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# Managing Corporate Federalism: The Least-Bad Approach to the Shareholder Bylaw Debate

Christopher M. Bruner
*Washington and Lee University School of Law*, brunerc@wlu.edu

# MANAGING CORPORATE FEDERALISM: THE LEAST-BAD APPROACH TO THE SHAREHOLDER BYLAW DEBATE

BY CHRISTOPHER M. BRUNER*

ABSTRACT

*Over recent decades, shareholders in public corporations have increasingly sought to augment their own power – and, correlatively, to limit the power of boards – through creative use of corporate bylaws. The bylaws lend themselves to such efforts because enacting, amending, and repealing bylaws are essentially the only corporate governance actions that shareholders can undertake unilaterally. In this Article I examine the contested nature of bylaws, the fundamental issues of corporate power and purpose that they implicate, and the differing ways in which state and federal lawmakers and regulators may impact the debate regarding the scope of the shareholders' bylaw authority.*

*The Article first discusses various dimensions of corporate governance historically addressed in the bylaws, and the controversial uses to which bylaws have been put by shareholders seeking greater corporate governance power, focusing on Delaware – the jurisdiction of incorporation for most public companies. I then turn to the ways in which rules of corporate governance are generated in our federal legal system, including the complex and evolving mechanisms through which state and federal lawmakers and regulators interact. In particular, I evaluate the SEC's process for assessing whether shareholder proposals to amend bylaws must be included in a public company's proxy statement, as well as the recently created process through which Delaware permits SEC certification of contested issues of state law directly to the Delaware Supreme Court – a process the SEC has already used in evaluating the excludability of a proposed shareholder bylaw amendment. I conclude that this process threatens to substantially distort the evaluation and evolution of the shareholders' bylaw authority by presenting the Delaware Supreme Court with proposed bylaws to be assessed in the abstract – an awkward posture resulting in the sacrifice of important values reflected in the ripeness*

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*Associate Professor and Ethan Allen Faculty Fellow, Washington and Lee University School of Law. A.B., University of Michigan; M.Phil., University of Oxford; J.D., Harvard Law School. For generous financial support I am grateful to the Frances Lewis Law Center, Washington and Lee University School of Law. For helpful comments and suggestions, many thanks to Lyman Johnson and Brett McDonnell. Thanks also to James Moore for excellent research assistance.

*doctrine, and abandonment of the presumption of validity that ordinarily favors enacted bylaws.*

*I then consider who ought to determine the scope of permissible shareholder bylaws, concluding that there is no perfect approach because none of the relevant state and federal actors dominates with respect to both political legitimacy and expertise – the SEC possessing neither, while Congress possesses the former and Delaware the latter. I argue, however, that the least-bad approach would be to remove the SEC from the process entirely, leaving these matters to Delaware in the first instance, subject to potential intervention by Congress. The pragmatic means of achieving this outcome would be a strict SEC policy of refusal to permit exclusion from the proxy of proposed shareholder bylaws prompting competing opinions of Delaware counsel. This approach would eliminate the distortion introduced by SEC certification, permitting resolution of the fundamental issues at stake in a more organic and better informed manner through traditional Delaware litigation.*

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## I. INTRODUCTION

Over recent decades, shareholders in Delaware corporations have

increasingly sought to augment their own power—and, correlatively, to limit the power of boards—through creative use of corporate bylaws. Though an ostensibly mundane and mechanical instrument of corporate governance, the bylaws lend themselves to such efforts because—perhaps surprisingly—enacting, amending, and repealing bylaws are essentially the only corporate governance actions that shareholders can undertake unilaterally.

If such authority were entirely open-ended, then shareholders would literally possess the power to rewrite the rules of corporate governance on a company-by-company basis. The matter is not as straightforward as that, however, because, in addition to broadly phrased statutory authority to govern day-to-day corporate affairs, the board is generally granted bylaw authority in its own right by the charter. Consequently, it will be the Delaware courts' task to decide how far shareholder bylaws can go, and what rules of priority might govern incompatible shareholder and board actions in this area.

Fundamental ambiguities on these and related matters tee up a collision of shareholder and board claims to power that, in turn, implicate the core issues defining the field of corporate law. Who possesses ultimate corporate governance authority? And toward whose interests should corporate activities be directed? More concretely, can shareholders use their bylaw authority to limit the board's governance authority—say, by preventing the board from adopting takeover defenses? Likewise, could a shareholder bylaw reining in the board be insulated from board repeal? Much like the hostile takeover debate of the 1980s, the shareholder bylaw debate reveals itself to be a battle of deeply conflicting philosophies regarding the nature and purpose of the most consequential economic actors on the planet.

In this Article, I examine the contested nature and use of bylaws, as well as the differing ways in which state and federal regulators and lawmakers may affect the outcome of the shareholder bylaw debate. As a practical matter, a shareholder seeking to amend the bylaws of a public company may have no alternative but to seek inclusion of a proposal to this effect in the company's proxy statement, a matter regulated at the federal level by the Securities and Exchange Commission (SEC) pursuant to its broad statutory authority to regulate the solicitation of proxies. This adds another layer of complexity to the shareholder bylaw debate because it requires a threshold assessment of who ought to determine the permissible scope of shareholder bylaws, which in turn requires consideration of how state and federal governmental entities might interact and the competing claims to legitimacy in matters of corporate governance that might be advanced on their behalf.

The Article proceeds as follows. Part II discusses various dimensions

of corporate governance historically addressed in the bylaws, and the novel uses to which bylaws have been put by shareholders seeking greater corporate governance power. As I explain, the outer reaches of the shareholders' bylaw authority remain blurry today, reflecting the fact that Delaware lacks a definitive theory regarding the appropriate role of shareholders in corporate governance and the degree to which their interests ought to prevail over those of other corporate constituencies.

In Part III, I turn to the ways in which rules of corporate governance are generated in our federal legal system, including the complex and evolving mechanisms through which state and federal lawmakers and regulators interact. In particular, I evaluate the impact of the SEC's shareholder proposal process on the bylaw debate, as well as the impact of a recently created process through which Delaware permits SEC certification of questions of state law directly to the Delaware Supreme Court. I conclude that the resulting manner in which bylaw disputes arrive at the court threatens to substantially distort the evaluation and evolution of the shareholders' bylaw authority—and consequently the fundamental matters of corporate governance policy implicated by the shareholder bylaw debate. This distortion arises primarily due to the fact that SEC certification presents the Delaware Supreme Court with a proposed bylaw (not an enacted one), necessarily bereft of any factual background regarding its use. The consequences—demonstrated by the first case to reach the court through this process—are the sacrifice of important values reflected in the ripeness doctrine, and abandonment of the presumption of validity that ordinarily favors enacted bylaws.

Part IV builds on this analysis, evaluating who ought to determine the scope of permissible shareholder bylaws. Here, I examine the competing claims to legitimacy in matters of corporate governance that can be advanced on behalf of the relevant state and federal actors—Delaware, Congress, and the SEC. I conclude that there is no perfect approach to the shareholder bylaw debate because none of these actors dominates with respect to both political legitimacy and epistemic legitimacy (essentially a reputation for expert, policy-relevant knowledge). The SEC, I argue, possesses neither, while Congress possesses the former and Delaware the latter.

Ultimately, I conclude that the least-bad approach would be to leave these matters entirely to Delaware—a claim supported by its considerable epistemic legitimacy, coupled with at least indirect political legitimacy via long-standing congressional acquiescence in Delaware's dominant corporate lawmaking role and the potential for future intervention should Congress see fit. The pragmatic means of achieving this outcome would be a strict SEC policy of refusal to permit exclusion from the proxy of proposed shareholder bylaw amendments that prompt competing opinions of Delaware

counsel—an outcome consistent with the company's burden of persuasion already established in the SEC's shareholder proposal rule. This approach, I argue, would effectively eliminate the distortion introduced by SEC certification of disputes over proposed bylaws directly to the Delaware Supreme Court, thereby permitting resolution of the fundamental issues at stake in a more organic and better informed manner through traditional Delaware litigation.

## II. THE CONTESTED NATURE OF "BYLAWS"

The debate regarding the scope of the shareholders' bylaw authority has, unsurprisingly, involved analysis of the nature of bylaws and the role they play in corporate governance. In this part of the Article, I discuss various dimensions of corporate governance historically addressed in the bylaws, and the novel uses to which they have been put by shareholders seeking to augment their power over public companies—including the assertion of control over sensitive matters like the use of takeover defenses.

As we shall see, the outer reaches of the shareholders' unilateral power to enact, amend, and repeal bylaws remain blurry today, a state of affairs reflecting Delaware's long-standing ambivalence regarding shareholders—specifically, the lack of a definitive theory regarding the appropriate role of shareholders in corporate governance and the degree to which their interests ought to guide the activities of Delaware corporations.

### A. *Section 109's Grant of Power*

For lawyers steeped in the day-to-day practice of corporate law, bylaws hardly represent the enigma that academics find them to be. One practitioner's guide, for example, speaks of what Delaware bylaws "typically" include—things like "meetings of stockholders; directors and committees of directors; the selection and duties of officers; and miscellaneous provisions" addressing indemnification and the like.[1] While the Delaware General Corporation Law (DGCL) concededly imposes "no substantive restrictions" on their content, it is rightly observed that numerous provisions throughout the Delaware statute provide guidance on the scope and operation of bylaws in significant areas of corporate governance.[2] For example, section 141 expressly permits bylaws to address the number of

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[1] A. Gilchrist Sparks, III & Frederick H. Alexander, *The Delaware Corporation: Legal Aspects of Organization and Operation*, 1-4th Corp. Prac. Series (BNA) § II.D (2010).

[2] *See generally id*.

board seats and director qualifications (section 141(b)); the powers of board committees (section 141(c)); the board's capacity to act by written consent (section 141(f)); the location of board meetings (section 141(g)); the board's authority to set its own compensation (section 141(h)); and the capacity of directors to participate in meetings remotely (section 141(i)).[3] Similar guidance regarding the mechanics of shareholder action appears in section 211, which expressly permits bylaws to address the location of shareholder meetings (section 211(a)); the date and time of the annual meeting for election of directors (section 211(b)); and the authority to call special meetings (section 211(d)).[4] Those seeking a standard "form" of bylaws for a Delaware corporation addressing the typical contents noted above need only consult one of the prominent treatises in the area.[5] In the ordinary life of a Delaware corporation, a number of important (although mechanical) aspects of corporate governance clearly fall within their ambit, such that bylaws are aptly styled "the operating rules for the governance of the corporation."[6]

Over recent years, however, shareholders have increasingly used bylaws as a means to augment their power,[7] a development rendered possible by two core features of the DGCL's general grant of bylaw authority. First, in stark contrast with other major corporate decisions (including mergers, sales of substantially all assets, charter amendments, and dissolution), which shareholders generally lack the power to initiate,[8] shareholders can adopt, amend, or repeal bylaws unilaterally—and this power cannot be taken away. Section 109(a) says that "the power to adopt, amend or repeal bylaws *shall be in the stockholders* entitled to vote," and that while the charter may extend this power to the board as well, it may not limit the shareholders' own bylaw authority.[9] In a corporate governance system forcing most decisions

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[3] DEL. CODE ANN. tit. 8, § 141(b)-(c), (f)-(i) (2010).

[4] *Id.* § 211(a)-(b), (d).

[5] *See, e.g.*, R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS, form 1.17 (3d ed. 2009) (including provisions addressing shareholder meetings; the board of directors and committees thereof; officers; stock; indemnification; and "miscellaneous" provisions regarding notice, bylaw amendments, and so on).

[6] *See* WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 92 (2d ed. 2007).

[7] *See* Brett H. McDonnell, *Bylaw Reforms for Delaware's Corporation Law*, 33 DEL. J. CORP. L. 651, 651-52 (2008).

[8] In each case, the decision must be proposed by the board. *See* DEL. CODE ANN. tit. 8, §§ 251(c) (mergers), 271(a) (sales of substantially all assets), 242(b) (charter amendments), 275(b) (dissolution). *But see id.* § 275(c) (permitting shareholders to dissolve the corporation unilaterally, but only by unanimous vote).

[9] *Id.* § 109(a) (emphasis added). The intention of the 1974 amendment to section 109(a) was, in fact, to clarify that a charter provision granting the board bylaw authority would not have the effect of depriving the shareholders of this power. *See* EDWARD P. WELCH ET AL., FOLK ON THE

through the board, this unique mode of unilateral action provides an obvious window of opportunity for shareholders looking to impact corporate affairs. Indeed, it is rendered even more attractive by another core feature of Delaware's bylaw statute—the open-ended nature of this grant of power. Section 109(b) says that "bylaws 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."[10] Taken at face value, section 109 would appear to offer shareholders the unilateral (and inalienable) ability to rewrite the rules of corporate governance on a company-by-company basis as, and when, they see fit.

### B. *Section 109's Limits*

Section 109's grant of power is not, however, without limits. While broadly permitting bylaws "relating to the business of the corporation" and "the conduct of its affairs"—and even contemplating bylaws affecting "the rights or powers" of directors—section 109(b) states that bylaws may not be "inconsistent with law or with the certificate of incorporation."[11] This reflects a long-standing hierarchical conception of forms of corporate authority. As the Delaware Court of Chancery explained in 1929:

> [W]ith respect to corporations the law of their being is characterized by gradation of authority. That which is superior overrides all below it in rank. The by-laws must succumb to the superior authority of the charter; the charter if it conflicts with the statute must give way; and the statute, if it conflicts with the constitution, is void.[12]

While bylaws trump board resolutions—such that "a board cannot override a bylaw requirement by merely adopting a resolution"[13]—bylaws are

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DELAWARE GENERAL CORPORATION LAW § 109.1 (5th ed. 2010).

[10] DEL. CODE ANN. tit. 8, § 109(b) (emphasis added).

[11] *See id.*

[12] Gaskill v. Gladys Belle Oil Co., 146 A. 337, 340 (Del. Ch. 1929). *See also* Airgas, Inc. v. Air Products and Chemicals, Inc., 8 A.3d 1182, 1189 (Del. 2010) ("It is settled Delaware law that a bylaw that is inconsistent with the corporation's charter is invalid.").

[13] Hollinger Int'l, Inc. v. Black, 844 A.2d 1022, 1080 (Del. Ch. 2004). For additional background on the status of board resolutions and policies, see Unisuper Ltd. v. News Corp., 2005 WL 3529317, *5 (Del. Ch. Dec. 20, 2005) (observing that while board resolutions and policies are generally revocable, their adoption and maintenance may be the subject of an enforceable contract); *see also generally* Jennifer G. Hill, *Subverting Shareholder Rights: Lessons from News Corp.'s Migration to Delaware*, 63 VAND. L. REV. 1 (2010) (analyzing News Corp.'s reincorporation in

themselves unquestionably trumped by contrary provisions in the charter and the statute, rendering them "the least fundamental of the corporation's 'constitutional' documents."[14] The bylaws' low position on the totem pole is further reflected in section 102(b)(1), stating that anything "required or permitted . . . to be stated in the bylaws may instead be stated in the certificate of incorporation"[15]—but not vice versa.

With respect to the shareholders' bylaw authority, then, the hierarchy reflected in section 109(b) could impose substantial limitations indeed, given the enormous grant of power to Delaware boards under the statute and (through it) the charter—though the nature of these limits remains far from clear, given the ambiguity and circularity of the relevant DGCL provisions. Section 141(a) says that the "business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors" unless the statute or the charter says otherwise.[16] Correspondingly, section 102(b)(1) contemplates inclusion in the charter of "[a]ny provision for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders."[17] These provisions broadly suggest that limits on the board's ability to manage the business and affairs of the corporation are to appear in the charter, not the bylaws. It is unclear how far this logic goes, however, because section 109(b) itself contemplates bylaws at least "relating" to the corporation's business and affairs[18]—whatever that means. Confusion regarding the interaction between sections 109 and 141, in particular, is compounded by what Jeffrey Gordon famously called the "recursive loop."[19] Section 141(a)'s grant of power to the board "permits variations 'otherwise provided' in the chapter, which includes section 109, a broad source of shareholder power—but whose use cannot be 'inconsistent with' the charter or the law, meaning—and here the circle starts again—section 141(a)."[20]

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Delaware, the ensuing litigation, and the relative weakness of Delaware shareholder rights relative to those in News Corp.'s native Australia).

[14] ALLEN ET AL., *supra* note 6, at 92; *see also* BALOTTI & FINKELSTEIN, *supra* note 5, at 1-15; 1 DAVID A. DREXLER ET AL., DELAWARE CORPORATION LAW AND PRACTICE § 9.03 (2009); WELCH ET AL., *supra* note 9, §§ 109.5.1-.5.2.

[15] DEL. CODE ANN. tit. 8, § 102(b)(1).

[16] *Id.* § 141(a).

[17] *Id.* § 102(b)(1).

[18] *Id.* § 109(b).

[19] Jeffrey N. Gordon, *"Just Say Never?" Poison Pills, Deadhand Pills and Shareholder-Adopted Bylaws: An Essay for Warren Buffet*, 19 CARDOZO L. REV. 511, 546 (1997).

[20] *Id.* at 547; *see also* John C. Coffee, Jr., *The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?*, 51 U. MIAMI L. REV. 605, 607-08 (1997); Brett H. McDonnell, *Shareholder Bylaws, Shareholder Nominations, and Poison Pills*, 3 BERKELEY BUS.

It is widely recognized that the statute itself provides no clear means of reconciling these provisions.[21] In discrete areas the DGCL explicitly envisions certain forms of bylaws considered favorable to shareholders, including majority voting requirements,[22] the ability to include board nominees in the corporation's proxy statement,[23] and reimbursement of shareholders' election-related proxy expenses.[24] Outside these discrete areas, however, confusion reigns.[25]

Indeed, aside from the collision with section 141, there is also the simultaneity of shareholder and board bylaw authority under section 109 itself to reckon with.[26] While at common law only shareholders could amend bylaws, many corporate law statutes later permitted the board to be granted concurrent power in the charter—an approach reflected in DGCL section 109(a).[27] This, of course, "raises the prospect of cycling amendments and

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L.J. 205, 213-15 (2005). *But see* Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?*, 73 TUL. L. REV. 409, 429-33 (1998) (contesting Gordon's reading and arguing that "section 141(a) is more naturally read to refer to statutes which address its specific subject matter—the allocation of managerial power to the board of directors—and which clearly and explicitly depart from that allocation by providing for management by persons other than directors").

[21] *See, e.g.*, Christopher M. Bruner, *The Enduring Ambivalence of Corporate Law*, 59 ALA. L. REV. 1385, 1423-24, 1444-47 (2008); Coffee, *supra* note 20, at 606-08; McDonnell, *supra* note 20, at 213-15; Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers*, 80 TEX. L. REV. 261, 319-20 (2001). On the approach subsequently taken by the Delaware Supreme Court, see *infra* notes 72-75 and accompanying text.

[22] DEL. CODE ANN. tit. 8, § 216. Majority voting requirements enhance shareholder power by transforming votes withheld into votes against a given candidate. Under the plurality voting requirement that otherwise applies to board elections by default, a single vote would be sufficient to elect an unopposed candidate. *See* HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SECURITIES AND FEDERAL CORPORATE LAW § 24:84.30 (2010), *available at* Westlaw SECFEDCORP.

[23] DEL. CODE ANN. tit. 8, § 112. Shareholder rights advocates viewed section 112's adoption as an effort to preempt an anticipated federal proxy access rule by permitting ownership thresholds to be established in the bylaws at a higher level than those anticipated in the federal rule. *See* J. Robert Brown, *The SEC, Access and the Need to Preempt Delaware Law*, THE RACE TO THE BOTTOM, (Apr. 23, 2009, 6:00 AM), http://www.theracetothebottom.org/preemption-of-delaware-law/the-sec-access-and-the-need-to-preempt-delaware-law.html. The effort was unsuccessful. *See infra* notes 146-152 and accompanying text.

[24] DEL. CODE ANN. tit. 8, § 113.

[25] The lack of clarity described above is further reflected elsewhere in the DGCL. For example, section 121 indicates that a corporation's powers are to be exercised by "its officers, directors and stockholders." *Id.* § 121(a). As Balotti and Finkelstein observe, however, the statute provides no guidance on the allocation of these powers, effectively leaving this to discrete sections of the DGCL and, in the many circumstances lacking such specification, to the charter, bylaws, and common law. BALOTTI & FINKELSTEIN, *supra* note 5, at 2-2. Likewise, section 122 gives the corporation power to "[a]dopt, amend and repeal bylaws," again without further guidance as to when or by whom. *See* DEL. CODE ANN. tit. 8, § 122(6).

[26] DEL. CODE ANN. tit. 8, *Id.* § 109.

[27] *Id.* § 109(a). *See* STEPHEN M. BAINBRIDGE, CORPORATE LAW 15 (2d ed. 2009).

counter-amendments"—say, a shareholder bylaw invading the board's turf in some respect, to which the board responds by simply repealing the offensive bylaw.[28] Today, new Delaware corporations typically permit the board to enact, amend, and repeal bylaws pursuant to section 109(a),[29] yet the statute leaves entirely unclear how shareholder and board bylaws relate to one another—notably whether (and if so, how) a shareholder bylaw might be insulated from board amendment or repeal. While section 216 provides that a shareholder bylaw establishing "the votes that shall be necessary for the election of directors shall not be further amended or repealed by the board of directors,"[30] it is unclear what, if any, implication can be drawn regarding the myriad other types of bylaws shareholders might enact. Section 216 "might create a negative implication that the board can amend or repeal other kinds of shareholder bylaws"—or not.[31] This, like numerous other bylaw-related issues, awaits judicial resolution.[32]

### C. *The National Landscape*

It is worth pausing at this point to observe that the ambiguity and circularity discussed above is not unique to Delaware's corporate statute. While there is certainly variation across the states, most fall into one of two broad camps, as the tables in the appendix suggest—the Delaware approach, and the Model Business Corporation Act (MBCA) approach. Seven other states appear generally to follow Delaware,[33] while thirty-four states appear to have modeled their bylaw statutes on section 10.20 of the MBCA.[34] As between the two, the MBCA approach differs principally in that it reverses the default rule on board bylaw authority (i.e., providing that the board possesses such power unless the charter says otherwise), and it binds the board's hands where "the shareholders in amending, repealing, or adopting a bylaw expressly provide that the board of directors may not amend, repeal, or reinstate that bylaw."[35] In this manner, the MBCA approach offers a clear

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[28] BAINBRIDGE, *supra* note 27, at 16. *See also* Hamermesh, *supra* note 20, at 467-75; McDonnell, *supra* note 7, at 664-65.

[29] *See, e.g.*, DREXLER ET AL., *supra* note 14, § 9.02; Hamermesh, *supra* note 20, at 468-70.

[30] DEL. CODE ANN. tit. 8, § 216.

[31] McDonnell, *supra* note 7, at 665.

[32] *See id.* (observing that the legislative history explicitly disavows any such intention).

[33] *See infra* Appendix Table 1; *see also infra* note 262 (describing salient Delaware features and variations among certain of these states).

[34] *See infra* Appendix Table 2; MODEL BUS. CORP. ACT § 10.20.

[35] MODEL BUS. CORP. ACT § 10.20(b); *see also infra* note 263. As to the remaining statutes, some appear to be modeled on § 27 of the 1969 Model Business Corporation Act (with variations), the salient features of which include board bylaw authority "unless reserved to the shareholders" in

solution to the "cycling amendments" problem described above.[36]

It should be recalled, however, that notwithstanding the large number of states following the MBCA approach, Delaware alone accounts for over 50 percent of U.S. publicly traded companies and 63 percent of the Fortune 500.[37] Consequently, the "cycling amendments" problem remains an important issue for much of corporate America.[38] It should also be observed that, like in Delaware, the MBCA offers little guidance on the distinct issue of the permissible scope of bylaws, and particularly the degree to which shareholders may carve back the board's power through bylaw amendments. MBCA section 2.06(b) similarly requires that bylaws not be "inconsistent with law or the articles of incorporation," adding in a comment that this "precludes provisions that limit the managerial authority of directors that is established by section 8.01(b)," yet provides no more concrete guidance on their interaction than DGCL sections 109 and 141.[39] Under each of the predominant models, then, the balance of board and shareholder bylaw power has been left almost entirely to the courts to determine.

### D. *Delaware's (Murky) Bylaw Jurisprudence*

What guidance have the Delaware courts offered in this area? Recent developments will be discussed below,[40] but at most a few significant

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the charter, and inalienable shareholder authority to amend or repeal board bylaws. *See infra* Appendix Table 3 and note 264; 1969 MODEL BUS. CORP. ACT § 27. Others vary considerably. *See infra* Appendix Table 4 and note 265.

[36] *See* BAINBRIDGE, *supra* note 27, at 16. Note that certain states generally following other approaches favor shareholders either by explicitly permitting them to amend or repeal board bylaws, or by requiring affirmative authorization for the board to amend or repeal a shareholder bylaw. *See infra* notes 262-265.

[37] *See Division of Corporations—About Agency*, DELAWARE DIVISION OF CORPORATIONS, http://corp.delaware.gov/aboutagency.shtml (last updated May 27, 2010); *see also* Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 565-68 (2002).

[38] *See* Brett H. McDonnell, *Setting Optimal Rules for Shareholder Proxy Access*, 43 ARIZ. ST. L.J. (forthcoming 2010) (manuscript at 33), *available at* http://ssrn.com/abstract=1537211 (observing that Delaware's rules regarding "the scope of valid bylaws are more important by far than the rules of any other state, and quite possibly more important than the rules of all other states combined").

[39] MODEL BUS. CORP. ACT § 2.06(b) and Official Comment; *see also* MODEL BUS. CORP. ACT § 8.01(b). While the comment to section 2.06(b) might seem to suggest that shareholder bylaws simply cannot limit board power in any way, this is implausible for the reason identified by the Delaware Supreme Court – "[t]hat reasoning, taken to its logical extreme, would result in eliminating altogether the shareholders' statutory right to adopt, amend or repeal bylaws" because "by their very nature, [they] set down rules and procedures that bind a corporation's board and its shareholders." CA, Inc. v. AFSCME Emp. Pension Plan, 953 A.2d 227, 234 (Del. 2008). Hence some balance must inevitably be struck. *See infra* notes 76-78 and accompanying text.

[40] *See infra* notes 67-96 and accompanying text.

principles emerge from the case law prior to 2008. Consistent with the hierarchical view of corporate authority discussed above,[41] the Delaware Court of Chancery, in its *Gow v. Consolidated Coppermines Corp.* opinion, suggested in 1933 that "as 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."[42] Here the court suggests that, at least as of the 1930s, bylaws related not to matters implicating the corporation's core "nature," but rather more mundane matters implicating its "convenient functioning" in the day-to-day sense.[43]

The hierarchical view of corporate authority further animates the Delaware Supreme Court's conclusion that bylaws must be consistent with common law and "reasonable in their application."[44] In its famous *Schnell v. Chris-Craft Industries* opinion, the Delaware Supreme Court articulated a bedrock principle of modern Delaware corporate law, namely that "inequitable action does not become permissible simply because it is legally possible"—one consequence being that technically valid bylaw amendments may nevertheless be struck down by the court if done for "inequitable purposes."[45] Hence, in *Frantz Manufacturing Company v. EAC Industries*, a new controller's amendment of the bylaws (i.e., after control was secured) to place various restrictions on the target board was held valid because the court deemed this "a permissible part of [its] attempt to avoid its disenfranchisement as a majority shareholder."[46] In *Schnell* itself, by contrast, the board's amendment of the bylaws to advance the date of the annual shareholders meeting was struck down because the board's action was

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[41] *See supra* notes 11-15 and accompanying text.

[42] Gow v. Consol. Copper Mines Corp., 165 A. 136, 140 (Del. Ch. 1933) (emphasis added).

[43] This, for the *Gow* court, included setting the number of directors on the board. *See id.* at 139-40. Recall that the DGCL itself now confirms that this subject may be addressed in the bylaws. *See* DEL. CODE ANN. tit. 8, § 141(b).

[44] Frantz Mfg. Co. v. EAC Indus., 501 A.2d 401, 407 (Del. 1985); *see also* BALOTTI & FINKELSTEIN, *supra* note 5, at 1-15 to -17.

[45] Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971); *see also* Hollinger Int'l, Inc. v. Black, 844 A.2d 1022, 1080-81 (Del. Ch. 2004); WELCH ET AL., *supra* note 9, §109.6.

[46] *Frantz*, 501 A.2d at 407. The bylaw amendments at issue in *Frantz* required that all directors be present for any board action, that there be a single class of directors, that a unanimous vote be required for all board action (including ratifying committee action), and that indemnification of directors be approved by the stockholders. *Id.* at 405. The controller's fears proved to be well founded, as the target board attempted to regain control by issuing treasury shares to an employee stock ownership plan (diluting the new controller). The target board's action was itself found to be invalid, however, because its primary purpose was "to perpetuate their control of the company," violating *Schnell*. *Id.* at 402, 407-09.

undertaken "for the purpose of perpetuating itself in office" (i.e., by making a proxy contest more difficult).[47]

Notwithstanding the position of bylaws at or near the bottom of the hierarchy of corporate authority, however, the Delaware Supreme Court has described "[t]he power to make and amend the bylaws of a corporation" as "an inherent feature of the corporate structure."[48] Thus, while bylaws most assuredly must be consistent with all superior forms of corporate authority—the charter, the statute, the common law, and so on—the Delaware Supreme Court has stated that "[t]he bylaws of a corporation are *presumed to be valid*," meaning that "the courts will construe the bylaws in a manner consistent with the law rather than strike down the bylaws."[49] This, I will argue below, is an important principle that appears to be eroding in light of recent developments at both the state and federal levels.[50]

Perhaps the most striking aspect of the Delaware case law prior to 2008, however, is that it offers no guidance whatever regarding the core questions of board and shareholder power discussed above. To a great extent, this reflects the fact that shareholders' use of bylaws as a means of asserting substantial control over publicly held corporations is a relatively recent phenomenon. Franklin Balotti and Jesse Finkelstein observe that "vigorous debate" regarding the ability of shareholders to limit board power through bylaw amendments arose only in the 1990s[51] in response to the overwhelming victory of boards in the hostile takeover battles of the late 1980s. In a series of opinions coming down between 1985 and 1990, the Delaware Supreme Court created a takeover regime in which boards have a clear duty to maximize return to shareholders only in the narrow circumstance where the corporation faces an "inevitable" sale, break-up, or change of control[52]—a framework leaving the board enormous discretion in all other circumstances to implement defensive measures such as poison pills.[53] Critically, the court even held that target boards could keep such

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[47] *Schnell*, 285 A.2d at 439.

[48] *Frantz*, 501 A.2d at 407.

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

[50] *See infra* notes 195-215 and accompanying text.

[51] *See* BALOTTI & FINKELSTEIN, *supra* note 5, at 1-18.

[52] *See* Revlon, Inc. v. MacAndrews & Forbes Holding, Inc., 506 A.2d 173, 182 (Del. 1986); Paramount Commc'ns v. QVC Network Inc., 637 A.2d 34, 43-44 (Del. 1994) (applying this duty in the context of a change of control).

[53] *See* Unocal Corp. v. Mesa Petrol. Co., 493 A.2d 946, 954-55 (Del. 1985) (permitting defensive measures where the board can demonstrate that there were "reasonable grounds for believing that a danger to corporate policy and effectiveness existed" and that the defenses employed were "reasonable in relation to the threat posed"); Moran v. Household Int'l, Inc., 500 A.2d 1346, 1350, 1354 (Del. 1985) (validating preemptive use of poison pills under *Unocal*); Versata Enter.,

defenses in place and refuse to negotiate with hostile bidders—even those making all-cash, all-shares bids at substantial premia—in order to protect their own long-term business plans, concluding that "the selection of a time frame for achievement of corporate goals" is entirely within the board's discretion.[54] For lack of any effective means of policing boards' use of takeover defenses, the unique statutory authority to act unilaterally in enacting bylaws naturally recommended itself to shareholders seeking to reassert themselves in this and other areas of corporate governance.[55]

So in the 1990s shareholders began to test the degree to which their bylaw authority could be used to carve back the board's power[56]—an issue on which Delaware law remains murky today.[57] As a threshold matter, recall

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Inc. v. Selectica, Inc., 5 A.3d 586, 599-607 (Del. 2010) (applying *Unocal* and *Moran* in upholding validity of a particularly restrictive pill implemented to protect the value of net operating losses). Shareholders' rights plans, colloquially called "poison pills," work by attaching rights to common stock permitting purchase of deeply discounted shares when a stated ownership threshold (perhaps 15-20 percent) is exceeded by another stockholder without the board's approval. The poison pill threatens dilution of the would-be hostile acquirer because such rights are not exercisable by the person triggering them. *See* ALLEN ET AL., *supra* note 6, at 536-39.

[54]Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1149-54 (Del. 1990). Chancellor Chandler expresses a dim view of this approach in his *eBay* opinion, rejecting use of a poison pill in a purported effort to protect the "corporate culture" of Craigslist (in which eBay held a minority stake, but desired control) into the indefinite future. *See* eBay Domestic Holdings, Inc. v. Newmark, 2010 Del. Ch. LEXIS 187, *80-*90 (Del. Ch. 2010). Chancellor Chandler's opinion strongly emphasizes the interests of shareholders, though he acknowledges that the case involved "a unique set of facts heretofore not seen in the context of a challenge to a rights plan" – notably, a poison pill implemented by controllers of a closely held corporation, who openly disavowed "revenue maximization" as a corporate aim. *Id.* at *44-*45, *77-*78, *90. In this light, the case offers little guidance on the permissible use of defensive measures in widely held public corporations. *Cf.* Bruner, *supra* note 21, at 1418-19 (observing the limited significance of the emphasis placed on shareholders' interests in Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919), which responded to similarly unusual facts).

For additional background on Delaware's approach to hostile takeovers, and the anti-takeover statutes enacted in other states, see Bruner, *supra* note 21, at 1415-18; Christopher M. Bruner, *Power and Purpose in the "Anglo-American" Corporation*, 50 VA. J. INT'L L. 579, 596-99, 639-41 (2010).

[55]*See, e.g.*, Gordon, *supra* note 19, at 544 ("The pressure to test the limits of shareholder bylaw authority over poison pills arises now [i.e. 1997] both because of judicial rulings that have augmented their preclusive effect, and because of the rise of institutional activism in the governance arena . . . ."); McDonnell, *supra* note 20, at 209 ("In the nineties shareholders tried to enact bylaws limiting the ability of boards to adopt and maintain poison pills."); *cf.* Securities and Exchange Commission, Roundtable Discussions Regarding the Federal Proxy Rules and State Corporation Law 220, May 7, 2007, *available at* http://www.sec.gov/spotlight/proxyprocess/proxy-transcript050707.pdf [hereinafter SEC, Roundtable Discussions] (Joseph Grundfest characterizing the larger debate regarding shareholder proposals in the corporation's proxy statement as "the knock-on effect of us having stifled the hostile takeover market").

[56]The manner in which shareholders have endeavored to do so will be discussed below in connection with the federal securities regime governing their ability to include proposals in the corporation's proxy statement. *See infra* notes 155-182 and accompanying text.

[57]*See* ALLEN ET AL., *supra* note 6, at 93; Robert B. Thompson, *Defining the Shareholder's*

that whether Delaware shareholders can insulate bylaws from subsequent amendment or repeal by the board is not addressed in the statute, and the case law provides essentially no guidance on this issue. In her 1984 opinion in *American International Rent a Car v. Cross*, then-Vice Chancellor Berger found no violation of *Schnell* where a board, fearing a failed vote at the shareholders' meeting, simply passed the desired bylaw itself during the lunch recess—though Berger appears to have believed that "several recourses" remained available to the shareholders, including further "amending the bylaws and, as part of the amendment, . . . remov[ing] from the Board the power to further amend the provision in question."[58] Later Court of Chancery opinions, however, suggest that whether boards may subsequently amend or repeal shareholder bylaws purporting to curtail the board's power remains unclear. In 1999, Vice Chancellor Strine observed in *General Datacomm Industries v. State of Wisconsin Investment Board* that "whether a stockholder-approved bylaw may be repealed by a board of directors with [section 109(a)] authority has not clearly been answered by a Delaware Court."[59] Likewise Vice Chancellor Lamb, citing the foregoing cases in his 2006 opinion in *Bebchuk v. CA, Inc.*, noted that the issue remained unresolved.[60]

In 1990, the Delaware Supreme Court held, in *Centaur Partners, IV v. National Intergroup*, that a proposed shareholder bylaw setting the number of directors and prohibiting the board from subsequently amending or repealing it "would be a nullity if adopted" because the company's charter provided that "the number of directors of the Corporation shall be fixed by and may from time to time be altered as provided in the By-Laws."[61] This, the court explained, meant that the proposed shareholder bylaw would be "inconsistent with" the charter, violating DGCL section 109(b), because the charter granted bylaw authority to the board pursuant to section 109(a).[62] The court's analysis in *Centaur Partners* may tend to suggest that shareholder bylaws aimed at curtailing board power may simply be amended or repealed subsequently by the board, though the opinion does not squarely answer this question, focusing rather on the validity of the shareholder bylaw in light of the charter provision addressing the number of directors (which

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*Role, Defining a Role for State Law: Folk at 40*, 33 DEL. J. CORP. L. 771, 776 (2008).

[58] American Int'l Rent A Car, Inc. v. Cross, 1984 Del. Ch. LEXIS 413, *5-*9 (Del. Ch. 1984). The bylaw amendment at issue raised the stock ownership limit for American's licensees, permitting a new financing plan to be pursued. *Id.* at *2-*4.

[59] Gen. Datacomm Indus., Inc. v. State of Wisconsin Inv. Bd., 731 A.2d 818, 821 n.1 (Del. Ch. 1999).

[60] Bebchuk v. CA, Inc., 902 A.2d 737, 742-43 (Del. Ch. 2006).

[61] Centaur Partners, IV v. Nat'l Intergroup, Inc., 582 A.2d 923, 929 (Del. 1990).

[62] *Id.*

the court interprets as "grant[ing] the board broad authority to fix the number of directors, which power may be exercised from time to time through the adoption of by-laws").[63]

The case law likewise has shed little light on the distinct issue of the degree to which shareholder bylaws may, as a substantive matter, carve back board power. As noted above, there was little practical reason to tackle this subject directly until relatively recently, though the cases have long suggested that shareholder bylaws may restrain the board in non-trivial ways. In *Gow*, for example, the court explained in 1933 that the ability to set the number of directors in the bylaws "makes it possible for the stockholders to effect a radical change in the personnel of the board of directors more expeditiously than they could if the number were a subject of regulation by the charter," but that "this consideration is of no moment"—demonstrating only that "the Legislature evidently regarded it as sound policy that the control of the corporation should at all times be subject to a fairly quick response to the [shareholders'] wishes."[64] In a similar spirit, in *SEC v. Transamerica Corporation*, the Third Circuit in 1947 rejected the notion that a Delaware charter provision vesting "all powers of corporate management" in the board rendered improper a proposed shareholder bylaw mandating independent public auditors.[65] More recently, Vice Chancellor Strine observed in his 2004 *Hollinger* opinion that section 109 "[b]y its plain terms . . . provides stockholders with a broad right to adopt bylaws," which "could impose severe requirements on the conduct of a board without running afoul of the DGCL."[66]

### E. CA, Inc. v. AFSCME Employees Pension Plan

In its 2008 opinion in *CA, Inc. v. AFSCME Employees Pension Plan*, the Delaware Supreme Court took a more concerted look at the degree to which shareholder bylaws may carve back board power. In June 2008, the Securities and Exchange Commission (SEC) for the first time certified questions to the court pursuant to a 2007 amendment to the Delaware Constitution permitting certification.[67] AFSCME sought to include in the

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[63] *Id.; Gen. Datacomm Indus.*, 731 A.2d at 821 n.1; *Bebchuk*, 902 A.2d at 743 & n.37; *see also* BALOTTI & FINKELSTEIN, *supra* note 5, at 1-18 to -20; DREXLER ET AL., *supra* note 14, § 9.02; WELCH ET AL., *supra* note 9, § 109.3.3.

[64] Gow v. Consol. Copper Mines Corp., 165 A. 136, 141-42 (Del. Ch. 1933).

[65] SEC v. Transamerica Corp., 163 F.2d 511, 516-17 (3d Cir. 1947).

[66] Hollinger Int'l, Inc. v. Black, 844 A.2d 1022, 1078-79 (Del. Ch. 2004).

[67] CA, Inc. v. AFSCME Emp. Pension Plan, 953 A.2d 227, 229 (Del. 2008); *see also* DEL. CONST. art. IV, § 11(8) (granting the Delaware Supreme Court jurisdiction "[t]o hear and determine

company's proxy statement a proposed bylaw that, if adopted, would require the board, under certain circumstances, to reimburse shareholder proxy expenses incurred in nominating a short slate of board candidates.[68] The SEC's two questions for the court related to potential bases for excluding AFSCME's proposed bylaw from the proxy statement under Securities Exchange Act Rule 14a-8, each of which turned on Delaware corporate law. The first question was whether the proposed bylaw was "a proper subject for action by [Delaware] shareholders," and the second question was whether the bylaw, if adopted, would otherwise cause the company to violate Delaware law.[69]

The impact on the court's analysis of the manner in which these questions were put to it—i.e., their certification by the SEC to assess the excludability of a proposed bylaw from the company's proxy—will be assessed in some detail below.[70] To facilitate the analysis that follows, however, I summarize the court's conclusions here.[71] On the first question—whether the proposed bylaw was "a proper subject for action by [Delaware] shareholders"—the court took a relatively expansive view of the legitimate scope of shareholder bylaws. Acknowledging that determining the degree to which shareholder bylaws can restrain board authority "is an elusively difficult task,"[72] Justice Jacobs framed the first inquiry as being whether the bylaw would "facially violate any provision of the DGCL or of CA's Certificate of Incorporation."[73] This, of course, required reckoning with the "recursive loop" created by sections 109(b) and 141(a).[74] Justice Jacobs broke the loop in favor of section 141(a), and thus the board, concluding that "[b]ecause the board's managerial authority under Section 141(a) is a cardinal precept of the DGCL," section 109(b) would not be construed as limiting section 141(a), while section 141(a) would be construed as limiting section 109(b).[75]

Justice Jacobs flatly rejected CA, Inc.'s contention that shareholder bylaws could in no way limit board authority, however, because this

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questions of law certified to it by . . . the United States Securities and Exchange Commission").

[68] *CA, Inc.*, 953 A.2d at 229-30.

[69] *Id*. at 231. On AFSCME's long campaign for proxy access, see BLOOMENTHAL & WOLFF, *supra* note 22, §§ 24:71.20-.26. On the proxy access rule ultimately adopted, see *infra* notes 146-152 and accompanying text.

[70] *See infra* notes 195-215 and accompanying text.

[71] For additional analysis of the case, see generally Christopher M. Bruner, *Shareholder Bylaws and the Delaware Corporation*, 11 TRANSACTIONS 67 (2009).

[72] *CA, Inc.*, 953 A.2d at 232.

[73] *Id.* at 238.

[74] *See id.* at 232 ("Section 109(a) does not exist in a vacuum. It must be read together with 8 Del. C. § 141(a) . . . .").

[75] *Id.* at 232 & n.7.

approach, "taken to its logical extreme, would result in eliminating altogether the shareholders' statutory right to adopt, amend or repeal bylaws."[76] Observing that the relevant statutes and preexisting case law offered no discernible "bright line," rendering the court's decision "case specific," Justice Jacobs nevertheless endorsed a distinction (widely recognized by academics and practitioners) between procedural and substantive bylaws, the former being permissible while the latter are not.[77] Stating the issue to be "whether the Bylaw is one that establishes or regulates a process for substantive director decision-making, or one that mandates the decision itself," the court concluded that the proposed bylaw had "both the intent and the effect of regulating the process for electing directors of CA," and thus was a proper subject for action by Delaware shareholders.[78]

AFSCME fared less well, however, on the second question—whether the bylaw, if adopted, would otherwise cause the company to violate Delaware law. Here, the court focused on the common law and concluded that a mandatory proxy reimbursement bylaw could force the board to breach its fiduciary duties in circumstances where the board concluded that reimbursement in any amount would be inconsistent with the best interests of the company.[79] Explaining that the questions certified by the SEC "request a determination of the validity of the Bylaw in the abstract," the court determined that it "must necessarily consider any possible circumstance under which a board of directors might be required to act."[80] Observing that "[u]nder at least one such hypothetical, the board of directors would breach their fiduciary duties if they complied with the Bylaw," the court concluded that AFSCME's bylaw, if enacted, "would violate the prohibition . . . 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."[81]

Citing to cases that involved board action precluding it from discharging its fiduciary duties—specifically, the "no shop" merger

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[76] *Id.* at 234.

[77] *CA, Inc.*, 953 A.2d at 234-36; *see also* Frederick H. Alexander & James D. Honaker, *Power to the Franchise or the Fiduciaries?: An Analysis of the Limits on Stockholder Activist Bylaws*, 33 DEL. J. CORP. L. 749, 750-52 (2008); Bruner, *supra* note 71, at 69; Coffee, *supra* note 20, at 613-15; McDonnell, *supra* note 7, at 660-61; McDonnell, *supra* note 20, at 216-18; Eric S. Wilensky & Angela L. Priest, *Corporate Governance Developments in a Recessionary Environment*, 41 Sec. Reg. & L. Rep. (BNA) No. 921, at 5 (May 18, 2009). *But see* Hamermesh, *supra* note 20, at 428-44 (rejecting this approach).

[78] *CA, Inc.*, 953 A.2d at 234-36.

[79] *See id.* at 238.

[80] *Id.*

[81] *Id.*

provision at issue in *Paramount Communications, Inc. v. QVC Network, Inc.*, and the "delayed redemption" poison pill at issue in *Quickturn Design Systems, Inc. v. Shapiro*[82]—the court rejected the notion that shareholder-imposed constraints on the board should be treated differently. AFSCME endeavored to characterize the bylaw not as mandating violation of fiduciary duties, but as relieving the board of its duties in the area of proxy reimbursement.[83] The court, however, dismissed this argument as "more semantical than substantive."[84] Effectively shareholders desiring such a bylaw have three options following *CA, Inc.* They can include a fiduciary-out provision;[85] seek to amend the charter (which, of course, would require board approval);[86] or "seek recourse from the Delaware General Assembly."[87]

While *CA, Inc.* offers some limited guidance on the permissible scope of shareholder bylaws through its effective endorsement of the procedural-substantive distinction, the practical difficulty of identifying any coherent "bright line," coupled with the court's resort to the board's fiduciary duties as an evaluative principle, leave numerous questions unanswered.[88] Given the origins of the bylaw debate discussed above, one of the most consequential issues in this area is the permissibility of shareholder bylaws curtailing the board's ability to deploy takeover defenses.[89] Lucian Bebchuk, as a

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[82]*Id.* at 238-39; Paramount Commc'n Inc. v. QVC Network Inc., 637 A.2d 34 (Del. 1994); Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281 (Del. 1998).

[83]*CA, Inc.*, 953 A.2d at 239.

[84]*Id.* at 239-40.

[85]A fiduciary out provision—permitting the board to avoid the requirement in question where necessary to comply with its fiduciary duties—has effectively been mandated in other such circumstances. *See, e.g.*, Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 936-39 (Del. 2003) (citing Paramount Commc'n Inc. v. QVC Network Inc., 637 A.2d 34 (Del. 1994)). This may not be so bad for shareholders, as availing itself of the provision could prove costly to the board reputationally and prompt distracting litigation. *See* McDonnell, *supra* note 38, at 46-47.

[86]DEL. CODE ANN. tit. 8, § 242(b).

[87]*CA, Inc.*, 953 A.2d at 240. Interestingly, on the specific issue of proxy expense reimbursement bylaws, the relationship between the court's holding in *CA, Inc.* and the recently enacted § 113 remains uncertain. While section 113 clearly permits such bylaws, its list of potential "procedures or conditions" does not reference the board's fiduciary duties. DEL. CODE ANN. tit. 8, § 113. It thus remains unclear whether section 113 "overrides" the *CA, Inc.* requirement that the board have discretion to deny reimbursement altogether. *See* Sullivan & Cromwell LLP, *Corporate Governance of Delaware Corporations: Delaware Adopts Amendments to the Delaware General Corporation Law Relating to Corporate Governance*, at 4 (Apr. 28, 2009), *available at* http://www.sullcrom.com/files/Publication/07c461b2-4fa9-4942-af0a5694e0d9f46b/Presentation/PublicationAttachment/ca563f25-9583-4c9b-9f67-59510f78f260/SC_Publication_Corporate_Governance_of_Delaware_ Corporations.pdf; *see also* Wilensky & Priest, *supra* note 77 (observing that as "an opt-in statute," the board could repeal a section 113 shareholder bylaw).

[88]*See* Bruner, *supra* note 71, at 72-74.

[89]*See* ALLEN ET AL., *supra* note 6, at 623-24.

shareholder of CA, Inc., sought a declaratory judgment in 2006 regarding the validity of a proposed bylaw requiring that adoption or extension of a poison pill either be approved by the shareholders or be re-approved annually by unanimous vote of the board.[90] Amendment or repeal of the bylaw itself likewise would require a unanimous vote of the board.[91] Vice Chancellor Lamb, observing that "the validity of stockholder bylaws which limit a board of director's exercise of one of its powers" raises an issue "fraught with tension," suggested that such a bylaw might survive,[92] yet refused to provide declaratory relief on ripeness grounds, explaining that "[t]he key event necessary to vest jurisdiction in this court is the adoption of the proposed bylaw."[93] Ultimately, Bebchuk's bylaw received 41 percent of the vote at the CA, Inc. annual meeting in September 2006, thus failing and leaving the question unanswered.[94] The Delaware Supreme Court's more recent (and unrelated) decision in *CA, Inc.* has led some to speculate (quite reasonably) that pill bylaws of this sort would be unlikely to survive without a fiduciary-out provision,[95] but the matter remains unresolved.[96]

### F. *Delaware's Ambivalence*

Perhaps the most important takeaway from *CA, Inc.* is that in answering questions like this, trying to divine the intrinsic nature of "bylaws" is essentially a red herring. Put differently, the core debate here is not really about bylaws in themselves, but rather about what the division of power between shareholders and boards in Delaware corporations ought to be. To be sure, there have long been indirect indications that testing the validity of bylaws was about something more than ascertaining what bylaws "are" in some metaphysical sense. For example, the prohibition against using bylaws to arbitrarily or unreasonably impinge on shareholder rights[97] necessarily means that there must be some underlying metric or balance of power against which to evaluate them, regardless of whatever the "bylaw" concept itself may signify. *CA, Inc.* accordingly reveals—at least indirectly,

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[90] Bebchuk v. CA, Inc., 902 A.2d 737, 738-39 (Del. Ch. 2006).
[91] *Id.*
[92] *Id.* at 742-43.
[93] *Id.* at 740-42.
[94] *See* ALLEN ET AL., *supra* note 6, at 624.
[95] *See, e.g.*, McDonnell, *supra* note 7, at 664.
[96] *See* Wilensky & Priest, *supra* note 77, at 14.
[97] *See* BALOTTI & FINKELSTEIN, *supra* note 5, § 1.10. The fact that "amendments to the by-laws can occur in certain situations through custom and usage," *id.* § 1.11, similarly casts doubt on the notion that elucidating the meaning of the term "bylaw" could be expected to illuminate core questions implicated by their use.

through its mode of analysis—that the contemporary bylaw debate implicates the same core questions of corporate power and purpose that were raised by the 1980s takeover debate, out of which it grew.

The similarities between the takeover debate and the contemporary bylaw debate, and likewise the similarities between the judicial responses to them, are indeed quite striking. In each case, board power is challenged by what we might term a nascent shareholder right. Hostile tender offers in the 1980s built on the long-standing right of shareholders unilaterally to sell their stock,[98] but put this to a novel and powerful use with the potential to destabilize the long-standing balance of power in Delaware corporations. The same can be said of the new uses to which the right of shareholders unilaterally to enact bylaws has been put, these new bylaws bearing no more resemblance to the old bylaws than hostile tender offers do to garden variety stock sales. Bylaws seeking to restrain the use of takeover defenses, to pry open the proxy machinery, and so forth, similarly challenge fundamental corporate power arrangements and therefore raise anew the fundamental issue of corporate purpose—the aims and intended beneficiaries of corporate activity.[99]

I have argued in prior work that Delaware corporate law has long remained deeply ambivalent regarding the appropriate role of shareholders in corporate governance, and likewise the degree to which corporate decision-making should focus on the shareholders' interests.[100] Delaware's ambivalence regarding shareholder power manifests itself, for example, in limits on the shareholder franchise (notably the inability to remove directors from a staggered board other than for cause); the shareholders' inability to initiate fundamental actions (e.g., mergers, charter amendments) or to accept hostile tender offers without interference; and of course the fog surrounding the shareholders' bylaw authority.[101] Ambivalence regarding the degree to which shareholder wealth maximization ought to be the aim of corporate decision-making manifests itself in the lack of a clear duty to maximize shareholder wealth in any but the most limited circumstances; a hostile

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[98] While the Delaware statute does not provide explicitly for free transferability, it is implicit in § 202, which requires that restrictions on transfer be "noted conspicuously on the [stock] certificate." DEL. CODE ANN. tit. 8, § 202(a); Thompson & Smith, *supra* note 21, at 276 n.83.

[99] *See* Bruner, *supra* note 21, at 1408-32; Bruner, *supra* note 71, at 73-74; Gordon, *supra* note 19, generally (exploring how takeover defenses and shareholder bylaws similarly raise "far-reaching questions on the distribution of power between shareholders and the board"); Thompson & Smith, *supra* note 21, at 314-23 (exploring hostile takeovers and shareholder bylaws as contexts similarly "illustrating shareholder-director conflict").

[100] *See generally* Bruner, *supra* note 21. *See also* Bruner, *supra* note 54 (contrasting this ambivalence with the clear shareholder orientation of U.K. company law).

[101] *See* Bruner, *supra* note 21, at 1421-24; Bruner, *supra* note 54, at 593-97.

takeover regime that—in addition to permitting interference with shareholder decision-making—actually permits boards some degree of latitude to consider the interests of other constituencies; and a somewhat murky statement of fiduciary duties owed simultaneously "to the corporation and its stockholders."[102]

These forms of ambivalence regarding shareholders stand out most starkly in contrast with U.S. corporate law's closest relative, U.K. company law, which by statute clearly defines the purpose of the corporation as being to promote the shareholders' interests, and which favors shareholders with (among other things) far greater power to remove directors without cause; initiate charter amendments; compel board action; and approve (or disapprove) the use of takeover defenses.[103] The critical difference, I have argued, lies in the fact that we in the United States have relied on public corporations to pull substantially more weight—notably including the provision of critical social welfare protections (such as health and retirement benefits) often provided directly by the state in other countries—which has resulted in far greater political pressure being brought to bear on U.S. corporate governance to accommodate non-shareholders' interests.[104]

To stay with the comparative perspective for a moment, the fundamental ambivalence that Delaware bylaws represent is clearly reflected in the fact that other common law-oriented, capital market-based corporate legal systems appear to have no use for this bizarre form of governance instrument, into which the shareholders and the board alike may lob amendments—seemingly willy-nilly—with no coherent rules establishing their priority. The U.K. Companies Act (2006) simply provides that shareholders in a public corporation can unilaterally amend the company's "constitution"—the core governance document—by special resolution of a 75 percent majority,[105] firmly "plac[ing] the shareholders at the centre of the

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[102] *See* Bruner, *supra* note 21, at 1424-27; Bruner, *supra* note 54, at 597-603.

[103] *See* Bruner, *supra* note 54, at 603-11.

[104] *See generally* Bruner, *supra* note 54. *See also* Bruner, *supra* note 21, at 1427-32. For analysis of the role that this distinction has played in conditioning the two countries' corporate governance reforms in the wake of the financial crisis, see generally Christopher M. Bruner, *Corporate Governance Reform in a Time of Crisis*, 36 J. CORP. L. 309 (2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1617890.

[105] Companies Act, 2006, c. 46, §§ 21(1), 283 (U.K.). The company's constitution includes the "articles" and various resolutions and agreements. The articles set out "regulations for the company," but "model articles" apply by default. *Id.* §§ 17-20. While the articles have been loosely analogized to U.S. bylaws, the core distinction regarding shareholder power to alter the respective documents is apparent from the British perspective. *See, e.g.*, SEC, Roundtable Discussions, *supra* note 55, at 205 (William Underhill, a partner of the leading U.K. law firm Slaughter and May, analogizing U.K. articles to U.S. bylaws while observing that changes to the articles require

corporate power structure."[106] Other countries with similar legal systems and market structures essentially follow the U.K. approach,[107] including Australia[108] and Canada.[109] In this light, it should come as no surprise that comparative corporate scholars consider the bylaw power dynamics discussed above to be idiosyncratic to U.S. corporate governance. *The Anatomy of Corporate Law*, for example, in its comparative analysis of the corporate laws of France, Germany, Italy, Japan, the United Kingdom, and the United States, observes that Delaware bylaws "have a curious status," and particularly that an "odd provision" of the Delaware statute (i.e., DGCL section 109) permits simultaneous shareholder and board competence to enact, amend, and repeal bylaws, with no guidance on their interaction.[110]

This relative ambivalence regarding the appropriate distribution of power naturally conditions the response of Delaware judges to cases probing the outer reaches of the shareholders' bylaw authority. Recall that the Delaware Supreme Court, in *CA, Inc.*, provides little guidance regarding the distinction between permissible and impermissible shareholder bylaws. The procedural-substantive distinction is conceptually useful, to be sure, but ultimately far short of a principled means of defining the bylaw authority. As the court itself observes, "the Bylaw's wording, although relevant, is not dispositive of whether or not it is process-related," which ultimately turns on the bylaw's "context and purpose."[111] Put differently, there is an underlying criterion against which the bylaw must be evaluated, but the court cannot say what it is—precisely because what is at stake is the core balance of power in Delaware corporations, regarding which Delaware remains ambivalent.

Indeed, "ambivalent" would be a good word to describe the court's doctrinal conclusions in *CA, Inc.* Ultimately the "context and purpose"—"to

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shareholder approval).

[106] ALAN DIGNAM & JOHN LOWRY, COMPANY LAW 7-8 (5th ed. 2009); *see also* Bruner, *supra* note 54, at 604-05.

[107] *See* Jennifer G. Hill, *The Rising Tension between Shareholder and Director Power in the Common Law World* 13-15, 26-27 (European Corporate Governance Inst. Law Working Paper no. 152/2010, Apr. 2010), *available at* http://ssrn.com/abstract=1582258.

[108] *See* Corporations Act 2001, §§ 9, 136(2), 249D (Austl.); *see also* R.P. AUSTIN & I.M. RAMSAY, FORD'S PRINCIPLES OF CORPORATIONS LAW 202-03 (14th ed. 2010).

[109] *See* Canada Business Corporations Act, C.R.C, c. C-44, §§ 2(1), 173, 175-76. Under the Canadian statute, a special resolution requires a two-thirds vote of shareholders. *Id.* § 2(1). While the Canadian statute includes separate bylaws that directors possess default authority to enact, this power can be taken away by the shareholders through unilateral amendment of the articles. *Id.* § 103(1); *see also* BRUCE WELLING, CORPORATE LAW IN CANADA: THE GOVERNING PRINCIPLES 459-61 (3d ed. 2006).

[110] Edward Rock et al., *Fundamental Changes*, *in* REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 183, 188-89 & n.22 (2d ed. 2009).

[111] CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 236-37 (Del. 2008).

promote the integrity of [the] electoral process"—militate toward declaring the proposed proxy expense reimbursement bylaw a proper subject for shareholder action, evidently because shareholders have "a legitimate interest" in the selection of board candidates.[112] However, the criterion against which we evaluate the legitimacy of shareholder interests—the critical matter at issue here—is not specified. This most sensitive issue is effectively obscured by the second part of the court's analysis, in which the issue is reframed by reference to the board's fiduciary duties. AFSCME's argument that the board could not be forced to violate fiduciary duties of which it had been relieved by the shareholders is not really "more semantical than substantive," as the court suggests.[113] The problem is that accepting it would force the court, as a substantive matter, to define the board's governance power, and effectively the corporation, in highly shareholder-centric terms—a step the court has long remained unwilling to take.

Just like in the hostile takeover cases, where the core issue of control over the success of hostile tender offers is reframed as being whether the board's fiduciary duties permit such a decision to be "delegated to the stockholders,"[114] in *CA, Inc.*, the core issue of control over proxy expense reimbursement is reframed as being whether a bylaw can "relieve the board entirely of [its fiduciary] duties in this specific area."[115] Just like Delaware's takeover jurisprudence, this nascent Delaware bylaw jurisprudence employs an ambivalent formulation of fiduciary duties as a means of obscuring the core policy choices at issue, papering over the lack of a definitive theory regarding the appropriate role of shareholders in corporate governance.[116]

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[112] *Id.* at 237.

[113] *See supra* notes 82-87 and accompanying text.

[114] Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1154 (Del. 1990) (characterizing the critical authority to set the "time frame for achievement of corporate goals" as a fiduciary duty matter that "may not be delegated to the stockholders").

[115] *CA, Inc.*, 953 A.2d at 239; *see also* Bruner, *supra* note 71, at 73-74.

[116] *See* Gordon, *supra* note 19, at 547 ("The Delaware court needs a theory to explain the appropriate boundary between shareholder power and the board's authority . . . ."); McDonnell, *supra* note 20, at 222 (observing, as of 2005, that "no theory . . . perfectly explains the full pattern of what can and cannot be included in the bylaws"); Thompson, *supra* note 57, at 784 ("The [*CA, Inc.*] court tells us, in effect, that section 141 trumps section 109 but there is little in the opinion in the way of explicit discussion of what governance function that leaves for shareholder voting, or more generally, the role for shareholder participation in corporate governance by voting, selling, or suing."); Thompson & Smith, *supra* note 21, at 320 ("Most commentators . . . have concluded that the two sections of the Delaware statute [sections 109 and 141] cannot be reconciled without appeal to policy arguments."); *cf.* William T. Allen et al., *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U. CHI. L. REV. 1067, 1070-71 (2002) (observing the Delaware judiciary's tendency "to write judicial opinions in a way that obscures policy choices," including in its takeover jurisprudence); Lyman Johnson, *The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law*, 68 TEX. L. REV. 865, 876 (1990) (arguing that, "in the guise of evaluating

## III. SHAREHOLDER BYLAWS AND CORPORATE FEDERALISM

A close examination of the bylaw debate, including the Delaware Supreme Court's latest and most extensive foray into that debate, reveals that it implicates a constellation of issues at the heart of corporate governance itself—what the core division of power between shareholders and boards ought to be. The court's opinion in *CA, Inc.* reflects that, much like with hostile takeovers in the 1980s, Delaware judges have again been placed in the awkward position of answering the core policy questions of corporate law itself—something they are loathe to do in a clear and direct manner for reasons discussed above. At the same time, however, *CA, Inc.* reflects another important dimension of corporate lawmaking in the United States—the complex balance of state and federal power in this area. Recall that the dispute related to a proposed bylaw, not an enacted one; that it arrived at the Delaware Supreme Court's door not on appeal from the Court

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the propriety of various defensive measures in specific takeover battles, the Delaware judiciary is deciding the foundational question of corporate purpose").

While one state, North Dakota, has adopted a decidedly shareholder-centric corporate statute for public companies, it has effectively become the exception that proves the rule of American ambivalence regarding shareholders. Adopted at the behest of activist investor Carl Icahn (who first shopped it to Vermont, unsuccessfully), the statute attracted no adherents in its first two years of existence. As of June 2010, only a single corporation – controlled by Icahn – had reincorporated in North Dakota to take advantage of the law. *See* American Railcar Industries, Inc., Form 10-Q for the quarter ended June 30, 2009, at 7, 42 (Aug. 7, 2009), *available at* http://www.sec.gov/Archives/edgar/data/1344596/000095012309032254/c89011e10vq.htm; Associated Press, *Rail car maker moves corporate home to N.D.*, BISMARCK TRIB., July 1, 2009, at 1B; E-mail from Darcy Hurley, Administrative Staff Officer, Secretary of State Business Division, State of North Dakota, (June 7, 2010, 10:43 CST) (on file with author); Carl Icahn, *More Rights for Shareholders in North Dakota*, ICAHNREPORT.COM (Dec. 17, 2008), http://www.icahnreport.com/report/2008/12/more-rights-for.html; Elizabeth Lopatto, *'Virgin' North Dakota Draws Billionaire Icahn in Raider Quest*, BLOOMBERG.COM (Feb. 20, 2009), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aXgfseyKwJmI; Dale Wetzel, *Icahn company setting up corporate residence in ND,* ASSOCIATED PRESS FINANCIAL WIRE (June 11, 2009. 10:06 PM), http://www.allbusiness.com/government/government-bodies-offices-regional-local/12511376-1.html. The company in question, American Railcar Industries, Inc., lists among its publicly filed "risk factors" that Icahn's interests "may conflict with the interest of our other stockholders," and that "[i]nterpretation and application of [the North Dakota Publicly Traded Corporations Act] is scarce and such lack of predictability could be detrimental to our stockholders." American Railcar Industries, Inc., Form 10-K for the fiscal year ended Dec. 31, 2009, at 19-20 (Mar. 12, 2010), *available at* http://www.sec.gov/Archives/edgar/data/1344596/000095012310024240/c97389e10vk.htm (accessed June 7, 2010). Ironically, proxy disclosure to shareholders preceding the vote on reincorporation notes that "shareholders may not immediately be able to avail themselves of all of the benefits otherwise available to them under the North Dakota Corporate Law" due to Icahn's control. American Railcar Industries, Inc., Schedule 14A, at 43 (Apr. 30, 2009), *available at* http://www.sec.gov/Archives/edgar/data/1344596/000136231009006080/c84436def14a.htm (accessed June 7, 2009). Meanwhile, according to Bloomberg, "the publicly traded Icahn Enterprises LP remains incorporated in Delaware." *See* Lopatto, *supra*.

of Chancery, but rather via the SEC's direct certification; and that the questions put to the court were framed not by reference to a Delaware legal dispute, but rather an SEC rule governing inclusion of shareholder proposals in public company proxy statements, which itself turns (in part) on state law.[117]

Fully comprehending the nature of the shareholders' bylaw authority and its likely future development, then, will clearly require grappling with the ways in which rules of corporate governance are generated in our federal legal system—including the complex and evolving mechanisms through which state and federal lawmakers and regulators interact. In this part of the Article I evaluate the impact of the SEC's shareholder proposal process on the shareholder bylaw debate, as well as its interaction with Delaware's new process for SEC certification of questions of Delaware law directly to the Delaware Supreme Court. I conclude that the resulting manner in which such disputes are framed threatens to substantially distort the evaluation and evolution of the shareholders' bylaw authority—and consequently the fundamental matters of corporate governance policy that they implicate.

### A. *Spheres of Corporate Governance Regulation*

A typical public company in the United States will find itself regulated by corporate law made in Delaware and securities regulation made by Congress and the SEC.[118] Looking no further than this, we can already identify three relevant spheres in which corporate governance rules are generated.[119] Under the "internal affairs doctrine"—the prevailing choice of law rule for corporate governance matters in the United States—the internal affairs of corporations are generally subject to the laws of the state of incorporation.[120] Hence, for most public companies, this means the law of Delaware. By the same token, it is quite clear that Congress possesses ample

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[117] *See supra* notes 67-69 and accompanying text.

[118] *See* Bruner, *supra* note 104, at 326.

[119] Note that the typical public company will also be subject to stock exchange listing rules and market customs predominantly developed in New York. *See id.* For example, New York Stock Exchange listing rules require shareholder votes in a broader range of circumstances than Delaware law does, including certain transactions involving the issuance of common stock equaling 20 percent of pre-transaction outstanding shares or voting power, and transactions involving a "change of control." NYSE, Inc., Listed Company Manual § 312.03(c)-(d), http:// nysemanual.nyse.com/lcm/.

[120] *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 302, 304 (1971); CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69, 89 (1987) ("No principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations, including the authority to define the voting rights of shareholders."); *see also* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479 (1977).

authority under the Commerce Clause to federalize substantial swathes of the corporate governance terrain,[121] as it has frequently done in times of crisis. Notable examples include passage of the core federal securities laws in the 1930s (i.e., the Securities Act of 1933 and the Securities Exchange Act of 1934) following the stock market crash and onset of the Great Depression; the Sarbanes-Oxley Act of 2002 following accounting scandals at Enron, WorldCom, and other companies; and most recently the Dodd-Frank Wall Street Reform and Consumer Protection Act following the subprime mortgage crisis and ensuing economic downturn.[122] However, as courts and commentators have repeatedly observed, federal securities law quite clearly has not preempted the field,[123] leading many to speak of a rough division of labor in which states predominantly regulate internal corporate affairs while the federal government predominantly regulates external capital markets.[124]

The upshot of this state of affairs is an uneasy balance of state and federal competence in the regulation of corporate governance. While the degree to which Delaware faces competition from other states desiring to attract incorporations has been a topic of academic discussion for decades, it is increasingly clear that Delaware's true competition lies not among the other states, but in Washington, DC. Robert Daines, in a study of 6,671 initial public offerings between 1978 and 2000, found that 95 percent of firms incorporating outside their headquarters state incorporated in Delaware, and that "no state besides Delaware has had any meaningful success in attracting out-of-state firms going public."[125] Lucian Bebchuk and Assaf Hamdani similarly found (in 2002) that 85 percent of public companies incorporated outside their headquarters state were incorporated in

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[121] *See* U.S. CONST. art. I, § 8, cl. 3.

[122] *See* Bruner, *supra* note 104, at 332-35; Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573, 1574-90 (2005); Mark J. Roe, *Delaware and Washington as Corporate Lawmakers*, 34 DEL. J. CORP. L. 1, 6-12 (2009); Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 591-92 (2003); Leo E. Strine, Jr., *Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward*, 63 BUS. LAW. 1079, 1084-85 (2008); E. Norman Veasey, *What Would Madison Think? The Irony of the Twists and Turns of Federalism*, 34 DEL. J. CORP. L. 35, 39-42 (2009).

[123] *See, e.g.*, *CTS Corp.*, 481 U.S. at 89; *Santa Fe Indus.*, 430 U.S. at 479 ("Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden."); Kaminsky v. Abrams, 281 F. Supp. 501, 504-05 (S.D.N.Y. 1968); Veasey, *supra* note 122, at 41-42.

[124] *See, e.g.*, Veasey, *supra* note 122, at 43.

[125] Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559, 1570-74 (2002).

Delaware.[126] "Other than Delaware," Marcel Kahan and Ehud Kamar argue, "no state structures its taxes to gain from incorporations or stands to reap substantial benefits from legal business by attracting incorporations."[127] Delaware cannot, however, afford to ignore the threat that Congress poses to its preeminent position in the creation of corporate governance rules. As Mark Roe has observed, "Delaware players have reason to fear that if they misstep, they will lose their lawmaking business"—that federal players, "even if not breathing down their necks at every moment, could act if they so chose."[128]

Much of the federal government's involvement in corporate governance takes shape in the years following congressional action, through agency rulemaking—notably at the SEC. Created by Congress through the Securities Exchange Act of 1934 (often called the Exchange Act), the SEC is an independent agency charged with implementation of various federal securities statutes.[129] This inserts the SEC directly into the middle of substantial corporate governance matters due, among other things, to Exchange Act Section 14(a), which gives the agency broad authority to enact rules regulating the solicitation of proxies by public companies—the critical mechanism for voting in large companies with widely dispersed shareholders.[130] This authority naturally brings us back to the issue of the shareholders' bylaw authority under state law which, as a practical matter, can be operationalized in a typical public company only by aggregating proxies in favor of the proposal from a large number of minority shareholders—a costly endeavor indeed.[131] It was "[i]n response to the high

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[126]Bebchuk & Hamdani, *supra* note 37, at 578.

[127]Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 687 (2002); *see also* Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 843-47 (1995) (arguing that "network externalities" associated with Delaware chartering have effectively locked in Delaware's dominant position); Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 YALE J. ON REG. 209, 214 (2006) (arguing that other states do compete with Delaware, though acknowledging that this principally takes the form of "defensive" competition to keep locally headquartered corporations incorporated in their home state).

[128]Roe, *Delaware's Competition*, *supra* note 122, at 601; *see also* Edward Rock & Marcel Kahan, *How to Prevent Hard Cases from Making Bad Law: Bear Stearns, Delaware, and the Strategic Use of Comity*, 58 EMORY L.J. 713, 715 (2009).

[129]*See* 15 U.S.C. § 78d (2006); LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 67-68 (5th ed. 2004).

[130]*See* 15 U.S.C. § 78n(a); ALLEN ET AL., *supra* note 6, at 185-86; SEC, Roundtable Discussions, *supra* note 55, at 6 (former Chairman Christopher Cox acknowledging that proxy rulemaking "involves fundamental questions of what shareholders get to do and how they get to do it"). Note that the creation of proxies (as opposed to their solicitation) remains a matter of state law. *See, e.g.*, DEL. CODE ANN. tit. 8, § 212(c).

[131]The default requirement for shareholder action (aside from board elections and certain

cost of shareholder voting" that the SEC promulgated Rule 14a-8,[132] which —in its own words—"addresses when a company *must* include a shareholder's proposal in its proxy statement and identify the proposal in its form of proxy."[133]

### B. *Rule 14a-8 and State Corporate Law*

A shareholder seeking inclusion of a proposal in the corporation's proxy statement—effectively meaning that the cost of making the proposal will be shifted to the company[134]—must meet various threshold eligibility requirements; follow a specified procedure; and avoid falling within enumerated substantive categories that Rule 14a-8 permits the company to exclude. To be eligible, the shareholder must have held securities worth $2,000 in market value, or 1 percent, of the company's securities entitled to vote for at least one year as of the date of the proposal, and continue to hold them through the meeting.[135] The shareholder may make only one proposal per meeting, which (together with its supporting statement) cannot exceed 500 words.[136] Rule 14a-8 further specifies the deadline by which proposals must be submitted, and generally requires that the proposing shareholder or "a qualified representative" attend the meeting.[137] The rule then specifies various substantive bases on which the company may seek to exclude the proposal, the first two of which gave rise to the questions put to the Delaware Supreme Court in *CA, Inc.*—"[i]f the proposal is not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization," and "[i]f the proposal would, if implemented, cause the company to violate any state, federal, or foreign law to which it is subject."[138]

The corporation may not, however, simply exclude the proposal at its own discretion. Rule 14a-8 requires that a company seeking to exclude a

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fundamental actions) is "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." DEL. CODE ANN. tit. 8, § 216(2).

[132] STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 718-19 (2d ed. 2008). The SEC's proxy rules appear in Regulation 14A, consisting of a series of rules that collectively regulate the process for soliciting proxies from public company shareholders, including disclosures required in connection with such solicitation efforts. *See* 17 C.F.R. §§ 240.14a-1 to -20 (2010).

[133] 17 C.F.R. § 240.14a-8 (2010) (emphasis added).

[134] *See* ALLEN ET AL., *supra* note 6, at 222; CHOI & PRITCHARD, *supra* note 132, at 718-19.

[135] 17 C.F.R. § 240.14a-8(b)(1).

[136] *Id.* § 240.14a-8(c)-(d).

[137] *Id.* § 240.14a-8(e), (h).

[138] *Id.* § 240.14a-8(i)(1)-(2).

proposal "must file its reasons" with the SEC—including "[a]n explanation of why the company believes that it may exclude the proposal, which should, if possible, refer to the most recent applicable authority, such as prior Division letters issued under the rule" (so-called "no-action letters," discussed below), as well as a "supporting opinion of counsel when such reasons are based on matters of state or foreign law."[139] Shareholders are urged to respond to such arguments,[140] but are assured that in general "the burden is on the company to demonstrate that it is entitled to exclude a proposal" – meaning that a tie should break in favor of the shareholder proponent.[141]

This cursory overview of the structure of Rule 14a-8 is sufficient to expose the federal systemic tensions posed by the shareholder bylaw authority in large public companies. Congress' intent in enacting Exchange Act Section 14(a)—of which Rule 14a-8 naturally can be but an expression—was "to require fair opportunity for the operation of corporate suffrage."[142] As the Third Circuit put it, in *SEC v. Transamerica Corp.*, "control of great corporations by a very few persons was the abuse at which Congress struck in enacting Section 14(a)."[143] In this light, the potential for conflict between Rule 14a-8 and Delaware corporate law arises in two senses. First, "corporate suffrage," as noted above, is quintessential corporate governance, a matter historically left to the states.[144] Second, the board's authority to manage the "business and affairs" of the corporation under DGCL section 141(a)—which *CA, Inc.* describes as "a cardinal precept" of Delaware corporate law[145]—clearly militates to some degree (for better or worse) toward "control of great corporations by a very few persons."

Such tensions were quite vividly illustrated in the SEC's August 2010 proxy access rulemaking. Should the SEC overcome Business Roundtable's suit challenging its legality,[146] the new Rule 14a-11 would permit (in certain circumstances) shareholders or groups holding 3 percent voting power for three years to include in the company's proxy their own nominees for up to

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[139] *Id.* § 240.14a-8(j).
[140] 17 C.F.R. § 240.14a-8(k).
[141] *Id.* § 240.14a-8(g).
[142] SEC v. Transamerica Corp., 163 F.2d 511, 518 (3d Cir. 1947).
[143] *Id.*
[144] *See supra* notes 130-131 and accompanying text.
[145] CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 232 n.7 (Del. 2008).
[146] On October 4, 2010, the SEC stayed implementation of the new proxy access regime pending resolution of a suit filed by Business Roundtable challenging its legality. *See* Securities and Exchange Commission, Facilitating Shareholder Director Nominations, 75 Fed. Reg. 64641 (Oct. 20, 2010); Jessica Holzer, *SEC Awaits Court Ruling on Proxy Rule*, WALL ST. J., Oct. 4, 2010.

25 percent of the board (or at least one seat).[147] The SEC's amendment of Rule 14a-8 would also facilitate shareholder proposals to establish nomination procedures in the company's governing documents.[148] Critically, the proxy access rule would effectively be mandatory, permitting states or companies to opt out only through the extreme step of prohibiting shareholder nominations entirely.[149] Though styled in the adopting release as merely "facilitat[ing] the effective exercise of shareholders' traditional State law rights to nominate and elect directors,"[150] dissenting Commissioners characterized the mandatory proxy access rule as "confer[ring] upon shareholders a new substantive federal right that in many respects runs counter to what state corporate law otherwise provides,"[151] and the adopting release itself as "a jiu-jitsu exercise of purporting to give deference to state law . . . when in fact the rules do exactly the opposite."[152]

The SEC, recognizing the inevitability of such tensions in the area of proxy regulation, has sought to manage them in the context of shareholder proposals principally by crafting Rule 14a-8 exclusions turning on the permissibility of a given proposal under state law.[153] As noted above, these provisions permit the company to exclude proposals that are not proper subjects for shareholder action under state law and proposals that, if enacted, would otherwise cause the company to violate state law.[154]

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[147] *See generally* Securities and Exchange Commission, Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56668 (Sept. 16, 2010) [hereinafter SEC, Facilitating Shareholder Director Nominations]; 17 C.F.R. § 240.14a-11.

[148] *See* SEC, Facilitating Shareholder Director Nominations, *supra* note 147, at 56730-34; *see also* 17 C.F.R. § 240-14a-8(i)(8).

[149] *See* SEC, Facilitating Shareholder Director Nominations, *supra* note 147, at 56678; *see also* 17 C.F.R. § 240.14a-11(a)(2). The creation of a proxy access regime followed an express invitation by Congress to do so. *See* SEC, Facilitating Shareholder Director Nominations, *supra* note 147, at 56674 (observing that "Congress confirmed our authority in this area and removed any doubt that we have authority to adopt a rule such as Rule 14a-11" in § 971 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub L. No. 111-203, 124 Stat. 1376 (2010)).

[150] SEC, Facilitating Shareholder Director Nominations, *supra* note 147, at 56668.

[151] Troy A. Paredes, Commissioner, Securities and Exchange Commission, Statement at Open Meeting to Adopt the Final Rule Regarding Facilitating Shareholder Director Nominations ("Proxy Access") (Aug. 25, 2010), http://sec.gov/news/speech/2010/spch082510tap.htm.

[152] Kathleen L. Casey, Commissioner, Securities and Exchange Commission, Statement at Open Meeting to Adopt the Final Rule Regarding Facilitating Shareholder Director Nominations (Aug. 25, 2010), http://sec.gov/news/speech/2010/spch082510klc.htm; *see also* Proxy Access Forum: Christopher Bruner, CONGLOMERATE BLOG (Aug. 26, 2010), http://www.theconglomerate.org/forum-proxy-access/.

[153] *See* McDonnell, *supra* note 20, at 254 (describing the proper subject exclusion as "part of the intricate balancing of state and federal law that goes on in this area").

[154] 17 C.F.R. § 240.14a-8(i)(1)-(2).

### C. *The SEC's Response to Delaware's Ambivalence*

Given the degree of state-federal tension involved, and the core questions of shareholder power implicated, it is unsurprising that the proper subject exclusion has been the "most recurrent question" in this area.[155] This exclusion, taken at face value, would appear to leave the appropriate balance of power between boards and shareholders entirely to state law, but that does not mean that the SEC has no impact here. Recall that companies may not simply exclude proposals at their own discretion. Rule 14a-8 establishes a specific process that a company seeking to exclude a shareholder proposal must follow, involving a submission to the SEC detailing "why the company believes that it may exclude the proposal," citing "the most recent applicable authority, such as prior Division letters issued under the rule," and including a "supporting opinion of counsel when such reasons are based on matters of state or foreign law"[156]—the burden being on the company to demonstrate entitlement to the exclusion.[157] As Louis Loss and Joel Seligman explain,

> [W]ith the Commission in the position in which the federal courts frequently find themselves under the *Erie* doctrine of guessing what the state courts would say, there is inevitably much room for the exercise of administrative discretion—and for resort to the "burden of proof" and "benefit of the doubt" techniques in deciding individual cases.[158]

Such circumstances, in fact, arise quite often, rendering the SEC's process for evaluating shareholder proposals highly consequential. The SEC's Division of Corporation Finance reportedly receives between 300 and 450 requests to exclude shareholder proposals each year,[159] and of the 373 addressed between October 2007 and October 2008, approximately 9 percent involved state law issues.[160] When Rule 14a-8 directs companies seeking to exclude a proposal to cite "the most recent applicable authority,

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[155]LOSS & SELIGMAN, *supra* note 129, at 553.

[156]17 C.F.R. § 240.14a-8(j).

[157]*Id.* § 240.14a-8(g).

[158]LOSS & SELIGMAN, *supra* note 129, at 556.

[159]John W. White, Director, Division of Corporation Finance, Securities and Exchange Commission, Speech to the Committee on Federal Regulation of Securities of the American Bar Association Section of Business Law (Aug. 11, 2008) (transcript available at http://www.sec.gov/news/speech /2008/spch081108jww.htm).

[160]Verity Winship, *Cooperative Interbranch Federalism: Certification of State-Law Questions by Federal Agencies*, 63 VAND. L. REV. 181, 203 (2010).

such as prior Division letters issued under the rule,"[161] it refers to prior "no-action" letters.[162] No-action letters are in fact what companies are requesting, as a technical matter, when they write to the SEC seeking to persuade it that a proposal should be deemed excludable. No-action letters reflect not the formal position of the Commission, as such, but the informal position of the SEC staff regarding whether it would recommend enforcement action to the Commission if the party in question were to proceed in the manner described in its request letter. Hence when the SEC provides the requested assurance, it is said to have provided "no-action" assurance.[163] According to an SEC regulation, "[w]hile opinions expressed by members of the staff do not constitute an official expression of the Commission's views, they represent the views of persons who are continuously working with the provisions of the statute involved."[164] Though an informal statement with no binding effect on the SEC (or on a court for that matter), such assurances are nevertheless viewed by market actors as providing "a high degree of confidence that they can proceed as planned without any SEC interference."[165] In fact, no-action letters are widely viewed as "de facto adjudication," given that the staff only rarely takes a matter to the full Commission, and parties involved in the no-action process only rarely challenge the staff's position.[166]

While the SEC claims to "have no interest in the merits of a particular proposal,"[167] it is quite common for the SEC to request an opinion of counsel when not provided with the initial request, and one practitioner observes that "[a]ny qualifications or waffling in the opinion of counsel . . . are usually met with resistance by the Staff."[168] Likewise the staff has expressed

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[161] 17 C.F.R. § 240.14a-8(j).

[162] Securities and Exchange Commission, Division of Corporation Finance Staff Legal Bulletin No. 14 (July 13, 2001), http://www.sec.gov/interps/legal/ cfslb14.htm [hereinafter SEC, Staff Legal Bulletin No. 14] ("explain[ing] the rule 14a-8 no-action process").

[163] *See generally* Alan J. Berkeley, *Obtaining Staff Guidance Today, in* FUNDAMENTALS OF SECURITIES LAW (ALI-ABA Course of Study Materials, June 2008) (LEXIS, Course Number SN018); *see also* BLOOMENTHAL & WOLFF, *supra* note 22, § 24:70.10; SEC, Staff Legal Bulletin No. 14, *supra* note 162, §§ B.3-B.5; White, *supra* note 159.

[164] 17 C.F.R. § 202.1(d). The regulation adds that "any statement by the director, associate director, assistant director, chief accountant, chief counsel, or chief financial analyst of a division can be relied upon as representing the views of that division." *Id.*

[165] Berkeley, *supra* note 163 at "What Staff Relief Means."

[166] *See* BLOOMENTHAL & WOLFF, *supra* note 22, § 24:70.10; *see also* 17 C.F.R. § 202.1(d) (indicating that the staff generally puts questions to the Commission only when they "involve matters of substantial importance and where the issues are novel or highly complex"); McDonnell, *supra* note 20, at 255.

[167] SEC, Staff Legal Bulletin No. 14, *supra* note 162, § B.7.

[168] Berkeley, *supra* note 163, at "Legal Opinions."

impatience with "kitchen sink" arguments for exclusion, urging companies not to "throw in extras that don't provide a solid basis for exclusion."[169] In evaluating opinions of counsel, the staff has indicated that it focuses particularly on "whether the law underlying the opinion of counsel is unsettled or unresolved," and reiterates Rule 14a-8's invitation for shareholders "to contest a company's reliance on an opinion of counsel as to matters of state or foreign law" with their own competing opinion of counsel.[170] This, of course, gestures toward the company's burden to persuade the SEC that it is entitled to exclude the proposal. As then-Deputy Director of Corporation Finance Martin Dunn explained at a May 2007 roundtable on the federal proxy rules, a tie on contested matters of state law should clearly break in favor of a shareholder proposing to amend the bylaws to constrain board power:

> Every time we get a binding [proposal], we get competing state law opinions, one of which says from the company that 141 doesn't allow this, and then we get one that says 109 does allow this. We sit there and go we don't know. We are going to say you haven't met your burden of proof because we have competing opinions.[171]

Put this way, it would seem that the federal dimension of the bylaw issue should be quite straightforward—the consequence of legal indecision in Delaware is that proposed shareholder bylaw amendments make it into the proxy.

Yet, the staff positions actually taken on proposed bylaw amendments in hot-button areas over the last couple decades have been far less consistent than this statement would tend to suggest. When the Division of Corporation Finance receives a state law-based request to exclude a shareholder proposal to amend the bylaws, it effectively has three options—it can provide the requested no-action assurance (i.e. permitting exclusion); it can refuse to provide no-action assurance (i.e. rejecting the claimed basis for exclusion); or it can respond that "the staff is unwilling to take a position on whether the proposal is excludable or not."[172] Since the

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[169]White, *supra* note 159.

[170]Securities and Exchange Commission, Division of Corporation Finance Staff Legal Bulletin No. 14B (Sept. 15, 2004), § E, http://www.sec.gov/interps/legal/cfslb14b.htm; *see also* SEC, Staff Legal Bulletin No. 14, *supra* note 162, § G.5.

[171]SEC, Roundtable Discussions, *supra* note 55, at 32; s*ee also* BLOOMENTHAL & WOLFF, *supra* note 22, § 24:84.11.

[172]McDonnell, *supra* note 20, at 254.

early 1990s, as Brett McDonnell observes, the staff "changed tack at several points" with no "clear pattern," at times permitting inclusion in the proxy of governance-related bylaws, at times permitting their exclusion, and by 1999, "declaring in many letters that it will not express any view with respect to this ground of exclusion where there is no compelling state law precedent."[173] This position appears to have had the practical effect of leading many companies to exclude such proposals, evidently gambling that the SEC would be unlikely to pursue a matter in which the core legal principles remain so murky, and which in any event fall under state rather than federal law.[174]

Harold Bloomenthal and Samuel Wolff, in an analysis of SEC responses to such no-action requests, identify "the staff's ambivalence with respect to the shareholders right to propose amendments to a corporation's bylaws under the Delaware law," exhaustively cataloguing the SEC staff's flip-flopping on the excludability of various types of proposed bylaw amendments.[175] For example, as of the 1999 proxy season, the staff refused to express a view on whether proposed bylaws limiting the ability of boards to adopt poison pills could be excluded as improper under state law, yet by the 2000 proxy season, the staff appeared to have concluded that such proposals could be excluded on this basis.[176]

Analysis of the staff's position is inevitably hampered by the fact that it "characteristically doesn't articulate the basis for its conclusion" in responding to no-action requests,[177] though it must also be acknowledged that bylaw proposals themselves in any given area have continually morphed over the last decade. Since 2002, shareholder proposals aimed at reining in the use of poison pills have increasingly been phrased in "precatory" form—that is, in the form of requests or recommendations to the board, rather than mandates.[178] This development responds to a "note" included by the SEC in Rule 14a-8 indicating that "most proposals that are cast as recommendations or requests that the board of directors take specified action are proper under state law" (a debatable legal proposition).[179] Additionally,

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[173] *Id.* at 254-55.

[174] *See id.* at 255-56.

[175] BLOOMENTHAL & WOLFF, *supra* note 22, § 24:71.10.

[176] *See id.* § 24:84.

[177] *Id.* § 24:71.20; *see also* Robert B. Ahdieh, *The Dialectical Regulation of Rule 14a-8: Intersystemic Governance in Corporate Law*, 2 J. BUS. & TECH. L. 165, 173 (2007).

[178] *See* BLOOMENTHAL & WOLFF, *supra* note 22, § 24:84.10.

[179] 17 C.F.R. § 240.14a-8(i)(1), Note to paragraph (i)(1). There is certainly state case law endorsing precatory proposals. *See, e.g.*, Auer v. Dressel, 118 N.E.2d 590, 592-93 (N.Y. 1954). Their legality in Delaware, however, is less clear. *See, e.g.*, Ahdieh, *supra* note 177, at 173; Strine, *supra* note 122, at 1088-89; Veasey, *supra* note 122, at 53.

shareholder advocates have continually tried new and creative approaches to limiting board power, one notable example being Lucian Bebchuk's 2006 bylaw proposal at CA, Inc.—a binding proposal, yet which focused principally on the manner in which the board itself could approve or extend a poison pill.[180] In that instance, the SEC staff expressed "no view with respect to CA's intention to omit the [proposal] from the proxy materials" because Bebchuk preemptively sought declaratory relief (unsuccessfully, as it turned out) in the Delaware Court of Chancery.[181] By 2007, as the explanation offered by Martin Dunn quoted above tends to suggest, the SEC seems to have thrown up its hands, purporting to fall back on the straightforward consequence of the burden of persuasion established in Rule 14a-8 itself—uncertainty in the underlying state law breaks in favor of the shareholders.[182]

### D. *Delaware's Certification Process*

This confluence of state and federal regulation of proxy voting in public companies places the SEC in the deeply awkward position of evaluating the propriety of permitting proposed shareholder bylaw amendments into the company's proxy while somehow avoiding evaluation of their legality under state law. In an effort to achieve greater coherence—both systemic and substantive—in the evaluation of shareholder proposals, the Delaware Constitution was amended on May 3, 2007 to permit the SEC to certify questions of Delaware law directly to the Delaware Supreme Court.[183]

Given the endemic problems they have raised, it is unsurprising that the first use of this new certification process was to determine the legality of a proposed shareholder bylaw phrased in mandatory form—the proxy reimbursement bylaw at issue in *CA, Inc*.[184] Presumably reflecting the staff's checkered history in grappling with such proposals, and the frustration reflected in Martin Dunn's characterization of the situation by 2007, the SEC's certification to the Delaware Supreme Court on June 27, 2008,

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[180]Bebchuk v. CA, Inc., 902 A.2d 737, 738 (Del. Ch. 2006).

[181]*Id.* at 738-39, 745; *see also* BLOOMENTHAL & WOLFF, *supra* note 22, § 24:84.20. For additional discussion of this decision, see *infra* notes 205-209 and accompanying text.

[182]For additional background on the SEC's evolving position on the excludability of various types of corporate governance proposals by shareholders, see BLOOMENTHAL & WOLFF, *supra* note 22, §§ 24:71.10-.26, 24:84-24:84.30.

[183]*See* CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 229 n.1 (Del. 2008); BLOOMENTHAL & WOLFF, *supra* note 22, § 24:71.24.

[184]*CA, Inc.*, 953 A.2d at 229 n.1; WELCH ET AL., *supra* note 9, § 109.5.1.

observed three times (in a four-page letter) that, unless the court instructs otherwise, the company would be unable to exclude the proposal for failure to meet its burden of persuasion.[185] "The Division [of Corporation Finance], faced with two conflicting opinions on Delaware law from Delaware law firms, does not resolve disputed questions of Delaware law," the letter explains.[186] "If there is no way to obtain any such resolution, the Division intends to inform CA that it has not satisfied its burden of demonstrating that it may exclude the AFSCME Proposal under Rule 14a-8(i)(1) or Rule 14a-8(i)(2)"—that is, the exclusions for matters not proper subjects for shareholder action under state law, and proposals that, if adopted, would otherwise cause the company to violate state law.[187]

SEC staff openly welcomed the advent of Delaware's new certification process. Then-Director of the Division of Corporation Finance John White stated in an August 2008 speech that "this is a very useful tool to have available to the Corp Fin staff as we review the hundreds of no-action requests we receive each year on shareholder proposals."[188] He specifically cited the SEC's first certification to the Delaware Supreme Court on June 27, noting that by July 17 the court had answered the certified questions, resulting in exclusion of the proposal from CA, Inc.'s proxy.[189] "This was obviously an important decision substantively," he said, but added that "it also was very important to us in terms of process . . . . We're very excited to have this tool at our disposal, and look forward to using it further, as appropriate, in coming years."[190] Practitioners likewise heralded the efficiency of the process, observing that at the time of its creation "it was unclear exactly how the certification would work, how long a response would take, and whether the SEC would utilize this process. This case shows that the SEC will indeed utilize the certification process and that the process itself can be accomplished fairly quickly," just three weeks having elapsed between submission of the certification letter and rendering of the court's opinion in *CA, Inc*.[191]

Academic commentary has gone further. McDonnell characterizes

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[185] *See* Securities and Exchange Commission, Certification of Questions of Law Arising from Rule 14a-8 Proposal by Shareholder of CA, Inc., at 2-4 (June 27, 2008), *available at* http://www.sec.gov/ rules/other/2008/ca14a8cert.pdf [hereinafter SEC, Certification of Questions].

[186] *Id.* at 2.

[187] *Id.*; *see also* 17 C.F.R. § 240.14a-8(i)(1)-(2).

[188] White, *supra* note 159.

[189] *Id.*

[190] *Id*.

[191] Wilensky & Priest, *supra* note 77, § I.B n. 22; *cf*. BLOOMENTHAL & WOLFF, *supra* note 22, § 24:84.11 (suggesting that the Delaware certification process "could provide an answer to Mr. Dunn's quandary").

SEC certification to the Delaware Supreme Court as "an important new procedure that increases the chances for useful dialogue."[192] Robert Ahdieh similarly suggests that it permits "more meaningful opportunity for dialectical engagement" between state and federal governmental actors, providing a model for "a broader pattern of [SEC] engagement with relevant state authorities."[193] Verity Winship likewise argues that "states should consider following and expanding on Delaware's lead to institute federal agency certification," said to be "a flexible mechanism with the potential to promote cooperative interbranch federalism."[194]

### E. *The Distortion of Bylaw Disputes*

It is undoubtedly true that the SEC is poorly positioned to guess how state courts—including those of Delaware—would handle a given dispute. As Winship observes, the "flip side" of *Chevron* deference to federal agency statutory interpretation is that such agencies "are not expected to be expert beyond the limits of the statute or subject area they administer."[195] In this light, the SEC's expression of humility in flatly refusing to wade into "disputed questions of Delaware law"[196] is entirely appropriate. The question remains, however, whether the structure the SEC and Delaware have struck upon—certification by this federal agency of open questions of law to the Delaware Supreme Court—is in fact the optimal solution, given the predominant manner in which such questions arise in the federal securities regime.

Ahdieh emphasizes that addressing bylaws at the proposal stage avoids expense and effort associated with pursuing adoption of the bylaw and then litigating its validity in state court, while effectively supplanting a flawed "status quo, in which one-paragraph no-action letters are the final arbiter of proxy proposals."[197] This is undoubtedly correct, but *CA, Inc.* itself nevertheless suggests that the costs of the certification approach in actual practice will likely outweigh any such benefits. First and foremost, the fact that bylaw disputes come before the SEC (or its staff, rather) at the proposal stage means that matters certified by the SEC will arrive at the Delaware Supreme Court framed in ex ante, hypothetical terms, rather than ex post,

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[192]McDonnell, *supra* note 38, at 38.

[193]Ahdieh, *supra* note 177, at 175-76, 179.

[194]Winship, *supra* note 160, at 234.

[195]*Id.* at 212.

[196]SEC, Certification of Questions, *supra* note 185, at 2; *see also supra* notes 167-171 and accompanying text.

[197]Ahdieh, *supra* note 177, at 175-76.

factually specific terms. This point certainly was not lost on the Delaware Supreme Court in *CA, Inc.*:

> Were this issue being presented in the course of litigation involving the application of the Bylaw to a specific set of facts, we would start with the presumption that the Bylaw is valid and, if possible, construe it in a manner consistent with the law. The factual context in which the Bylaw was challenged would inform our analysis, and we would "exercise caution [before] invalidating corporate acts based upon hypothetical injuries. . . ." The certified questions, however, request a determination of the validity of the Bylaw in the abstract. Therefore, in response to the second question [i.e. whether the bylaw, if adopted, would require the company to violate Delaware law], we must necessarily consider any possible circumstance under which a board of directors might be required to act.[198]

Having framed the matter in this way—a direct consequence of its arrival via SEC certification rather than through Delaware litigation—the bylaw was ultimately found to be contrary to Delaware law because "[u]nder at least one such hypothetical, the board of directors would breach their fiduciary duties if they complied with the Bylaw."[199]

There are compelling reasons not to approach the issue of shareholder bylaws in this way. For ease of reference, the core distinctions between treatment of a bylaw arising organically through Delaware litigation, on the one hand, and through the SEC certification process, on the other, are summarized below in Figure 1. As the Delaware Supreme Court explained in *Stroud v. Grace*, the argument that "hypothetical injuries" should invalidate bylaws proves too much—because the practical reality is that "*every* valid by-law is *always* susceptible to potential misuse."[200] Consequently, it is not an overstatement to suggest that literally any bylaw arriving at the court's door via SEC certification is vulnerable to preemptive invalidation based on identification of a single hypothetical abuse.

McDonnell fairly questions whether the fact that the bylaw was not yet enacted really necessitated so demanding a validity test, suggesting that

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[198]CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 238 (Del. 2008) (citing Stroud v. Grace, 606 A.2d 75, 79 (Del. 1992)) (footnotes omitted).

[199]*Id.*

[200]Stroud v. Grace, 606 A.2d 75, 79, 96 (Del. 1992) (emphasis added); *see also* WELCH ET AL., *supra* note 9, § 109.9.

perhaps the court might have employed something akin to the test for a statute's facial constitutionality—an approach under which the bylaw's "overbreadth . . . must not only be real, but substantial as well, judged in relation to the statute's plainly legitimate sweep," before the court would conclude that enacting it would require violation of Delaware law.[201] It is not clear, however, that application of such a standard would have made a difference in *CA, Inc.* To be sure, McDonnell's test would require of the board something more than identification of a single hypothetical problem. Yet the court specifically emphasizes that it "is not far fetched" that the board's fiduciary duties might require that proxy expense reimbursement be denied entirely, an analysis turning heavily on the board's own perception of the company's best interests.[202] Given the court's rejection of AFSCME's claim that shareholders could relieve the board of its duties in this area[203]—and the consequent framing of the issue through traditional fiduciary duty analysis strongly protective of board discretion—we could readily imagine CA, Inc. arguing that AFSCME's mandatory reimbursement bylaw was substantially overbroad, and the court accepting that characterization.[204] In any event, such an alternative approach to evaluating a proposed bylaw's validity would not eliminate the core problem—the fact that SEC certification of proposed bylaws unavoidably requires this form of speculation regarding the hypothetical use of an as-yet hypothetical bylaw.

The dangers posed more generally by such evaluation of hypotheticals motivate the long-standing common law commitment to the ripeness doctrine, as Vice Chancellor Lamb discusses in his *Bebchuk v. CA, Inc.* opinion. Recall that Bebchuk sought a declaration from the Delaware court regarding the validity of a proposed bylaw limiting the manner in which the board could approve or extend a poison pill.[205] In refusing to provide declaratory relief, Vice Chancellor Lamb observed that "Delaware courts have announced justiciability rules that closely resemble those followed at the federal level."[206] Specifically, "Delaware courts do not rule on cases unless they are 'ripe for judicial determination,' consistent with a well

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[201] McDonnell, *supra* note 38, at 41-42 (quoting Broadrick v. Oklahoma, 413 U.S. 601, 615 (1973)).

[202] *CA, Inc.*, 953 A.2d at 240.

[203] *Id.*

[204] McDonnell quite reasonably questions whether "there's really a broad range of circumstances in which a board's duty would require it to not compensate successful shareholder nominees," but agrees that given the approach taken in *CA, Inc.*, SEC certification to the Delaware Supreme Court appears problematic. *See* McDonnell, *supra* note 38, at 42.

[205] Bebchuk v. CA, Inc., 902 A.2d 737, 738-39 (Del. Ch. 2006).

[206] *Id.* at 740.

established reluctance to issue advisory or hypothetical opinions."[207] The reason, Vice Chancellor Lamb explains (quoting the Delaware Supreme Court), is that "[w]henever a court examines a matter where facts are not fully developed, it runs the risk not only of granting an incorrect judgment, but also of taking an inappropriate or premature step in the development of the law"—a risk that is all that much greater in areas raising "novel and important [issues] to Delaware corporate law," including the scope of the shareholder bylaw authority.[208] In refusing to provide declaratory relief, Lamb rightly observes that this area is "fraught with tension," and that, "just as in *Stroud* and its progeny, the factual context . . . could be of the utmost importance."[209] Indeed, as Vice Chancellor Strine (facing a similar matter) explained several years earlier in *General Datacomm Industries*, "[a]bsent an imminent threat of irreparable injury, there seems to be no need and much risk for this court to step into the void when the SEC concludes that state law is not clear enough . . . to exclude a proposal."[210] He rightly adds that this very SEC determination—practically by hypothesis—renders the matter "precisely the sort about which this court should be reluctant to opine until the issue is ripe for judicial resolution."[211]

Figure 1: Treatment of Shareholder Bylaw Disputes in Delaware Litigation and the SEC Certification Process

| | **Delaware litigation** | **SEC certification** |
|---|---|---|
| **status of bylaw** | enacted | proposed |
| **factual posture** | ex post/ concrete | ex ante/ hypothetical |
| **presumed valid** | yes | no |
| **parity with board bylaws** | yes | no |

[207] *Id.* (quoting Stroud v. Milliken Enters. Inc., 552 A.2d 476, 479-80 (Del. 1989)).

[208] *Bebchuk*, 902 A.2d at 740-41 (quoting *Stroud*, 552 A.2d at 480).

[209] *Bebchuk*, 902 A.2d at 742. Ultimately the matter never became ripe, the bylaw in question receiving 41 percent of the vote at the subsequent annual meeting. *See supra* note 94 and accompanying text.

[210] *See* Gen. Datacomm Indus., Inc. v. State of Wisconsin Inv. Bd., 731 A.2d 818, 822 (Del Ch. 1999).

[211] *Id.*

Another consequence of this mode of analysis that should be of particular concern to the SEC itself is that shareholders are placed in a far less favorable position than they would occupy had the matter arisen through Delaware litigation. The Delaware Supreme Court explained, in *Frantz Manufacturing Co. v. EAC Indus.*, that, given their status as "an inherent feature of the corporate structure," enacted bylaws are "presumed to be valid, and the courts will construe the bylaws in a manner consistent with the law rather than strike down the bylaws."[212] As the court observed in *CA, Inc.*, however, this presumption of validity is lost in the SEC certification scenario because the nature of the inquiry requires "determination of the validity of the Bylaw in the abstract."[213] Should Exchange Act Rule 14a-8 and the new certification process become the principal lens through which shareholder bylaws are examined in Delaware, the consequence would presumably be a double standard—board (and controller) bylaws getting the benefit of a powerful presumption in their favor,[214] and minority shareholder bylaws being preemptively struck down based on hypothetical abuses. Recalling the *Stroud* court's observation that "*every* valid by-law is *always* susceptible to potential misuse,"[215] the new certification process taken to its logical extreme could result in de facto elimination of the shareholders' statutory authority to enact, amend, and repeal bylaws in public companies.

## IV. DECIDING WHO DECIDES

In light of the fundamental issues of corporate law implicated by shareholder bylaws; the uneasy balance of state and federal regulatory competence in the area of corporate governance; and the peculiar dynamics created by the interaction of Exchange Act Rule 14a-8 with the new process for certifying questions directly to the Delaware Supreme Court, it is enormously important that more concerted effort be devoted to thinking through how the balance between board and shareholder power ought to be struck, and more immediately, who ought to decide what the scope of permissible shareholder bylaws ought to be. In this part of the Article I consider how we ought to decide who decides.

I argue below that there is no perfect approach to the shareholder

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[212]Frantz Mfg. Co. v. EAC Indus., 501 A.2d 401, 407 (Del. 1985).

[213]CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 238 (Del. 2008); *see also* WELCH ET AL., *supra* note 9, § 109.4.

[214]*See, e.g.*, *Frantz Mfg. Co.*, 501 A.2d at 407; Stroud v. Grace, 606 A.2d 75, 96 (Del. 1992); Orloff v. Shulman, 2005 Del. Ch. LEXIS 184, at *49-*50 (Del. Ch. 2005); Underbrink v. Warrior Energy Servs. Corp., No. 2982-VCP, 2008 WL 2262316, at *13 (Del. Ch. May 30, 2008).

[215]*Stroud*, 606 A.2d at 96 (Del. 1992) (emphasis added).

bylaw debate because in our system of corporate federalism—whatever its strengths may be—there is no single governmental actor possessing both the requisite political legitimacy and epistemic legitimacy[216] to address the fundamental issues of corporate power and purpose in a compelling, broadly acceptable manner. The least-bad solution, however, would remove the SEC from the equation to the greatest degree practicable, leaving the matter in the first instance to Delaware, subject to the omnipresent threat of episodic legislative intervention by Congress. This could be achieved at lowest cost by a strict SEC policy of denying requests for exclusion of Rule 14a-8 proposals prompting competing Delaware legal opinions, thereby minimizing reliance on certification to the Delaware Supreme Court and facilitating the organic development of Delaware's case law in this area.

### A. *Federalism and Regulatory Legitimacy in Corporate Governance*

As discussed above, there are effectively three relevant spheres in which corporate governance rules are generated—Delaware, Congress, and the SEC.[217] Setting aside the internal affairs doctrine, the SEC plainly possesses little political or epistemic legitimacy to delineate the parameters of bylaw authority under state corporate law (see Figure 2 below). Like the takeover debate before it, the debate over the appropriate scope of the shareholders' bylaw authority necessarily implicates the core questions of power and purpose that define the field, in turn impacting not only the board and the shareholders, but other constituencies as well, notably employees.[218] The SEC's "lack of expertise in state law"[219]—out of which this debate arises – is clear. Perhaps more significantly, however, it must be borne in mind that the SEC is effectively a single-constituency regulator. Congress' principal intent in enacting the securities laws was investor protection (primarily through mandatory disclosure coupled with anti-fraud rules)—a goal not lost on the SEC, which accurately describes its "mission" as being

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[216] I have employed the distinction elsewhere. *See* Christopher M. Bruner, *States, Markets, and Gatekeepers: Public-Private Regulatory Regimes in an Era of Economic Globalization,* 30 MICH. J. INT'L L. 125, 125-30 (2008). In using the term "epistemic legitimacy" I refer generally to normative authority derived from recognized "expert" knowledge—effectively a form of reputational accountability. By "political legitimacy" I refer generally to democratic accountability. *See id.* at 129-33.

[217] *See supra* notes 118-133 and accompanying text. While one might further distinguish the perspectives and relative competencies of the Delaware General Assembly and the Delaware courts, the three-part distinction drawn in this Article suffices for a discussion of the general dynamics of American corporate federalism.

[218] *See supra* notes 51-116 and accompanying text.

[219] Ahdieh, *supra* note 177, at 172.

"to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."[220] Practically by hypothesis, such an agency is poorly positioned to address in a coherent fashion the degree of power shareholders ought to possess, or the degree to which corporate law ought to emphasize their interests over those of other constituencies—fundamental, policy-driven issues throwing into question the SEC's axiomatic premise. The SEC aptly styles itself "the investor's advocate,"[221] and in so doing it calls into question its competence to consider even-handedly these types of inherently multi-constituency issues.[222] Given the SEC's (ineffective) efforts to evade these types of matters through state law-based exclusions in Rule 14a-8, the Commission itself presumably would not disagree with this characterization.

Figure 2: Political and Epistemic Legitimacy in Corporate Governance

| | **epistemic legitimacy *strong*** | **epistemic legitimacy *weak*** |
|---|---|---|
| **political legitimacy *strong*** | ??? | Congress |
| **political legitimacy *weak*** | Delaware | SEC |

Congress, for its part, possesses political legitimacy far exceeding the SEC or Delaware. Congress, we must recall, possesses ample constitutional authority to legislate in this area (the internal affairs doctrine notwithstanding),[223] and by comparison many have called into question Delaware's political legitimacy to address matters impacting a broad range of regulatory fields and numerous constituencies well beyond Delaware's borders. As Renee Jones explains, "concerns about the lack of political representation in the state lawmaking process fade at the federal level, where all adult citizens enjoy political representation," and where Congress

[220] Securities and Exchange Commission, The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, *available at* http://www.sec.gov/about/whatwedo.shtml (last modified Oct. 10, 2010) [hereinafter SEC, Investor's Advocate]; *see also* CHOI & PRITCHARD, *supra* note 132, at 1.

[221] *See* SEC, Investor's Advocate, *supra* note 220.

[222] *Cf.* Winship, *supra* note 160, at 212 (suggesting that the "flip side of [agency] specialization is that agencies are not expected to be expert beyond the limits of the statute or subject area they administer").

[223] *See supra* notes 118-124 and accompanying text.

routinely must "balance the interests of competing constituencies in ways that legislators in Delaware and other states can avoid."[224] Mark Roe observes that, unlike Delaware's focus on the directors and shareholders who control the substantial flow of franchise taxes to the state's coffers, Congress' intervention in corporate governance "brings with it another strain of public policy: American populist sentiment and national public opinion," which will tend to "dilute the impact of managers and investors" in the federal lawmaking process.[225] Accordingly, Delaware's critics have vigorously challenged the legitimacy of one (small) state effectively determining the laws governing most of corporate America.[226]

Yet, it is undoubtedly Delaware that possesses the greatest epistemic legitimacy—by which I mean an authoritative reputation for expert, policy-relevant knowledge.[227] As Kahan and Kamar observe, a "principal attraction of incorporating in Delaware is the high quality of its chancery court," consisting of expert, well-supported judges hearing numerous corporate disputes without juries.[228] On this, they rightly add, "[t]here is a wide consensus . . . among academics, practitioners, and members of the judiciary."[229] Delaware's Division of Corporations touts the "complete package of incorporations services" that Delaware provides, including an "advanced and flexible" statute, a "business court that has written most of the modern U.S. corporation case law," a state government that is "business-friendly and accessible," and an efficient corporations division[230]—a self-serving depiction, to be sure, but a largely accurate one.

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[224]Renee M. Jones, *Legitimacy and Corporate Law: The Case For Regulatory Redundancy*, 86 WASH. U. L. REV. 1273, 1298-99 (2009); *see also* Kahan & Kamar, *supra* note 127, at 743-44; Strine, *supra* note 122, at 1080-81.

[225]Roe, *Delaware and Washington as Corporate Lawmakers*, *supra* note 122, at 16-17; *see also* Brett H. McDonnell, *Two Cheers for Corporate Law Federalism*, 30 J. CORP. L. 99, 101-03, 135-36 (2004).

[226]*See generally* Kent Greenfield, *Democracy and the Dominance of Delaware in Corporate Law*, 67 LAW & CONTEMP. PROBS. 135 (2004); Daniel J.H. Greenwood, *Markets and Democracy: The Illegitimacy of Corporate Law*, 74 UMKC L. REV. 41 (2005); *see also* Jones, *supra* note 224, at 1298-1300. David Skeel has suggested that legitimacy concerns may explain the high degree of unanimity in the Delaware Supreme Court's opinions. David A. Skeel, *The Unanimity Norm in Delaware Corporate Law*, 83 VA. L. REV. 127, 171 (1997). Likewise Lucian Bebchuk and Assaf Hamdani have suggested that Delaware's high degree of "reliance on judge-made law reduces the extent to which applying Delaware corporate law for most of the country's large firms is viewed as arbitrary and illegitimate." Bebchuk & Hamdani, *supra* note 37, at 604.

[227]*See* Bruner, *supra* note 216, at 130.

[228]Kahan & Kamar, *supra* note 127, at 708.

[229]*Id.* at 708 n.95; *see also* McDonnell, *supra* note 225, at 106, 118. *But see* Klausner, *supra* note 127, at 843-47 (arguing that "network externalities" augment Delaware's dominance in attracting new incorporations).

[230]*See Division of Corporations*, *supra* note 37.

### B. *The Least-Bad Approach to the Shareholder Bylaw Debate*

This state of affairs—in which no governmental actor possesses both strong political legitimacy and strong epistemic legitimacy—is depicted in Figure 2 (above). Clearly a decisionmaker combining the strongest democratic mandate among those affected by its decisions, coupled with the greatest degree of expert knowledge, would represent the ideal. In the regulation of corporate governance, however, no single entity achieves this. So of the three relevant actors, which provides the most desirable overall balance of political and epistemic legitimacy in addressing fundamental issues like the scope of the shareholders' bylaw authority?

There is a strong argument to be made that, of the three, reliance on Delaware—at least in the first instance—represents the least-bad approach. In addition to its considerable epistemic legitimacy, Delaware derives at least some measure of political legitimacy from long-standing federal acquiescence in its dominant role as a corporate lawmaker. As McDonnell observes, "the threat of federal intervention limits what Delaware can do," broadening the base of constituencies represented in the lawmaking process, and in particular, inhibiting "overly pro-managerial developments in state law while still leaving room for much lawmaking and experimentation at the state level."[231] Mark Roe likewise observes that "Delaware does seem to formulate policy with an eye on Washington," and that regardless of the volume of corporate law emerging from Delaware, Congress remains the "big gorilla of American economic lawmaking," capable of displacing Delaware's General Assembly and courts at any time "if they upset those who can influence Washington."[232]

In some cases, to be sure, Delaware endeavors to blunt anticipated federal moves in the area, as when it amended the DGCL to include a proxy access provision permitting ownership thresholds to be established in the bylaws at a higher level than those expected in the anticipated federal rule.[233] In times of crisis, however, Delaware quite rationally avoids confrontation with the federal government, a posture vividly illustrated in the aftermath of J.P. Morgan's federal government-orchestrated acquisition of Bear Stearns, when the Delaware Court of Chancery uncharacteristically agreed to stay a Delaware action challenging the use of extraordinary deal protections that almost certainly violated established Delaware precedent, permitting the

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[231] McDonnell, *supra* note 225, at 101; *see also id.* at 136-38.

[232] Roe, *Delaware and Washington as Corporate Lawmakers*, *supra* note 122, at 6, 9.

[233] *See supra* note 23. As noted above, the effort was unsuccessful. *See supra* notes 146-152 and accompanying text.

litigation to proceed in New York instead.[234] As Ed Rock and Marcel Kahan reasonably query, "how could Delaware even contemplate enjoining a transaction that was supported, indeed, arguably driven and financed by the Federal Reserve with the full support of the Treasury—a transaction that may have been necessary to prevent a collapse of the international financial system?"[235] By avoiding such confrontation—and particularly by bowing to the superior position of the federal government in matters involving political and social dimensions exceeding those normally associated with corporate governance—Delaware prudently manages its political capital and avoids "induc[ing] doubts about [its] ability to handle its role as maker of national corporate law."[236] Conversely, the fact that congressional intervention in corporate governance—though not infrequent—has consistently remained crisis-driven and piecemeal suggests that the likelihood of a complete federalization of corporate governance remains low indeed.[237]

The practical upshot of the analysis set forth above (depicted in Figures 1 and 2) is that the SEC's impact on state-level analysis of shareholder bylaws represents a distortion to be minimized. To be clear, this need not involve congressional action, removal of state law-based Rule 14a-8 exclusions, or elimination of Delaware's certification process, which in any event would involve substantial legal change (with attendant sound and fury) at both federal and state levels.[238] We can assume, for example, that there will be circumstances in which it really is clear that the subject of a given shareholder proposal falls squarely within the board's authority under state law, in which case failing to exclude the proposal would be tantamount to an assertion of federal competence to take power away from the board and give it to the shareholders—a truly "radical . . . federal intervention" regarding which courts would naturally expect a crystal clear expression of

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[234] *See In re* The Bear Stearns Companies, Inc. Shareholder Litigation, C.A. No. 3643-VCP, 2008 Del. Ch. LEXIS 46 (Del. Ch. 2008); Rock & Kahan, *supra* note 128, at 714-16.

[235] Rock & Kahan, *supra* note 128, at 744.

[236] *Id.* at 744-45; *see also* Bruner, *supra* note 104, at 333-35; Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749, 1770-71 (2006).

[237] *See, e.g.*, Veasey, *supra* note 122, at 42-55; *see also* Bruner, *supra* note 104, at 333-34; Roe, *Delaware and Washington as Corporate Lawmakers*, *supra* note 122, at 7-8, 33; Jones, *supra* note 224, at 1303-06; Roe, *Delaware's Competition*, *supra* note 122, at 596-98; Romano, *supra* note 127, at 210; Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859, 872-76, 906-07 (2003).

[238] For a brief overview of the SEC's rulemaking process—sometimes involving the issuance of a detailed "concept release" to solicit feedback prior to the issuance of a proposed rule, subject to additional public comment—see SEC, Investor's Advocate, *supra* note 220, at "How the SEC Rulemaking Process Works." In Delaware, abandonment of the SEC certification process would require amending the state constitution to remove it. *See* DEL. CONST. art. IV, § 11(8).

congressional intent.[239]

A far more pragmatic approach to the problem, permitting the SEC to withdraw itself entirely from a thorny set of issues that it is not prepared to address, would involve the SEC itself simply returning to the approach it has purported to take in the past—but, this time around, actually applying it consistently and strictly. If the SEC were to categorically apply the company's burden of persuasion already established in Exchange Act Rule 14a-8, and consequently refuse to provide no-action assurance permitting exclusion where that burden cannot be met due to competing opinions on the proposal's legality under Delaware law, then the substantial problems described in this Article—including resort to the problematic Delaware Supreme Court certification process—would literally go away.

It should be emphasized that evaluating bylaw proposals implicating contested matters of Delaware law places the SEC in an untenable position and likely hurts shareholders, the constituency it is charged to protect. Recall that the Delaware Supreme Court has articulated two standards for assessing bylaws – one for proposed bylaws (arriving via the SEC), and another for enacted bylaws (arriving via traditional Delaware litigation).[240] The SEC's task under Rule 14a-8(i)(2) is to determine whether a proposed bylaw, if enacted, would cause the company to violate state law – but of course the underlying message in *CA, Inc.* is that there is effectively no way to evaluate bylaws at the proposal stage, due to the ripeness doctrine and the concerns motivating it (to which the presumption of validity for enacted bylaws is closely related).[241] To be sure, the SEC could itself simply apply the "one such hypothetical" standard applied in *CA, Inc.* Given the potential for misuse of any bylaw, however, such a stringent standard would effectively shut down shareholder bylaws in public companies – an outcome tantamount to usurping an important state law issue, contradicting DGCL section 109, and abandoning its own investor protection mission in a single go. Alternatively, the SEC could try to guess how the bylaw would actually be used, and then focus its evaluation on that anticipated use (assuming its own non-involvement in vetting the bylaw, one imagines). This, however, would fly in the face of sound policies motivating the ripeness doctrine, likely resulting in just the sort of indeterminate floundering that led the SEC to punt to the Delaware Supreme Court in the first place. Far better to categorically apply the company's burden of persuasion already established in Rule 14a-8, permitting contested matters of Delaware law to be addressed

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[239] LOSS & SELIGMAN, *supra* note 129, at 554.

[240] *See supra* notes 212-215 and accompanying text.

[241] *See supra* notes 79-81, 198-211 and accompanying text.

through traditional Delaware litigation.

In such a case, the Delaware courts could assess those bylaws actually enacted, with the benefit of a fully developed factual record illustrating their application, and apply the same presumption of validity historically applicable to all challenged bylaws.[242] While it has been fairly suggested that lack of clarity in Delaware regarding the appropriate balance of power between the board and the shareholders has effectively invited some degree of "stealth preemption" at the federal level,[243] the lack of clarity regarding the permissible scope of shareholder bylaws is at least partly attributable, as Vice Chancellor Strine observes, to "the inability of stockholders to actually get real proposals on the table."[244] Allowing through those proposals relating to matters unsettled under Delaware law would, as McDonnell explains, permit "much more extensive development of the law in this area, with more expert state judges making decisions with much more detailed reasoning than the SEC staff provides in no-action letters"[245]—all the while subject to potential state legislative intervention reflecting the interests of boards and shareholders, as well as federal legislative intervention reflecting the interests of a broader range of constituencies.[246]

To be sure, concerns regarding the costs of more numerous—and potentially vexatious—shareholder proposals at the federal level and litigation at the state level are entirely legitimate. Neither, however, need in fact occur. Regardless of the SEC's posture on state law-based exclusions, Rule 14a-8's present structure already suggests numerous alternative levers to pull in order to regulate the flow of shareholder proposals without distorting the development of state law. For example, Rule 14a-8 already requires that numerical threshold qualifications be met, including that the shareholder have held at least $2,000 in market value, or 1 percent, of the company's securities entitled to vote for at least one year, and continue to do so through the meeting; that each shareholder submit no more than one

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[242] *Cf.* CA, Inc. v. AFSCME Emp. Pension Plan, 953 A.2d 227, 238 (Del. 2008).

[243] Thompson, *supra* note 57, at 776.

[244] SEC, Roundtable Discussions, *supra* note 55, at 23; *see also id.* at 34, 79; Strine, *supra* note 122, at 1098; Gen. Datacomm Indus., Inc. v. State of Wisconsin Inv. Bd., 731 A.2d 818, 822 (Del. Ch. 1999).

[245] McDonnell, *supra* note 20, at 257.

[246] *Compare* SEC, Roundtable Discussions, *supra* note 55, at 34 (Vice Chancellor Strine observing that "if we make the wrong decisions, you can bet we are going to hear about it from the institutional investor community and from the management community"), *with* Roe, *Delaware and Washington as Corporate Lawmakers*, *supra* note 122, at 17 (observing that while boards and shareholders "are also influential at the federal level, an array of other interests and ideas also come into play").

proposal per meeting; and that the proposal be kept to 500 words.[247] The rule also permits exclusion of a proposal that "deals with substantially the same subject matter as another [recently submitted] proposal," based on the level of support the proposal previously received.[248] A host of similar bright-line eligibility criteria—perhaps raising the minimum investment level, or requiring a threshold showing of interest by some specified percentage of shareholders—might be employed to limit shareholder proposals to a reasonable, cost-justified volume.[249]

It should also be borne in mind that applying state law-based exclusions by reference to opinions of counsel[250] incorporates at least a weak constraint against inclusion of frivolous proposals—the lawyers' professional responsibilities. Admittedly, legal opinions submitted to SEC staff in connection with no-action requests are thought to be "low-risk from the firm's standpoint," one practitioner suggesting that "[t]here probably isn't a risk of third-party liability in this circumstance; rather than an opinion to a private party, it's more like written advocacy."[251] Nevertheless, such an opinion "still needs to be credible"[252] and, as any lawyer with an active securities practice is acutely aware, the SEC possesses the power to bar a lawyer from practicing before it if he or she is found to be "lacking in character or integrity or to have engaged in unethical or improper professional conduct."[253] One hopes, then, that norms of professionalism among the corporate bar, reputational considerations, and awareness of potentially dire consequences at the SEC would combine to deter sufficiently the rendering of frivolous legal opinions simply to permit shareholder clients to get proposals into company proxies.

At the state level, meanwhile, there is little reason to believe that a flood of bylaw-related litigation would cripple the Delaware Court of Chancery. In addition to the range of potential federal filters at the proposal stage, recall that Delaware courts already apply a very effective filter in the

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[247] 17 C.F.R. § 240.14a-8(b)(1), (c)-(d).

[248] *Id.* § 240.14a-8(i)(12).

[249] *See, e.g.*, SEC, Roundtable Discussions, *supra* note 55, at 43-45, 196-98, 229, 241; Strine, *supra* note 122, at 1100-01.

[250] *See supra* notes 155-171 and accompanying text.

[251] Berkeley, *supra* note 163, at "Legal Opinions."

[252] *Id.*

[253] 17 C.F.R. § 201.102(e)(1)(ii) (2010). The scope of such a bar would render it catastrophic for the lawyer in question, as the SEC defines "appearing and practicing before the Commission" to include providing advice in connection with any filing, and indeed any form of communication with the Commission. *Id.* § 205.2(a). Given the severity, the SEC has used this authority "exceedingly sparingly," and most often following "a prior disbarment by state bar authorities." *See* CHOI & PRITCHARD, *supra* note 132, at 184-85.

form of the ripeness doctrine, requiring that a bylaw be enacted before the courts will hear challenges to its validity.[254] Indeed, among the investor community there remains great enthusiasm for precatory proposals—that is, recommendations to the board, rather than mandates—as a means of fostering dialogue.[255] Assuming that precatory proposals are permitted by Delaware law,[256] they could in no event give rise to a dispute regarding the validity of a bylaw proposed by shareholders because, by hypothesis, such a bylaw could be enacted only with the cooperation of the board.[257]

## V. CONCLUSIONS

The SEC ought to reflect on the crowning irony of its resort to the much-heralded mechanism for certifying questions to the Delaware Supreme Court. Shareholders—the SEC's people—are effectively left worse off for the agency's engagement with the issue of shareholder bylaws than they would be if exclusion were simply refused, leaving gray-area proposals entirely to Delaware.[258]

To be sure, I have criticized elsewhere those recent initiatives aimed at expanding shareholders' governance rights as a faulty response to the financial crisis, and believe that the political and social forces motivating U.S. corporate law's historically ambivalent posture toward shareholders remain as potent as ever.[259] As the analytical approach taken by the Delaware Supreme Court in *CA, Inc.* tends to suggest, however, it is far from obvious that allowing more bylaw proposals into proxies at the federal level would necessarily translate into substantial expansion of shareholder power at the state level. As discussed above, Delaware's nascent bylaw jurisprudence appears to be closely tracking the analytical approach taken in

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[254] *See supra* notes 200-211 and accompanying text.

[255] *See* SEC, Roundtable Discussions, *supra* note 55, at 231 (Ann Yerger, Executive Director of the Council of Institutional Investors, explaining that institutions "in many cases . . . don't want to be overly prescriptive," whereas precatory proposals are viewed as a means of fostering "dialogue" and "communication"); *see also* LOSS & SELIGMAN, *supra* note 129, at 573 (characterizing the "very opportunity to submit proposals, even of an advisory nature," as "afford[ing] a safety valve for stockholder expression at a price that to the registrant would seem to be relatively slight"); Strine, *supra* note 122, at 1098 ("Gagging institutional investors from attempting to exercise their state law rights will, in the long run, just generate frustration and fuel appeals for more federal 'solutions.'").

[256] *See supra* note 179 and accompanying text.

[257] *See* SEC, Roundtable Discussions, *supra* note 55, at 79 (Vice Chancellor Strine observing that, "frankly, a lot of times the boards go along with it voluntarily once there is a stockholder vote").

[258] *See supra* part III.

[259] *See supra* note 104 and accompanying text.

its hostile takeover jurisprudence, reflecting the fact that the underlying matters at issue—the fundamental debates on corporate power and purpose that define the field—are virtually identical in these seemingly dissimilar settings. In each case, the court has used the board's fiduciary duties as a flexible means of massaging the policy choices at issue in thrashing out contested claims about the nature and purpose of Delaware corporations—essentially bracketing deeply contested social and political issues that continue to defy tidy resolution, while in the meantime endeavoring to maintain a workable and predictable corporate governance structure to the degree possible.[260] For lack of a better alternative—and in the absence of any governmental actor with greater overall legitimacy in such matters[261]—leaving them to Delaware remains the least-bad approach.

## APPENDIX

### General Bylaw Authority: Statutes By Type

| **Table 1: Bylaw Statutes Resembling Delaware's § 109(a)**[262] | |
|---|---|
| **State** | **Statute** |
| Delaware | DEL. CODE. ANN. TIT. 8 § 109 (2010) |
| Kansas | KAN. STAT. ANN. § 17-6009 (2009) |
| Maryland | MD. CORPS. & ASS'NS CODE ANN. § 2-109 (2010) |
| Massachusetts | MASS. GEN. LAWS ANN. CH. 156D § 10.20 (2010) |
| Missouri | SECTION 351.290, RSMO 2006. (2010) |
| New York | N.Y. BUS. CORP. § 601 (2010) |
| Ohio | OHIO REV. CODE ANN. 1701.11 (2010) |
| Pennsylvania | 15 PA.C.S. § 1504 (2010) |

[260] *See supra* part II.

[261] *See supra* part IV.

[262] Salient Delaware features include (1) inalienable shareholder bylaw authority; (2) board bylaw authority only if the charter provides; and (3) no guidance regarding their relationship. The Maryland, New York, and Pennsylvania statutes permit a shareholder bylaw to confer board bylaw authority. The Massachusetts, New York, and Pennsylvania statutes permit shareholders to amend or repeal board bylaws. The Maryland and Missouri statutes appear to permit divestment of shareholder bylaw authority (through the charter or bylaws in Maryland and through the charter in Missouri).

| Table 2: Bylaw Statutes Resembling MBCA § 10.20[263] | |
|---|---|
| **State** | **Statute** |
| Alabama | ALA. CODE § 10-2B-10.20 (2010) |
| Arizona | ARIZ. REV. STAT. § 10-1020 (2010) |
| Arkansas | ARK. CODE ANN. § 4-27-1020 (2010) |
| California | CAL. CORP. CODE § 211 (2009) |
| Colorado | COLO. REV. STAT. § 7-110-201 (2009) |
| Connecticut | CONN. GEN. STAT. § 33-806 (2010) |
| Florida | FLA. STAT. ANN. § 607.1020 (2010) |
| Georgia | GA. CODE ANN. § 14-2-1020 (2010) |
| Hawaii | HAW. REV. STAT. ANN. § 414-301 (2010) |
| Idaho | IDAHO CODE § 30-1-1020 (2010) |
| Illinois | 805 ILL. COMP. STAT. 5/2.25 (2010) |
| Iowa | IOWA CODE § 490.1020 (2010) |
| Kentucky | KY. REV. STAT. ANN. § 271B.10-200 (2010) |
| Maine | ME. REV. STAT. ANN. TIT. 13-C, § 1020 (2009) |
| Michigan | MICH. COMP. LAWS ANN. § 450.1231 (2010) |
| Mississippi | MISS. CODE ANN. § 79-4-10.20 (2010) |
| Montana | MONT. CODE ANN. § 35-1-234 (2010) |
| Nebraska | NEB. REV. STAT. ANN. § 21-20, 125 (2010) |
| New Hampshire | N.H. REV. STAT. ANN. § 293A-10.20 (2010) |
| New Jersey | N.J. STAT. ANN. § 14A:2-9 (2010) |
| North Carolina | N.C. GEN. STAT. § 55-10-20 (2010) |
| Oregon | OR. REV. STAT. § 60.461 (2009) |
| Rhode Island | R.I. GEN. LAWS § 7-1.2-203 (2010) |
| South Carolina | S.C. CODE ANN. § 33-10-200 (2009) |
| South Dakota | S.D.C.L. § 47-1A-1020 (2009) |
| Tennessee | TENN. CODE ANN. § 48-20-201 (2010) |
| Texas | TEX. BUS. ORG. CODE ANN. § 21.057 (2010) |
| Utah | UTAH CODE ANN. § 16-10A-1020 (2010) |
| Vermont | VT. STAT. ANN. TIT 11A § 10.20 (2010) |
| Virginia | VA. CODE ANN. §13.1-714 (2010) |
| Washington | WASH. REV. CODE. ANN. § 23B.10.200 (2010) |
| West Virginia | W. VA. CODE ANN. § 31D-10-1020 (2010) |
| Wisconsin | WIS. STAT. ANN. § 180.1020 (2010) |
| Wyoming | WYO. STAT. ANN. § 17-16-1020 (2010) |

[263]Salient MBCA features include (1) inalienable shareholder bylaw authority; (2) board bylaw authority unless the charter provides otherwise; and (3) shareholder capacity to insulate bylaws from board interference. The North Carolina statute requires affirmative authorization (in the charter or a shareholder bylaw) for the board to amend or repeal a shareholder bylaw.

| Table 3: Bylaw Statutes Resembling 1969 MBCA § 27[264] | |
|---|---|
| **State** | **Statute** |
| District of Columbia | D.C. CODE ANN. § 29-101.24 (2010) |
| Louisiana | LA. REV. STAT. ANN. § 12:28 (2010) |
| Minnesota | MINN. STAT. § 302A.181 (2009) |
| New Mexico | N.M. STAT. ANN. § 53-11-27 (2009) |
| North Dakota (BCA) | N.D. CENT. CODE § 10-19.1-31 (2010) |

| Table 4: Other Bylaw Statutes[265] | |
|---|---|
| **State** | **Statute** |
| Alaska | ALASKA STAT. § 10.06.228 (2010) |
| Indiana | IND. CODE ANN. § 23-1-39-1 (2010) |
| Nevada | NEV. REV. STAT. ANN. § 78.120 (2009) |
| North Dakota (PTCA) | N.D. CENT. CODE § 10-35-05 (2010) |
| Oklahoma | OKLA. STAT. ANN. TIT. 18 § 1013 (2009) |

[264] Salient 1969 MBCA features include (1) board bylaw authority "unless reserved to the shareholders" in the charter; and (2) inalienable shareholder authority to amend or repeal board bylaws. The District of Columbia and New Mexico statutes omit explicit shareholder authority to amend or repeal board bylaws.

[265] The remaining statutes vary considerably. The Indiana and Oklahoma statutes limit bylaw authority to the board unless the charter provides otherwise. The Alaska statute gives bylaw authority to both the board and the shareholders, while permitting either to be limited or eliminated in the charter. The Nevada statute gives bylaw authority to both the board and the shareholders, and permits shareholders to insulate bylaws from board interference, yet permits the shareholders' bylaw authority (but not the boards') to be eliminated in the charter. The North Dakota Publicly Traded Corporations Act (which, for companies opting in, supplements the Business Corporation Act and trumps it where they conflict under § 10-35-04) appears to provide that shareholders possess inalienable bylaw authority, the board possesses bylaw authority unless the charter provides otherwise, and shareholders possess inalienable authority to amend or repeal board bylaws.