectively mitigate transaction costs.[438] This insight counsels us to reject a one-size-fits-all governance system where private ordering is not feasible.

UniSuper stands in stark contrast to *Airgas* and evinces the potential of private ordering to benefit shareholders in public corporations. The unconventional contract in *UniSuper* also highlights the difficulty of private ordering in public corporations. We propose legal reforms that will enhance the ability of shareholders in public corporations to contract with shareholder bylaws. By empowering shareholders in this way, we hope to improve shareholder monitoring of managers and to create laboratories of corporate governance that benefit the entire corporate governance system.

437. Air Prods. & Chems., Inc. v. Airgas, Inc., 16 A.3d 48, 54 (Del. Ch. 2011).
438. *See* Williamson, *supra* note 14, at 277.