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Bylaw Governance

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Abstract

This article argues that Delaware corporate law permits shareholders to use bylaws to circumscribe the managerial authority of the board of directors. While shareholders cannot mandate action by the board, they can enact specific prohibitions on its behavior, so long as the board retains enough discretion to implement—in practice, not merely in theory—its managerial policies by other means. The use of such circumscribing bylaws to discourage shirking (or analogous managerial abuses) by the directors or officers resembles the use of negative covenants in debt contracts that seek to prevent the debtor from squandering assets. Bylaw governance thus subtly but significantly reallocates governance power within the corporation, so as to reduce the agency costs of management. Its legal validity should also prompt courts and scholars alike to focus less on the quantity of power wielded by the shareholders, and more on the ways that power can be configured to produce managerial efficiencies.

KEYWORDS: Governance, Corporate Law, Bylaws

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INTRODUCTION

Shareholder bylaw power under Delaware corporate law has long been ill-defined. Section 109(b) of the Delaware General Corporate Law ("DGCL") states, rather unhelpfully, that almost any shareholder-enacted bylaw is valid if it is not "inconsistent with law." It also says nothing about what consistency with law means. It can be inferred that bylaws must respect the basic corporate principle of separated ownership and control. Indeed, it is widely accepted that bylaws cannot validly arrogate for shareholders the power to manage the business and affairs of the corporation, as that authority is granted exclusively to the board of directors.[1] At the same time, shareholders must be able to do *something* meaningful with their expressly non-derogable and expansive power to enact bylaws that "relat[e] 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."[2]

This article represents the first comprehensive analysis of shareholder bylaws since the landmark Delaware Supreme Court ("the Court"[3]) opinion in *CA, Inc. v. AFSCME*.[4] It shows that shareholders' inalienable power to amend corporate bylaws gives them the ability to enact what might be called circumscribing bylaws—that is, provisions that place substantive limits on the board's decision-making without narrowing the scope of the directors' managerial authority over corporate policy and action. Circumscribing bylaws cannot force decisions on the board; they can prohibit ways of implementing the

1. *See, e.g.*, John C. Coates IV & Bradley Faris, *Second Generation By-Laws: Post-Quickturn Alternatives*, 56 BUS. LAW. 1323, 1326 (2001) (noting that bylaws that "conflict with the board's authority under section 141(a) . . . to manage the business and affairs of the corporation" are likely invalid); Jeffrey N. Gordon, *"Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett*, 19 CARDOZO L. REV. 511, 546-47 (1997) (noting that the validity of bylaws are restricted the grant of managerial authority to the board under § 141(a)).

2. DEL. CODE ANN. tit. 8, § 109(b).

3. This Article does not refer to the U.S. Supreme Court, so this shorthand form is available for other use.

4. 953 A.2d 227 (2008).

board's judgment. The argument here is necessarily predictive in nature, as the Delaware courts have not expressly set forth a coherent framework for evaluating the legality of bylaws. Still, the circumscribing bylaw theory reconciles what otherwise appears to be a bewildering morass of inconsistent and sometimes incoherent cases—in particular, the convoluted[5] *CA* opinion and the important but similarly opaque Chancery Court case of *UniSuper, Ltd v. News Corp*.[6] Moreover, the 2014 opinion in *ATP Tour, Inc. v. Deutscher Tennis Bund* appears to be moving the law in this direction.[7]

This Article also addresses the implications of the shareholders' power to enact circumscribing bylaws, and how traditional corporate governance becomes supplemented by what might be called bylaw governance ("BG"). In particular, circumscribing bylaws provide shareholders with a conduit of direct authority useful for taking action against managerial 'shirking.'[8] The conduit must be narrow and it must leave control of the firm in the hands of the directors, who are the actors best-positioned to make sound business decisions.[9] Shareholders are

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5. Even Justice Jacobs admitted, in a talk at Harvard Law School, that the *CA* opinion he authored was not "necessarily the best way [the case] could have been handled." In part, the rushed procedural posture of the case negatively impacted the clarity of the resulting opinion. In Justice Jacobs' words, "if we had more than two weeks and were not under the pressure of time . . . we might have been able to write [the opinion] better." What the Court produced was not necessarily "the best way it could have been handled." For documentation of Jacobs' remarks, *see* Sabrina Ursaner, *Keeping "Fiduciary Outs" Out of Shareholder-Proposed Bylaws: An Analysis of* CA, Inc. v. AFSCME, 6 N.Y.U. J.L. & BUS. 479, 507-08 (2010).

6. No. 1699-N, 2005 Del. Ch. LEXIS 205 (Del. Ch. Dec. 20, 2005). As explained *infra* note 17, there are actually two *UniSuper* opinions: the original opinion in the case, and a subsequent opinion certifying the legal issues for interlocutory review. As it happened, the second opinion substantially revised the holding of the first, which has generally inhibited a clear understanding of the case holding.

7. 91 A.3d 554 (Del. 2014).

8. In this Article, 'shirking' is used as a term of art to refer to the pursuit of personal wealth or happiness by managers or directors at the expense of the companies they govern and/or the investors in those companies. Some scholars prefer a narrower, more traditional usage of the word 'shirking' to mean the substitution of leisure for work, but broad usage is hardly uncommon. *See, e.g.*, Stephen A. Bainbridge, *Corporation Law and Economics* 35-36 (2002) (defining "shirking" to "include any action by a member of a production team that diverges from the interests of the team as a whole . . . [including] not only culpable cheating, but also negligence, oversight, incapacity, and even honest mistakes").

9. *See, e.g.*, Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561 (2006) (collecting a number of persuasive arguments

simply not well-positioned to take an active role in company management,[10] and any governance system that confers on them the power to override the board's considered opinion invites "waste and disruption."[11] However, shareholders might be better situated to detect destructive decision-making processes and inefficient governance practices than the board,[12] and they certainly have more incentive to curtail opportunism or rent-seeking by insiders. Circumscribing bylaws gives shareholders just enough direct influence over management to curtail such abuses, while preserving the large universe of functionally substitutable[13] policy options from which the board can choose at its discretion.

Part I establishes the statutory foundation and normative desirability of bylaw governance. It specifies what it means for a shareholder-enacted bylaw to circumscribe, but not compromise, the board's discretion, and explains that the validity of such bylaws is implied by § 109 of the DGCL. It then sets forth the principal normative argument: BG can reduce certain types of agency costs that are

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against governance proposals that give shareholders greater power over corporate management). Perhaps the best argument against shareholder involvement is that shareholders should not want to manage the firm, since most know relatively little about the business and are not professional executives.

10. For an argument that shareholders cannot efficiently formulate corporate policy, *see* Stephen Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 608-10 (2006) (describing the "inefficiency of multiple constituency" decision-making). *See also* Brent H. McDonnell, *Shareholder Bylaws, Shareholder Nominations, and Poison Pills*, 3 BERKELEY BUS. L.J. 205, 237 (2005) (noting that very few people would disagree that "in a public corporation . . . it makes no sense for shareholders to engage in ordinary decision making").

11. *See* Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733, 743-44 (May 2007) (arguing that increases in shareholder voting powers will exact large costs "in corporate dollars wasted" on proxy contests and "perpetual management distraction").

12. Professors Brachton and Wachter observe that a shareholder-based agency model of the corporation sends management a simple instruction: "in all circumstances, manage to maximize the market price of the stock. And that is exactly what managers of some critical financial firms did . . . while fail[ing] to factor in concomitant increases in risk that went largely unobserved." *See* William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 658-59 (2010). This is but one illustration of the danger that can arise when shareholders' interests are represented only indirectly in the governance process.

13. "Functionally substitutable" is a rough approximation of the actual standard, explained in more detail in Part I.A.

generally unaffected by equity or incentive-based compensation, and can do so less intrusively than conventional shareholder-oriented governance systems. BG asks courts and scholars not to think of corporate governance as a zero-sum game in which power transferred to shareholders necessarily comes at the expense of the board, or vice versa. The quantity of power allocated to each group is far less important than the quality of that power. Because the board's power over corporate decision-making is nearly infinite,[14] it will never be compromised by a handful of targeted restrictions. It can be redirected toward more efficient mechanisms of effectuating the board's business judgments.

Part II develops the central positive argument in favor of BG, which is that the enforceability of circumscribing bylaws is implied by Delaware case law. *CA* established that shareholder-enacted bylaws are valid when they pass a two-prong test: (1) they must be within the "scope or reach" of the shareholders' bylaw power, and (2) they must not impermissibly intrude upon the managerial authority granted to the board by § 141(a).[15] The opinion, however, provides only a confusing and sometimes incoherent account of what these two prongs mean.[16] It makes the most sense when considered in light of the distinction between circumscribing and controlling bylaws. To say that a bylaw is within the "scope or reach" of the shareholders' bylaw power is to say that it has a circumscribing purpose—i.e. that it does not seek to mandate board action. To say that it is consistent with § 141(a) is to say that it also has a circumscribing effect. This distinction between circumscribing and controlling bylaws also animates other important decisions that address the proper allocation of authority between the shareholders and the board.[17]

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14. That is, the number of business decisions available to the board at any given time or on any given issue is, for all practical purposes, without limit. For instance, the CEO can be replaced by one of potentially thousands of candidates; the assets of the company can be organized, sold, or augmented in countless ways; the firm can enter or exit any number of markets or sub-markets, and so on.

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

16. In his talk at Harvard Law School, Justice Jacobs admitted that the procedural posture of the case influenced (in a negative way) the Court's exposition of the issues. *See supra* note 5.

17. Other than *CA*, the greatest attention is given to Frantz Mfg. Co. v. EAC Indus., 501 A.2d 401 (Del. 1985), Quickturn Design Sys. v. Mentor Graphics, Inc., 721 A.2d 1281 (Del. 1998), and the pair of decisions in the case of UniSuper, Ltd v. News Corp., No. 1699-N, 2005 Del. Ch. LEXIS 205 (Del. Ch. Dec. 20, 2005), and No. 1699-N, 2006 Del. Ch. LEXIS 11 (Del. Ch. Jan. 19, 2006).

I. BYLAW GOVERNANCE: AN OVERVIEW

As used here, the phrase bylaw governance ("BG") describes a variant of the prevailing Delaware corporate governance model[18] in which shareholders may exert authority over corporate affairs by promulgating bylaws that circumscribe the board's exercise of its authority. Such bylaws specify certain types of actions that management cannot take, and critically, have binding legal effect that can be enforced in court. The fundamental tenet of BG is that bylaws are valid as to *any* issue[19] so long as they are consistent with the certificate of incorporation and preserve nearly all[20] of the board's discretion to act according to its best business judgment.

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18. I refer here to the governance principles established in positive law by statute or case law, along with corollaries that would be accepted by most observers (though disputes may rage on normative issues). These include the propositions that: (a) management power is vested in the board of directors; (b) shareholders' inalienable right to guide corporate policy is limited to selecting directors and voting on specific matters as provided by statute; (c) a central role of the board of directors is to supervise and oversee the performance of the company's officers; and (d) directors' fiduciary duties run to the shareholders in the first instance. *See generally* Stephen Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003) (describing the implications of modeling the firm as a nexus of contracts); Jill Fisch, *Corporate Governance: Taking Boards Seriously*, 19 CARDOZO L. REV. 265 (1997) (describing the managing and monitoring duties of the board); Leo E. Strine, *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759 (2006) (stating the Delaware vice-chancellor's exposition of the traditional norms of corporate governance); Henry Hansmann & Rainer Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001) (describing the convergence of corporate governance systems worldwide toward a loosely defined "standard model" of shareholder-oriented but director-managed corporate governance); Martin Lipton & Jay W. Lorsch, *A Modest Proposal for Improved Corporate Governance*, 48 BUS. LAW. 59 (1992) (outlining a set of governance proposals as to board function and composition that were widely accepted in the years after it was published).

19. Any issue, in theory. But most ordinary business decisions will not be easily subject to circumscribing bylaws. *See infra* notes 57-59 and accompanying text.

20. The words "very nearly" perhaps understate the case. The central idea is that the board's managerial power is not diminished by prohibitions on specific, identifiable actions. At most, the directors could lose the unchecked power to adopt their favorite alternative of many roughly equivalent options. Such power may permit directors or other corporate insiders to extract rents—perhaps subconsciously—even when they remain faithful to the corporations' best interests. *See infra* notes 88-90 and accompanying text.

A. THE STATUTORY BASIS OF BG

The primary statutory basis for BG is section 109 of the Delaware General Corporate Law ("DGCL"), which defines the corporate bylaw power. Section 109(a) establishes that:

> After a corporation . . . has received any payment for any of its stock, the power to adopt, amend or repeal bylaws shall be in the stockholders entitled to vote. Notwithstanding the foregoing, any corporation may, in its certificate of incorporation, confer the power to adopt, amend or repeal bylaws upon the directors . . . . The fact that such power has been so conferred upon the directors . . . shall not divest the stockholders . . . of the power, nor limit their power to adopt, amend or repeal bylaws.[21]

In recent scholarship, Professors Gordon Smith and Christopher Bruner have separately noted that § 109(a) vests shareholders with an inherent authority over the bylaws that the certificate may not limit.[22] However, the issue may be more complex than they let on. The statutory text states only that the granting of bylaw power to the board does not *itself* divest shareholders of their bylaw power. Nowhere does § 109(a) address whether the shareholders' bylaw power can be separately compromised by a certificate provision expressly devoted to that end. Indeed, one could interpret the concluding sentence as merely a clarification that the bylaw power can in fact be concurrent; without such an explicit statutory command, courts and companies might have concluded that the granting of bylaw power to the board removes it from shareholders.

Still, a careful statutory analysis reaches the same conclusion as Professors Smith and Bruner. While § 109(a) may not expressly prohibit the divesture of the shareholders' bylaw power in the certificate, neither does it authorize that divestiture. Thus, the authority to do so would have to come from some other provision of the DGCL. The most natural candidate would be § 102(b)(1), which permits the certificate to contain

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21. DEL. CODE ANN. tit. 8, § 109.

22. *See* D. Gordon Smith, Matthew Wright, & Marcus Kai Hintze, *Private Ordering with Shareholder Bylaws*, 80 FORDHAM L. REV. 125, 150 (2011) (arguing that "the concluding sentence of § 109(a) seems designed to drive the point home that shareholders have an immutable statutory power"); Christopher M. Bruner, *Managing Corporate Federalism: The Least-Bad Approach to the Shareholder Bylaw Debate*, 36 DEL. J. CORP. L. 1, 6 (2011) (asserting that the corporate charter, per § 109(a) "may not limit the shareholders' own bylaw authority").

"any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders."[23] However, if this provision (or any other grant of authority) could apply to bylaws, then § 109(a) would be redundant. Why would that section need to provide that "any corporation may, in its certificate of incorporation, confer the power to adopt, amend or repeal bylaws upon the directors" if §102(b)(1) already authorizes it? The doctrine of independent significance, a fundamental interpretive principle in Delaware,[24] suggests that § 109(a) must have a purpose—which is to say that it must authorize something that § 102(b)(1) does not. In addition, even if *both* sections were to establish that the certificate can grant bylaw power to the board, Delaware courts also apply the maxim that any conflict between two statutory sections should be resolved in favor of the more specific one.[25] In this case, § 109(a) specifically declines to authorize the certificate to retract the shareholders' bylaw power, and certainly implies—though does not expressly state—that the shareholders' bylaw power cannot be compromised.[26] For these reasons, it is safe to agree with the recent scholarship that the shareholders' bylaw power is "sacrosanct."[27]

Section 109(b) presents a greater interpretive challenge. It provides that:

> (b) The 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.[28]

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23. DEL. CODE ANN. tit. 8, § 102(b)(1).

24. On the significance of this doctrine in Delaware corporate law, *see* D. Gordon Smith, *Independent Legal Significance, Good Faith and the Interpretation of Venture Capital Contracts*, 40 WILLAMETTE L. REV. 825, 828-40 (2004).

25. *See, e.g.*, Turnbull v. Fink, 668 A.2d 1370, 1377 (Del. 1995) (holding that when "two potentially conflicting statutes" cannot be reconciled, "the specific statute must prevail over the general").

26. DEL. CODE ANN. tit. 8, § 109(a).

27. *See supra* note 22.

28. DEL. CODE ANN. tit. 8, § 109.

The interaction of this section with § 141(a)[29] has been famously described as a "recursive loop."[30] According to this analysis, if shareholders enacted a bylaw pertaining to managerial decisions, it would violate the delegation of managerial authority to the board set forth in § 141(a). However, § 141(a)'s allocation of managerial power to the board can be curtailed by another provision of the DGCL—for instance, § 109(b) permits shareholders to enact bylaw provisions "relating to the business of the corporation."[31] Together, the two sections make clear that managers have exclusive managerial authority on all issues that lay beyond the shareholders' bylaw power. Unfortunately, this is a tautology—every possible allocation of authority between directors and shareholders is consistent with the statutory language.[32] We know that there must be some decisions shareholders cannot make with their residual bylaw power, as corporations are not participatory democracies.[33] But the line between valid and invalid bylaws does not appear to be demarcated by §109(b) and §141(a) alone.

In the absence of determinate statutory language, various theories of bylaw validity have been constructed around policy considerations.[34]

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29. DEL. CODE ANN. tit. 8, § 141(a) (providing that "the business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors," unless otherwise provided by the DGCL).

30. *See* Jeffrey N. Gordon, *"Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett*, 19 CARDOZO L. REV. 511, 546-47 (1997) (noting that any interpretation of the scope of the bylaw power runs into a "recursive loop," because the bylaws are restricted by § 141(a), but § 141(a) is limited by other provisions in the DGCL, presumably including § 109).

31. DEL. CODE ANN. tit. 8, § 109(b).

32. For instance, suppose A believes that compensation matters can be determined by shareholders under § 109(b). She would argue that the § 141(a) grant of exclusive authority to the board is limited by the grant of authority over compensation in § 109(b). By contrast, if B believes that compensation is not within shareholders' power, but business strategy is, he would make exactly the same argument, merely using the word strategy wherever A uses the word compensation. Both arguments have exactly the same truth value. The recursive loop provides no mechanism for preferring one argument over another, nor over C's argument in which "compensation" is replaced by "nothing."

33. *See, e.g.*, Quickturn Design Sys. v. Mentor Graphics, Inc., 721 A.2d 1281, 1291 (Del. 1998) (holding that "[o]ne of the most basic tenets of Delaware corporate law is that the board of directors has the ultimate responsibility for managing the business and affairs of a corporation[]" per § 141(a)).

34. *See, e.g.*, John C. Coffee, Jr., *The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?* 51 U. MIAMI L. REV. 605 (1997) (proposing ways to distinguish valid from invalid bylaws); McDonnell, *supra* note 10 at

These theories, however, have largely failed, because they turn on *ad hoc* distinctions between business decisions that are somehow 'special' enough to be regulated by shareholders, and the day-to-day decisions that entirely remain in the hands of the directors.[35] For instance, it has been argued that bylaws are valid insofar as they address 'special' issues that are "fundamental" or "procedural," or related to "corporate governance," and invalid if they pertain to "ordinary," "substantive," or "business decisions."[36] However, it is optimistic to assume that clean taxonomies—or even ones that are not convoluted and cryptic—can be imposed on the wide range of actions that boards may take. Many decisions have many different ramifications, and thus can be both special and ordinary. For instance, determining executive compensation is a quintessentially managerial task and part of the more general issue of resource allocation within the firm. But that decision also disproportionately influences the basic nature of the shareholders' investment, as it affects the future direction of the company, the risk-tolerance of executives, and its responsiveness to shareholders' interests. To argue that compensation is (or is not) shareholder-actionable is simply to privilege, without basis in statute or case law, one of these different aspects of the compensation decision.

This Article contends that the interaction between § 109(b) and § 141(a) is greatly clarified by the oft-ignored § 109(a). That latter provision holds the key to determining bylaw validity—not because of the rule it sets forth, but rather because it sets forth a mandatory rule. Mandatory rules of corporate law are precious. Most provisions of the DGCL establish default rules that can be modified by the certificate. Only three other corporate governance rules[37] are mandatory and non-waivable, each one applying to issues of the utmost importance to

237 & 251 (summarizing the views of scholars on the subject of bylaw validity and arguing that the validity of a bylaw should turn on whether it pertains to corporate governance).

35. For a critique of such distinctions as *ad hoc*, and a view that bylaws seeking to control director authority are anachronistic, *see* Lawrence A. Hammermesh, *Corporate Democracy and Shareholder-Adopted Bylaws: Taking Back the Street?*, 73 TUL. L. REV. 409, 433-46 (1998).

36. *See* Coffee, *supra* note 34, at 613-15.

37. This specifically refers to rules that allocate power between the board, the officers, and the shareholders.

shareholders:[38] the shareholders' merger veto must be preserved;[39] charter amendments are subject to shareholder approval;[40] and the shareholders must be permitted to inspect the books and records.[41] Many indisputably weighty matters do not receive this level of protection. For instance, the allocation of managerial authority to the board can be modified by charter,[42] and voting rights can be eliminated for some classes of stock.[43] It would therefore be logical to expect that the

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38. *See* Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1554 n.16 (1989). As Professor Gordon notes, there are other mandatory provisions, but these are not rules so much as limitations or qualifications of powers that are purely optional. For instance, if the company wants a staggered board, a maximum of three classes can be created; if the board or shareholders wants to delegate board power to a committee, that delegation cannot include decisions over mergers or bylaw amendments, etc. Gordon cites the rule that derivative suits cannot be brought without prior demand on the board, but that is a rule of civil procedure, not of the DGCL. *See* Del. Ct. Ch. R. 23.1(a) (a derivative suit "complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors"). There is also the appraisal right, *see* DEL. CODE ANN. tit. 8, § 262, which cannot be waived as such in the charter. But the appraisal right is not available for publicly traded companies in stock-for-stock deals. Thus, the board can avoid the appraisal right at its discretion; far from being non-waivable, the appraisal right is, in an important sense, optional.

39. *See* DEL. CODE ANN. tit. 8, § 251(c) (providing that a merger agreement shall become effective only when "a majority of the outstanding stock of [each] corporation entitled to vote thereon shall be voted for the adoption of the agreement"); DEL. CODE ANN. tit. 8, § 271(a) ("Every corporation may . . . sell, lease or exchange all or substantially all of its property and assets . . . when and as authorized by a resolution adopted by the holders of a majority of the outstanding stock of the corporation entitled to vote . . . .").

40. All charter amendments must be ratified by the shareholders. DEL. CODE ANN. tit. 8, § 242(b)(1). In addition, charter amendments that adversely affect the rights or economic interests of a particular class of stock must be ratified by a majority vote of that class. DEL. CODE ANN. tit. 8, § 242(b)(2).

41. *See* DEL. CODE ANN. tit. 8, § 220(b).

42. *See* DEL. CODE ANN. tit. 8, § 141(a) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.").

43. DEL. CODE ANN. tit. 8, § 212(a) ("Unless otherwise provided in the certificate of incorporation . . . each stockholder shall be entitled to 1 vote for each share of capital stock held by such stockholder."). Non-voting common stock is not frequently issued, but it does occasionally show up in the case law. *See, e.g.*, *In re* Frederick's of Hollywood, Inc., No. C.A. 15944, 2000 WL 130630, at *2 (Del. Ch. Jan. 31, 2000) ("As of December 6, 1996, Frederick's had issued and outstanding . . . 5,903,118 shares of Class B common stock (which were non-voting) that were held by approximately

shareholders' inviolate bylaw power would carry considerable significance. It would make little sense for the legislature to build a fortress around a power that could be exercised only with respect to isolated and largely trivial issues such as establishing the board's quorum.[44]

In other words, the bylaw power should be interpreted to protect the shareholders' essential interest in preventing gross mismanagement. Admittedly, § 109 provides no textual foundation for such a claim, but the existence and nature of such an interest can be inferred by analogy. Each of the other mandatory rules protects the shareholders' investment from being spoiled by the faithlessness or negligence of the board. The shareholder veto over mergers protects the shareholders from being forced to sell their equity at a lowball price;[45] the veto over charter amendments protects the shareholders from the curtailment of essential rights;[46] and the right to inspect the books gives shareholders the ability to detect misappropriation of corporate funds by the board.[47] These rights were made non-waivable to guard against opportunism by the board and/or powerful insider shareholders, who otherwise might

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504 shareholders of record."). Preferred stock frequently is stripped of voting rights. It is unclear if a corporation can eliminate voting rights from all classes of its equity securities.

44. *Cf.* CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 235 (Del. 2008) (noting that § 141(b) "authorizes bylaws that fix the number of directors on the board, [and] the number of directors required for a quorum (with certain limitations)").

45. *See* Gordon, *supra* note 38, at 1593 (noting that "[t]ransactions that transform the economic structure of the firm" such as mergers or asset sales are subject to non-waivable rules because such transactions can "tilt economic payoffs in a large-scale way").

46. *Id.* at 1591 (arguing that charter amendments should be viewed "in the same light as a merger between a parent and a partially owned subsidiary"). Charters also specify liquidation preferences. *See* DEL. CODE ANN. tit. 8, §§ 151(a), 242(a)(3) (specifying that designations and preferences shall be stated and expressed in the certificate of incorporation, and that the certificate can be amended to change the par value, preferences or designations of shares). Thus, shareholders without a veto power over certificate amendments could find their preferences eliminated, or alternately, their residual interests crushed underneath a mountain of preferred stock.

47. *See, e.g.*, ATR-Kim Eng Fin. Corp. v. Araneta, No. 489-N, 2006 Del. Ch. LEXIS 215, at *20-25 (Del. Ch. Dec. 21, 2006) (describing how a minority shareholder used a "books and records" request to discover that the majority shareholder had secretly stripped assets from the corporation and diverted them to his family members).

pressure or deceive shareholders into alienating them.[48] Consequently, the bylaw power should protect against some similarly severe loss of equity value that shareholders might not otherwise be able to prevent.

Indeed, the importance of such protection follows directly from the business judgment rule, which insulates directors from liability for their bad managerial decisions. Chancellor Allen has eloquently explained why shareholders should not want the ability to sue directors merely for making risky investment decisions: as a group, shareholders generally profit when the board takes risks, and a rule that holds the board responsible for answering for risks gone awry would chill the very behavior that shareholders want to promote.[49] However, this astute reasoning tells us only that shareholders should not want the right to hold the board liable ex post. It does not mean they should be indifferent to the board's foolishness. It is often said that the shareholders' chief remedy for inadequate performance of management is the power of the franchise—the ability to remove underperforming directors from the board.[50] Nowhere is it written that this removal power—largely a

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48. *See* Gordon, *supra* note 38, at 1574-75. *In re* Delphi Financial Group Shareholder Litigation, No. 7144-VCG, 2012 Del. Ch. LEXIS 45 (Del. Ch. 2012) describes an interesting example of such pressure. There, the founder, CEO and controlling shareholder of Delphi Financial essentially forced the public shareholders to repeal a certificate provision preventing him from obtaining a control premium for his shares in a proposed acquisition. *In re* Delphi Financial Group Shareholder Litigation, No. 7144-VCG, 2012 Del. Ch. LEXIS 45 at *3 (Del. Ch. 2012). That provision had been added to the charter when the company was taken public in 1990, presumably as a sale of the control premium right during the IPO. *Id.* at *3. Twenty years later, the controlling shareholder refused to permit the company to be sold—at an approximately 100% premium to market!—unless that provision was eliminated to allow him to receive an even higher price. *Id.* at *3-4. What choice did the board have, but to put the certificate amendment to the shareholders, and what choice did the shareholders have but to approve? On those facts, shareholders might be protected by fiduciary duties; the allegations in *Delphi* that the controller had acted in bad faith survived a motion to dismiss. The opinion's reasoning gives little reason to think that its holding would apply far beyond the specific facts.

49. *See* Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1052-55 (Del. Ch. 1996).

50. *See, e.g.*, MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1127 (Del. 2003) (noting that "[the Delaware Supreme] Court has repeatedly stated that, if the stockholders are not satisfied with the management or actions of their elected representatives on the board of directors, the power of corporate democracy is available to the stockholders to replace the incumbent directors"); Blasius Indus. v. Atlas Corp., 564 A.2d 651, 659 (noting that "[g]enerally, shareholders have only two protections against perceived inadequate business performance. They may sell their stock . . . or they may vote to replace incumbent board members").

reactive remedy[51]—implies that shareholders are powerless to take prophylactic measures. To the contrary, enabling such ex ante protection against mismanagement appears to be the central purpose of § 109.

At the same time, bylaws must respect, per the "not inconsistent with law" language of § 109(b),[52] the fundamental command of § 141(a) that the firm's "business and affairs . . . shall be managed . . . by or under the direction of a board of directors." Fortunately, these two provisions can be reconciled more easily than the "recursive loop"[53] argument suggests.[54] Section 141(a), by its own terms, is a *general grant* of managerial authority to the board; so long as bylaws do not challenge that general grant, they can be consistent with § 141(a) regardless of what issues they address. To be sure, a bylaw could easily encroach on the board's authority if it imposes on it particular managerial decisions, either directly (i.e. bylaws of the form "the board must do X") or indirectly (i.e. bylaws of the form "the board must not do A, B, C, etc." so that the only practicable choice remaining would be X). However, if an individual bylaw seeks to protect against mismanagement by identifying a single policy that it prohibits the board from implementing, leaving the board with virtually unlimited alternatives, it is hard to see how that in anyway threatens the statutory command of § 141(a).

To say that the board has broad managerial discretion is to say that it has a very large set of possible decisions at its disposal.[55] At the same

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51. In theory, it is possible for shareholders to anticipate that the business strategy of the board will have unhappy results, and thus remove the board proactively. In practice, the board is very rarely removed until the firm has performed quite poorly. *See generally* BEBCHUK & FRIED, *infra* note 99.

52. DEL. CODE ANN. tit. 8, § 109.

53. DEL. CODE ANN. tit. 8, § 141(a).

54. *See generally* Gordon, *supra* note 1 and accompanying text.

55. Indeed, unless the board's power is constrained by the certificate of authority, there are few lawful actions that the board cannot approve. It can donate corporate assets to charity. *See* DEL. CODE ANN. tit. 8 § 122(9) ("Every corporation . . . shall have power to [m]ake donations for the public welfare or for charitable, scientific or educational purposes . . . ."); Theodora Holding Corp. v. Henderson, 257 A.2d 398 (Del. Ch. 1969) (holding that § 122 authorizes any charitable donations so long as they are "reasonable"). Boards commonly give money away to private individuals—namely, former executives—in what Bebchuk and Fried call "gratuitous goodbye payments." *See* Lucian A. Bebchuk & Jesse M. Fried, *Symposium on Bebchuck & Fried's Pay without Performance: Overview of the Issues*, 30 IOWA J. CORP. L. 637, 663 (2005) (describing the prevalence of severance payments not required by the executive's

time, § 109(b) permits the bylaws to remove large sets of options from consideration by the directors—i.e. options that constitute the forms of grievous mismanagement against which § 109(b) protects. The bylaw-enacted invalidation of certain types of decisions by the board leaves the board with nearly unlimited discretion, and more or less as expansive as if there were no bylaws at all. Moreover, in practice the shareholders will enact but a handful of bylaws. If the bylaws are circumscribing in nature, their effect on managerial discretion would be infinitesimal.

B. What Is A Circumscribing Bylaw?

Section A described and derived the central tenet of BG:[56] Bylaws are valid and enforceable so long as they merely circumscribe the board's discretion, without attempting to control or bind it. Parts II and III of this Article evaluate the consistency of this hypothesis with Delaware case law, and section C of this Part will offer a normative defense of BG. Before moving onto either of these topics, it will be useful to more precisely define what it means for a bylaw to be circumscribing, and to consider some concrete examples.

A bylaw is circumscribing if it prohibits the board from implementing certain specified policies without reducing its overall discretion.[57] Bylaws that are not circumscribing can be said to be controlling, in that they force the board, *de jure* or *de facto*, to adopt a particular policy. Built into these concepts is a type of substance-over-

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compensation contract, which are granted to the executive after it has become clear that the executive's employment will be terminated).

56. It should be noted that this Article does not at all address federal securities law. Many circumscribing bylaws of the sort that I contend are enforceable under Delaware law might be excludable from the company's proxy statement under Rule 14a-8. That rule, for instance, permits the company to exclude proposals "deal[ing] with a matter relating to the company's ordinary business operations." 17 C.F.R. § 240.14a-8 (2011). Quite simply, proxy access and bylaw enforceability are distinct issues, even if they are somewhat co-dependent in practice.

57. This distinction between circumscribing bylaws and controlling bylaws to some degree resembles one of Professor Coffee's hypothetical tests for bylaw validity—one that he characterized as "affirmative orders versus negative constraints." *See* Coffee, *supra* note 34, at 614. However, it is not clear just what Coffee had in mind. He mentioned this distinction only in passing, without any explanation of what it meant, how it could operate as a legal rule, or how it was consistent with the statutory text. He wrote that that the "case law seems clearest" in establishing this as a test of bylaw validity, but no case citations. *Id.* Nor did he characterize the difference between affirmative orders and negative constraints as an empirical question. *Id.* at 608-09.

form analysis not unlike the one applied in *CA*.[58] To determine whether a bylaw was in fact circumscribing, a court would look not to the wording or the logical structure of the proposed bylaw restriction, but rather to the actual quantity and variety of options that would remain open to the board when the bylaw is implemented.[59] Thus, characterizing a bylaw as circumscribing is a fact-bound, if not precise, process.

It is important to be careful about defining what exactly constitutes the board's discretion. The number of options theoretically available to a board of directors at any given time is nearly unlimited; if they were all considered to be valid substitutes or alternatives for each other, then even highly intrusive shareholder interference could be characterized as circumscribing. For instance, consider the argument of an investor who wants to characterize as circumscribing a bylaw prohibiting an automaker from investing in any manufacturing facility that draws power from a carbon-burning electric plant: *millions of options would still remain! The company could build in areas with an abundance of wind power, launch (or acquire) a consulting business, invest in solar energy, pay dividends instead of re-investing in the company, outsource its manufacturing, etc*. To accept this argument would grant shareholders a veto power over nearly any substantive decision of the firm, because those options (or equivalent ones) are always available.

The key concept for assessing whether a bylaw circumscribes or controls is substitutability. What matters is not the number of options theoretically retained by the board, but the number that are reasonably substitutable for the policy that the bylaw purports to take away. This inquiry should be framed by the legitimate purpose of the decision or

58. *See* CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 236 (Del. 2008) ("But the Bylaw's wording, although relevant, is not dispositive of whether or not it is process-related. The Bylaw could easily have been worded differently, to emphasize its process, as distinguished from its mandatory payment, component.").

59. A hypothetical example illustrates the point. Suppose a company is considering ten possible locations for siting a manufacturing facility: five in Mexico, four in Costa Rica and one in Malaysia. If a shareholder proposes a bylaw that says "the company shall not locate a manufacturing plant within 3000 miles of the United States border," in form, that is circumscribing. In reality, such a proposal would be functionally equivalent to a binding bylaw requiring the facility to be sited in Malaysia. In such cases, courts will look behind the formal structure to the underlying reality.

policy prohibited by the bylaw.[60] To use the automaker example above, the investor's argument would fail because a consulting business is not a reasonable substitute for an automobile plant; the value propositions of these two investments implicate completely different economic and organizational concerns.[61] Or to take an example from finance, issuing equity is, in practice, rarely a reasonable substitute for issuing debt.[62] Thus, a bylaw prohibiting new debt issuance would not be circumscribing, but a bylaw prohibiting the issuance of certain types of debt (e.g., debt with ultra-short maturity) might be. Of course, shareholders would not invest energy passing bylaws about ordinary business matters such as the term structure of debt,[63]—unless it was something particularly dangerous, such as an overreliance on overnight

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60. By "legitimate" purpose, I am referring only to the purposes that would be accepted under the business judgment rule. Just as a director would not fare well in court if she defended her decision as the best means to entrench herself in office, the circumscribing nature of a bylaw would not be measured by whether the board retained alternatives as useful for self-dealing or shirking. I am not intending to invoke any strongly normative concept, such as the "legitimate business purpose" standard articulated in Wilkes v. Springside Nursing Home, 353 N.E.2d 657, 663 (1976).

61. For instance, a board might have an economic forecast in which demand for automobiles increases, which would make the automobile plant an attractive investment. It would say nothing in particular about demand for consulting—let alone debt collection services, railroad transport or even automobile financing. It would be outrageous to suggest that the board needs to consider all possible investments before making its decision, or even attempt to find the globally optimal investment. Likewise, boards will naturally take account of the manageability of the investment. For instance, an auto company will find it much easier to manage a new auto plant than a non-auto related investment. These two factors are just illustrations of the many ways in which different types of investments would not be considered to be reasonable substitutes.

62. Typically, firms issue equity only when they are unable to finance their capital needs from internal earnings or through debt. This is because the use of equity financing sends a signal—intended or not—to the market that management thinks poorly of the firm's future prospects. Hence firms will find it cheaper to finance out of internal earnings first, then to issue debt, and to issue equity only as a last resort. For description of this "pecking order" theory of finance and some citations to empirical evidence supporting it, *see* Robert P. Bartlett III, *Taking Finance Seriously: How Debt Financing Distorts Bidding Outcomes in Corporate Takeovers*, 76 FORDHAM L. REV. 1975, 1988 (2008).

63. Note that this would not be true of non-circumscribing bylaws. An investor who foresees a future rise in interest rates might try to compel the board to issue only long-maturity debt. This could be achieved by means of a controlling bylaw, but not with a circumscribing one.

repo borrowing rendering vulnerable to sudden illiquidity.[64] In such cases, a shareholder intervention may be greatly desirable.

To illustrate the concept, consider the following potentially useful circumscribing bylaws, some of which will be discussed later in the Article:

- A Real Say On Pay: This type of bylaw would permit shareholders to prohibit particular compensation practices, although not necessarily the overall amount. For instance, a bylaw might prohibit repricing of option grants, or require the strike prices of granted options to be indexed to broader market indices. Such bylaws would differ from the "say on pay" provisions of the Dodd-Frank Act[65] in two important respects. First, they would have legal force, as opposed to being merely advisory.[66] Second, they would not give shareholders a say over the entire compensation package, but merely some input over the form that compensation will take. Such bylaws would be circumscribing because they would permit the board great latitude in setting the amount of compensation and its form; only certain compensation measures would be taken off the table.

- No First Vote: This type of bylaw would prevent the board from issuing shares of stock in a private placement without a restriction preventing the shares from being voted in the first annual and/or special meeting following their issuance.[67] The purpose here would be to prevent managers

64. This type of overreliance triggered the collapse of Bear Stearns and Lehman Brothers. When counterparties chose not to lend against the repo collateral, Bear and Lehman could not satisfy a huge balance of immediately due liabilities, since they were holding mostly non-salable assets. *See* Brian J.M. Quinn, *The Failure of Private Ordering and the Financial Crisis of* 2008, 5 N.Y.U. J.L. & BUS. 549, 594 (2009). As it turns out, most of those non-salable assets also turned out to be non-valuable, but in theory both firms could have failed simply by virtue of the mismatched term structure of their assets and liabilities.

65. Pub. L. No. 111-203 (July 21, 2010) (hereinafter "Dodd-Frank").

66. *Id*. Dodd-Frank § 951 (providing that shareholder resolutions on compensation "shall not be binding on the issuer or the board of directors of an issuer").

67. Weaker forms of this bylaw might be more narrowly tailored to the bylaw's purpose at the expense of somewhat less protection of shareholders' interests. For

from stacking the deck in a close vote by issuing large blocks of equity to allied third parties expected to vote in favor of the managers' position.[68] It would be circumscribing because it permits the company to raise capital by practically any means imaginable, including equity issuance.[69]

- Director or Officer Term Limits: These speak for themselves. They can prevent entrenchment,[70] and promote a level of director turnover sufficient to prevent the board from becoming complacent or ineffective.[71] Such limits would be circumscribing because they permit the board to choose nominees to the board from an almost unlimited pool of applicants, just not the directors whose terms have expired.

- No Reappointment of Removed Directors: Boards of directors sometimes reappoint directors who have been

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instance, the restriction on the newly issued shares could last only 90 days, or perhaps a separate shareholder vote would be required for it to have effect.

68. *See, e.g.*, Frantz Mfg. Co. v. EAC Holdings, Inc., 501 A.2d 401, 403-04 (Del. 1985) (describing a plan by a board of directors to dilute the holdings of an adverse controlling shareholder by issuing stock to the company's Stock Ownership Program, administered by the board).

69. Indeed, it would be unlikely that new investors who are not white knights would place a high value on a single shareholder vote. At the very most, the company might have to accept a slightly lower price for the equity shares. If the company was actually unable to issue equity on these terms, then the bylaw might cease to be circumscribing in fact.

70. Term limits have been endorsed for this reason even by Martin Lipton, the supposed entrencher of "me-first managers" and "apologist for embattled chief executives who don't like shareholders sounding off on excessive pay and cozy boards." *See* Lipton & Lorsch, *supra* note 18, at 68; for the unflattering characterization, *see* Gretchen Morgensen, *Memo to Shareholders: Shut Up*, N.Y. TIMES, Feb. 11, 2007 at D1.

71. It is worth noting that from 2005 to 2008, the majority of the independent directors of Bear Stearns and Lehman Brothers had served on the boards for more than a decade, and disproportionately likely to be octogenarians. Some commentators have opined that companies would be better served with somewhat younger directors. *See, e.g.*, Marc Goldstein, *Mitigating Dysfunctional Deference Through Improvements in Board Composition and Board Effectiveness*, 103 NW. U. L. REV. COLLOQUY 490, 497 (2009) (urging investors to weigh the benefits of "expertise and free time" against those of "youth and diversity").

> voted out of office.[72] This quite obviously undermines the efficacy of shareholder democracy. To be sure, the reappointment decision is frequently motivated by good reasons—for instance, the director might have expertise rendering her service indispensable—but shareholders have a good reason to prohibit this practice: their vote should have a sting, so that directors are motivated to perform well. As with the issue of term limits, the circumscribing nature of this bylaw is obvious; it merely prevents the appointment of a small number of individuals out of the entire universe of qualified people.

The primary claim of this Article is that BG describes existing Delaware law, because the Delaware courts will enforce circumscribing bylaws as defined here. But before demonstrating that claim in the case law, it will be useful to inquire why shareholders would want to be able to promulgate circumscribing bylaws. By definition, they have a somewhat limited effect and permit the directors to retain ample discretion. In what ways are they useful? Would shareholders want more than circumscribing power? How would circumscribing bylaws affect the efficiency of corporate governance? These questions are addressed in the next section.

C. THE NORMATIVE CASE FOR BG

BG, like all theories of corporate governance, addresses a fundamental policy question: how can corporations operate efficiently when they are run by directors and officers who do not bear the costs of the decisions they make? As Berle and Means long ago observed, modern businesses consume capital so prodigiously that their operations can be financed only by aggregating the resources of a large number of

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72. *See, e.g.*, Airgas, Inc. v. Air Prods. & Chems., Inc., No. 5817-CC, 2010 Del. Ch. LEXIS 206, at *18 (Del. Ch. Oct. 8, 2010) (noting that, in response to a proxy contest that removed a director from the board, the Airgas board added a new seat and reappointed the removed director); U.S. Surgical Corp. v. Circon Corp., No. 15223, 1997 Del. Ch. LEXIS 161, at *4 (Del. Ch. Sept 17, 1997) (describing an announcement made by a company in its proxy statement that it would consider reappointing a director if the shareholders voted him out of office).

investors, most commonly on a foundation of publicly owned equity.[73] Professor Bainbridge, among many others, has reminded us that such a dispersed ownership base cannot manage an enterprise.[74] Perhaps more importantly, investors by and large do not want to.[75] The task must be delegated to dedicated professionals, and this, of course, creates an incentive for those professional managers to shirk.[76] While investors seek to minimize shirking (more precisely, the agency costs of shirking[77]), they also want to respect the managers' autonomy; after all, the managers were hired in the first place because investors lack enough information to intelligently make (or evaluate) business decisions.

Thus, the delicate task of corporate governance is to reduce agency costs while preserving sufficient independence for managers to make the decisions needed to maximize the value of the firm.[78] By this measure,

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73. *See* Adolf A. Berle, Jr. & Gardiner C. Means, *The Modern Corporation and Private Property* 6 (1932). Today, publicly-traded stock is common but not necessary. The "public" can indirectly own equity stakes in companies by means of intermediaries such as private equity, hedge or mutual funds. Companies controlled by private equity funds are considered closely held from a legal and operational point of view, though the economic benefits of that equity ownership may be widely dispersed.

74. *See* Bainbridge, *supra* note 18, at 557 (describing the problems inherent in decision-making structures characterized by dispersed authority).

75. *See* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 301-02 (1983) (arguing that corporations benefit from the separation of ownership and control because it can take advantage of the specialization of labor, hiring professional managers with deep expertise in their field).

76. On the definition of shirking as used in this article, *see supra* note 8.

77. Quite obviously, investors care about the impact of shirking on the bottom line, not the metaphysical question of "how much" shirking is going on. The cost of shirking is typically referred to as an agency cost, by analogy to the loss that a principal suffers when the agent does not faithfully follow instructions. *See, e.g.*, Robert H. Sitkoff, *The Economic Structure Of Fiduciary Law*, 91 B.U. L. REV. 1039, 1042 (2011) ("The losses and other inefficiencies resulting from the misalignment of the principal's and the agent's interests are called agency costs."). Note that this terminology does not imply that the directors or managers should be regarded as agents of shareholders. *See, e.g.*, Lynn A. Stout, *The Mythical Benefits Of Shareholder Control*, 93 VA. L. REV. 789, 791 (2007) (describing the incidence of agency costs in an article denying the validity of the principal/agent model of corporations).

78. This formulation is intended to be as consistent with as many theories of the firm as possible. The vast majority of corporate scholars would agree that reducing agency costs and maximizing the value of the firm are both desirable ends, all else being equal. I leave open the possibility that these goals are not fully compatible, which is to say that value might be maximized when agency costs are greater than the minimum achievable level. *See, e.g.*, Stout, *supra* note 77, at 790 (arguing that shareholders benefit from board governance despite its high agency costs, because it

BG can outperform the two governance paradigms that have received the most attention and advocacy from scholars in recent years. The "director primacy" ("DP") view of corporate governance asserts that corporations run most efficiently when managerial authority is centralized in the board of directors as much as possible.[79] Adherents of this view expect the board both to closely monitor the officers to make sure they are not shirking, and to fend off demands from the shareholders for near term profits that might come at the expense of long-term success.[80] By contrast, the "shareholder empowerment" view contemplates an active role for shareholders in the management of the corporation, permitting them to decide a number of fundamental issues, such as when the corporation should liquidate, distribute its earnings, sell itself to a bidder, or where it should incorporate.[81] This view, most closely identified with Professor Bebchuk, profoundly distrusts the directors' ability and/or inclination to act in the best interests of the shareholders, and calls attention to structural biases in board decision-making that result in inefficiently lavish compensation for managers and job security for the directors and officers alike.[82]

1. BG vs. Director Primacy

When comparing BG with DP, it should be noted at the outset that BG only mildly deviates from DP's central descriptive and normative

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"also promotes efficient and informed decision-making" among other more-than-offsetting benefits). If that were the case, I believe most scholars would prioritize value maximization. Real disagreement exists, however, as to whether the maximized value should be that of the shareholders' equity or a broader measure of economic value. *Compare* Hansmann & Kraakman, *supra* note 18, at 439-40 (arguing that the proper role of the corporate board and management is to maximize shareholder wealth), *with* Kent Greenfield, *Defending Stakeholder Governance*, 58 CASE W. RES. L. REV. 1043 (2008) (arguing that the concerns of all the firm's investors, including "employees, communities [and] creditors," should be "brought into the governance of the firm"). My intention is to be agnostic on these issues.

79. *See, e,g.*, Bainbridge, *supra* note 18 (expounding his view on the importance of director primacy).

80. *See, e.g.*, Lipton & Savitt, *supra* note 11, at 745-46, 750-51 (describing how a strong board of directors can protect against "short-termism" in corporate management and protect the firm from "runaway agency costs").

81. *See* Lucian Ayre Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 836-37 (2005).

82. *See* BEBCHUK & FRIED, *infra* note 99, at 1-15.

contention that the management of the corporation is best left to the board. The difference is that BG recognizes the validity and usefulness of circumscribing bylaws. However, bylaws will always be far less numerous than managerial decisions, so the differences between the two systems would be situated mostly at the margins. One might describe BG as a director primacy system with an attached bylaw feature. Thus, comparing the two paradigms is mostly a matter of understanding the value of the bylaw option.

The central advantage of BG is its ability to reduce agency costs over what DP can achieve. To see this, consider a commonly used method for controlling shirking by managers: equity compensation.[83] When executives are stockholders, they certainly have more incentive to increase the value of the corporation's shares,[84] but this effect wears out well before the point of value optimization.[85] Moreover, incentive alignment is rarely effective against the pursuit of private rewards, because managers will enjoy all of their benefits, but bear only a *pro rata* share of the costs.[86] Equity ownership by executives can

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83. *See, e.g.*, Robert J. Jackson, Jr., *Stock Unloading and Banker Incentives*, 112 COLUM. L. REV. 951, 953 (2012) (discussing use of equity compensation to reduce agency costs). As explained above, *supra* note 78, one need not believe that directors or managers are agents to accept that analogy for purposes of defining and diagnosing agency costs.

84. Since the financial crisis of 2008, scholars have paid more attention to a nasty side effect of equity compensation—namely, its encouragement of excessively risk-seeking behavior on the part of managers. *See, e.g.*, Simone M. Sepe, *Making Sense of Executive Compensation*, 36 DEL. J. CORP. L. 189, 192 (2011). This is a real problem and I would not minimize its significance. However, it only reinforces the point being made in this section—that structural approaches have important limitations, and discussing it at length simply introduces needless complication.

85. This is a simple matter of the declining marginal utility of labor and wealth. Assuming managers rationally pursue the easiest money first, the effect of increasing their price-maximizing effort—either by working harder or by increasingly focusing on increasing share price (as opposed to, for instance, their own job security)—decreases as the level of that effort increases. At the same time, the managers are getting wealthier as the share price increases, and thus the utility they derive from additional increases in stock price also declines. At some point, the executives will decline to increase their effort and/or faithfulness because it will not be worth it for them—even though it would still be valuable for shareholders.

86. To be sure, sophisticated equity compensation systems that rely on derivative instruments (such as deep out of the money options) might be able to increase the sensitivity of the executives' portfolio to small valuation changes resulting from shirking. *See* Bebchuk & Fried, *supra* note 55, at 665. However, these systems would

significantly change their incentives with respect to big decisions. For instance, it discourages repeated rejections of premium acquisition offers, as that practice can be expected to dramatically reduce the company's share price.[87] However, equity ownership is less effective at deterring managers from seeking costly perks, as the executives enjoy the benefits of their perks privately while spreading the costs across the entire shareholder base.[88] Board members who hold equity only have an incentive to stand firm against managerial rent-seeking that is proportional to their typically small stake in the firm.[89] A small financial incentive can be outweighed by a subjective utility in acquiescing to managers' demands—especially if the directors themselves expect to partake of some of the perquisites themselves.[90]

Thus, there is no substitute for scrupulous monitoring of the executives, by the board and/or the shareholders. Equity holdings notwithstanding, managers are likely to give their best stock price-

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be very difficult to value and could produce disproportionate windfalls for executives if their tenure happens to be successful.

87. Bratton and Wachter describe a heterogeneous expectations model for stocks, in which the stock prices are seen as "as having two components: first, the fundamental value of the stock; and second, the present owner's option to sell her stock to an even more optimistic investor." Bratton & Wachter, *supra* note 12, at 707. Since acquirers are almost by definition the most optimistic of investors, it is easy to see that under this model, a firm's "just say no" stance to all acquisition offers would decrease the current stock price.

88. Professors Henderson and Spindler have argued that it is good for companies to lavish perks—i.e. private jets, limo service, cheap loans, etc.—on their executives, because the executives become addicted to this "corporate heroin." M. Todd Henderson & James C. Spindler, *Corporate Heroin: A Defense of Perks, Executive Loans, and Conspicuous Consumption*, 93 GEO. L.J. 1835, 1878 (2005). The idea is that the executives fear of losing these benefits would make them extremely averse to the risk of losing their jobs through sub-optimal performance. *Id.* It's a clever idea, but not one that is useful for practical application. A board seeking to use the "corporate heroin" approach would have to determine how much utility their executives subjectively and unobservably ascribe to various perks—a task made even more difficult by the executives' incentives to feed disinformation to the board. *Id.* If the executives can convincingly exaggerate their utility and their avarice, they can reap a windfall.

89. *See id.* (describing the ways in which board members share in the perquisites typically granted to executives).

90. *See* Lucian Ayre Bebchuk, Jesse M. Fried, & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 754 (2002) (arguing that "executives can receive pay in excess of the level that would be optimal for shareholders; this excess pay constitutes rents").

maximizing effort only if they understand they will be punished for not doing so. In addition, management can simply make errors, believing in good faith in the ultimate success of bad managerial strategies. A good corporate governance system provides some mechanism by which these mistakes are corrected before they ruin the company.[91]

In director primacy systems, it is assumed that the board will monitor the executives and the shareholders will monitor the board. However, neither form of supervision is fully adequate. Directors have their own incentives to shirk, and they do.[92] Much recent scholarship has been devoted to explaining why independent directors can be expected, in theory, to be diligent in monitoring the executives.[93] Yet empirical studies have shown that the firm valuation is relatively unaffected by the

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91. While the spectacular flameouts of investment banks like Bear Stearns and Lehman Brothers deservedly grab the headlines, companies can be damaged by poor managerial decisions more subtly and gradually over time. Consider the example of Holland Furnace Company, the business at the center of the famous greenmail case Cheff v. Mathes, 199 A.2d 548 (Del. 1964). Holland's business was selling home furnaces door-to-door. *Id.* at 550. The firm's management was so proud of this business model that it took extraordinary measures—with the active support of the board—to fend off a takeover effort by an entrepreneur who thought that furnaces could be more efficiently sold at a retail or department store. *Id.* at 552-53. Had the board taken its job more seriously, it might have noticed that the company's stock traded on the market for less than half its book value. *Id.* This sure signal that investors expected the company to lose money in the near future was ignored, and to nobody's surprise, the door-to-door furnace company soon went out of business. *Id.*

92. To cite one of many examples, board shirking played an important role in the collapse of MF Global. Not long after the firm acquired a huge portfolio of risky sovereign debt that led to its collapse, its chief risk officer, Michael Roseman, alerted the board to the extent of the firm's downside exposure. *See* Ben Protess & Azam Ahmed, *Lax Oversight Blamed in Demise of MF Global*, N.Y. TIMES, Feb. 3, 2012, at B6. Instead of investigating the situation—which would have brought the board into some conflict with the firm's CEO, Jon Corzine—the board simply looked for a new chief risk officer. *Id.* Roseman resigned, and the board hired someone who, in the words of one U.S. Congressman, "would tell Mr. Corzine what he wanted to hear." *Id.* (quoting Representative William J. Posey of Florida).

93. *See, e.g.*, Fisch, *supra* note 18, at 281-83 (arguing that independent directors lack motivation to permit managers to destroy shareholder value, as they will not personally benefit); Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1563 (2009) (arguing that when corporations try to maximize shareholder value and stock market prices are informative, "independent directors are more valuable than insiders").

percentage of the board comprised of independent directors.[94] This is hardly a shocking discovery. Directors get paid no matter how much time they devote to their tasks and the consequences to them of failure are minimal.[95] Thus, boards too often fail to exercise sufficient diligence to protect against manager-induced catastrophic failure.[96] Director independence may help reduce the power of CEOs to some degree,[97] but often the directors are not given the resources necessary to adequately monitor the executives.[98] On compensation-related matters, even independent boards simply do not implement effective strategies. For

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94. *See* Gordon, *supra* note 93, at 1468 (noting the "lack of correlation between the presence of independent directors and the firm's economic performance" and that "studies have searched in vain for an economically significant effect on the overall performance of the firm"); P.M. Vasudev, *Default Swaps and Director Oversight: Lessons from AIG*, 35 J. CORP. L. 757, 782-83 (2010) (observing that the board of AIG was dominated by independent directors in the years before its collapse).

95. The business judgment rule usually protects directors from liability, and, in addition, they enjoy liability insurance purchased for them by the company. *See* Steven M. Davidoff, *Ex-Directors of Failed Firms Have Little to Fear*, DEALBOOK - N.Y. TIMES (Aug. 2, 2011), http://dealbook.nytimes.com/2011/08/02/ex-directors-of-failed-firms-have-little-to-fear/. While it has been claimed that directors fear the harm to reputation that comes from presiding over a corporate collapse, recent evidence suggests that their careers are minimally impacted, if at all. *Id.*

96. For instance, the nominally independent boards at Lehman Brothers and Bear Stearns were largely dysfunctional before those firms' collapse. At Lehman, most of the policy was made by the executive committee comprised of CEO Richard Fuld and John C. Macomber—an ex-CEO who was retired for twenty years and who had no background in financial services. The risk committee met only twice in 2007. Bear Stearns did not even have a risk committee until March 2007—only a year before its collapse and probably well after it had purchased enough bad debt that insolvency was inevitable. *See generally*, Richard Lieberman, *Corporate Governance Lessons From The 2008 Financial Crisis: Assessing The Effectiveness Of Corporate Governance Through A Look At Troubled Companies*, 64 CONSUMER FIN. L. Q. REP. 425, 427 (2010).

97. *See* Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 TEX. L. REV. 987, 989 (2010) (arguing that CEOs "are losing power to boards of directors that increasingly consist of both nominally and substantively independent directors").

98. *See, e.g.*, Nicola Faith Sharpet, *The Cosmetic Independence of Corporate Boards*, 34 SEATTLE U. L. REV. 1435, 1435 (2011) (arguing that outside directors may appear to be independent, when in fact they do not have the resources to be "substantively independent"); Anita Anand, Frank Milne, & Lynnette Purda, *Monitoring to Reduce Agency Costs: Examining the Behavior of Independent and Non-Independent Boards*, 33 SEATTLE U. L. REV. 809, 814 (2010) (presenting evidence that independent and non-independent boards act similarly, and thus there is little performance difference in the respective firms).

instance, they grant stock options at the money and do not award compensation that is sensitive to underlying firm performance.[99] To the extent that managers might be motivated to perform better out of fear of being ousted, generous severance packages can mitigate that motivation.[100]

Shareholders may fare no better in monitoring directors; they have only blunt instruments at their disposal and therefore can discipline only very poorly performing boards. To punish a director requires removing her from office, which in turn requires the selection of a replacement. In so doing, shareholders can choose only between retaining incumbent directors and replacing them with a rival slate that usually has no track record of managing the firm in question and whose performance generally cannot be predicted.[101] Assuming that the performance of the company has, on the whole, been acceptable—perhaps it would be better with reduced agency costs, but possibly worse with strategic or operational mismanagement—replacement of the incumbent is risky. The shareholders cannot mix the operational skills of one board and combine them with the faithfulness of another; they must choose one option or the other.[102] This "bundling problem" presents itself to any democratic polity with limited voting options.[103] Managers and

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99. *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE (2004). As the authors point out, at-the-money option grants are inefficient incentives. *Id.* They permit executives to reap large financial rewards from a rising stock market, even if the managers' performance has been quite poor in relative terms. When options lose value because of market conditions, the strike price is often reset. Bebchuk and Fried advocate the indexing of equity grants to market and industry performance, a suggestion that remains largely unfollowed.

100. *See* Bebchuk & Fried, *supra* note 55, at 666-76.

101. This is often referred to as the bundling problem, which Professor Bebchuk has identified as a principal justification for shareholder empowerment. *See* Bebchuk, *supra* note 81, at 857-64.

102. The shareholders can, of course, elect boards consisting of directors with different areas of expertise. A board might have a compensation expert, an operations expert, a finance expert, and so forth. There is little if any evidence, though, that these "teams of experts" inherit the best qualities of their individual members.

103. *See, e.g.*, NELSON W. POLSBY & AARON WILDAVSKY, PRESIDENTIAL ELECTIONS 292 (7th ed. 1988) ("It is possible for candidates to get 100 percent of the votes and still have every voter opposed to most of their policies, as well as having every one of their policies opposed by most of the voters."); *see also* Peter Shane, *Political Accountability in a System of Checks and Balances: The Case of Presidential Rulemaking*, 48 ARK. L. REV. 161, 213 (1994); Cynthia R. Farina, *Against Simple Rules for a Complex World*, 72 CHI.-KENT L. REV. 987, 998 (1997). *But see* K.A.D. Camara, *Shareholder Voting and the Bundling Problem in Corporate Law*, 2004 WIS. L. REV.

directors, aware of this problem, realize that they may extract rents without effective punishment so long as the overall performance remains solid.

At this point, it is evident why circumscribing bylaws might be useful: they permit shareholders to corral the worst excesses of management directly and correct the board's egregious failures without having to replace a majority of the directors. However, such bylaws cannot force the board to implement any particular policy. In theory, the shareholders could do this for any and all decisions of the board, but in practice bylaws would be used sparingly, at most. Circumscribing bylaws are purely defensive in nature, and cannot be used by shareholders to impose their will on the board. Bylaws are also costly to enact, therefore shareholders would only have an incentive to use them against the type of highly inefficient policies that we might normally characterize as abuses of power. Could shareholders use a series of circumscribing bylaws to consistently remand board decisions in an attempt to "wear down" the board and force it to acquiesce to their demands? Such circumstances are plausible, but the chances of them actually occurring are infinitesimal. After all, directors are more nimble than shareholders; the former can act with a single meeting, whereas the latter must laboriously collect consents or proxies from a majority of the outstanding shareholders.[104] The board usually wins wars of attrition.[105]

1425, 1429 (2004) (arguing, based on a rational-signaling model, that the bundling problem is "largely illusory").

104. To be sure, a small group of shareholders that together own a majority stake in the company can move quickly, as they have but a small number of written consents to obtain. In that case, however, they would not need to act via bylaw; they could simply replace individual directors one by one, via that same written consent process, until the board capitulated. *See* DEL. CODE ANN. tit. 8, § 228(a) (providing that "any action which may be taken at any annual or special meeting of such stockholders, may be taken without a meeting, without prior notice and without a vote, if a consent or consents in writing . . . shall be signed by the holders of outstanding stock having not less than the minimum number of votes" required to take the action.); DEL. CODE ANN. tit. 8, § 141(k) (providing that "[a]ny director or the entire board of directors may be removed, with or without cause, by the holders of a majority of the shares"). If the board is classified, then directors may not be removed individually without cause, *see id.*, so the process by which the majority bloc exerted its will on the board might be more complex. Still, acting via circumscribing bylaw would be an inefficient way or doing so.

It may be asked why BG should stop at circumscribing bylaws. If shareholders can control agency costs more effectively than the board, then why not permit them to force the board toward the policy with the lowest agency cost, instead of simply steering the board away from high agency cost policies? Indeed, some scholars have suggested just such a corporate governance paradigm, which can be described rather faithfully as a "shareholder empowerment" approach. This is the subject of the next subsection.

2. BG vs. Shareholder Empowerment

The central distinction between BG and "shareholder empowerment" ("ShEmp") is that the former countenances only circumscribing bylaws, and the latter advocates for direct shareholder control over corporate policy, whether via bylaws or expanded voting rights over substantive issues. Shareholder empowerment has been a debate largely framed by Professor Bebchuk's seminal article "The Case For Increasing Shareholder Power."[106] There, Bebchuk proposed to re-allocate to shareholders decision-making power on issues such as amending the charter, choosing a state of incorporation, scaling down the corporate enterprise through asset sales and/or distributions, and selling or dissolving the company.

For the same reasons that BG can reduce agency costs further than systems of director primacy, it is likely that ShEmp could reduce them even further. However, this governance paradigm comes with at least one substantial drawback: empowered shareholders can badly disrupt decision-making within the firm. While shareholders might occasionally have incentive to intentionally harm the company,[107] more frequently their participation would be procedurally burdensome and would interfere with management's expert decision-making.[108] Indeed,

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105. *Cf.* Air Prods. & Chems., Inc. v. Airgas, Inc., 16 A.3d 48, 55-56 (Del. Ch. 2011) (noting that Air Products had been attempting to acquire Airgas for 16 months, but gave up because the fight had become too expensive).

106. Bebchuk, *supra* note 81.

107. Shareholders who have used derivative securities to take a net short position in the firm would have an incentive to cause it harm. *See* Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 815 (2006).

108. *See, e.g.*, Bratton & Wachter, *supra* note 12, at 658-59 (noting that corporate law "has always privileged the directors and their appointed managers [over

sophisticated organizations cannot operate by referenda. Thus, at a minimum, the powers given to shareholders—along with the rules as to how and when they can be exercised—must be chosen with great care.

ShEmp advocates recognize the adverse effects that might stem from unchecked investor participation in corporate decision-making, and thus have proposed to restrict shareholder input to decisions pertaining to the "rules of the game." [109] Such proposals rest on the optimistic assumption that a coherent distinction can be found between decisions pertaining to the "rules" and those that occur during the game itself.[110] Moreover, there is little reason to be confident that shareholders' input over rules will be innocuous. It is not hard to imagine opportunistic investors using the threat of a dissolution vote to pressure the board to make particular business decisions favorable to their interests, beliefs or risk preferences.[111] The mere threat itself may have force: directors and

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shareholders] in business policymaking because they are better informed than the shareholders . . . and best suited to maximize the value of the corporation").

109. *See* Bebchuk, *supra* note 81 (advocating shareholder intervention for "rules-of-the-game decisions" such as changing the company's state of incorporation).

110. For instance, Bebchuk categorizes two types of decisions rules-of-the-game: state of incorporation, and amendments to the corporate charter. *Id.* But nearly *anything* can be put in the charter. If shareholders want the company to quote prices to customers only in Turkish lira, they could put a provision to that extent in the certificate. *See* DEL. CODE ANN. tit. 8, § 102(b)(1) (stating that the certificate of incorporation may contain "[a]ny provision for the management of the business and for the conduct of the affairs of the corporation . . . are not contrary to the laws of this State"). Clearly, a distinction is needed between those types of certificate provisions that pertain to the rules and those that do not; on this point, Bebchuk's proposals are fuzzy.

111. This is far from a hypothetical scenario. Consider, for instance, the efforts by Pershing Square Capital—a hedge fund with large holdings in the Target Corporation—to convince and then cajole the Target board into a plan to spin off all of the company's real estate into a REIT, which would then lease the land back to Target. *See* Stephanie Rosenbloom, *Seeing Gold in Target's Real Estate*, N.Y. TIMES, Oct. 30, 2008, at B1. The board repeatedly refused, in part because the proposal was very risky—meaning that it was attractive to hedge fund managers compensated with a 2-and-20 structure, but less attractive to other investors. The board's refusal prompted Pershing Square to launch a proxy contest, which it lost. *See* Zachery Kouwe, *Target's Shareholders Strongly Reject Dissident Slate, Ending Divisive Proxy Battle*, N.Y. TIMES, May 29, 2009, at B1. Had Pershing Square been able to threaten the board with rules-of-the-game changes, the board might have capitulated.

executives, after all, are far more dependent on the firm's continued existence than diversified investors.[112]

These problems of decisional inefficiencies and shareholder opportunism arise because ShEmp inadequately fine-tunes shareholder authority. In the ShEmp paradigm, shareholders either have power over an issue, which they can wield forcefully, or they do not. By contrast, BG regulates the amplitude of shareholder power, permitting it to be exercised frequently but with less consequence. Thus, shareholders will be largely unable to act opportunistically, because they cannot force the board to adopt any particular decision. Likewise, shareholders would rarely find it profitable to disturb the company's decision-making, as only very costly (and thus egregiously bad) board policies would be worth prohibiting. In other words, shareholders who can merely circumscribe will very likely accept the board's managerial vision, while intervening only to reduce agency costs. At the same time, the broad reach of shareholder power under BG (but not under ShEmp) means that shirking insiders would find it hard to evade the shareholders' proscriptions.[113]

The shareholder empowerment paradigm inaptly models corporate governance as the allocation of a fixed amount of "power" between the board and the equity holders. When Bebchuk writes about "Increasing Shareholder Power"[114] or when scholars debate the wisdom of giving "more power" to shareholders,[115] they assume that governance power is

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112. We can assume that dissolution of the corporate entity would not in fact cause the underlying businesses to liquidate, and thus the executives (and to a lesser extent, the directors) may be able to continue their employment under different ownership. However, managers and directors are typically heavily invested in the firm's equity, *see supra* notes 83-90 and accompanying text, and thus would stand to suffer a far greater injury if the dissolution turns out poorly.

113. To see how this might work, suppose there is a CEO named B earning $100M a year. ,$100M being extravagant, the shareholders obtain the power—a binding "say on pay"—to limit her salary and settle on a sum of $25M a year. In response, B directs the company to donate $75M to B's alma mater, to which B was intending to donate anyway. The donation might be in the company's name, but the school understands the identity of the real donor and agrees to name a new library after B. So B gets everything she originally wanted, and the shareholders are powerless to stop it because they don't have a "say on donations."

114. *See* Bebchuk, *supra* note 81.

115. *See, e.g.*, Anabtawi, *supra* note 9, at 564-65 (arguing that "transferring power from boards to shareholders . . . could reduce overall shareholder welfare"); Lynn A. Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667, 671 (2003)

finite and divisible. More power to shareholders means less power for directors, and vice versa. This arithmetic concept of governance power is mostly metaphorical, and does not account for different configurations of governance power. If shareholders were given the right to redeem a poison pill by majority vote, but lost the right to be reimbursed for proxy contests, has their power "increased" or "decreased"? Does it even make sense to ask that question?

This Article proposes that corporate governance is less about quantities of power than it is about the possible outcomes of corporate action. The business judgment rule empowers boards to establish goals and choose means for implementing those goals from a very large set of possible alternatives, all without fear of ex post reprisal by angry shareholders.[116] Some of those alternatives are proscribed by corporate law—for instance, by fiduciary duties or doctrines governing actions by control shareholders—but we do not ordinarily think of such proscriptions as neutering the board's power. Why, then, would it compromise the board's discretion for shareholders to use bylaws to further proscribe the board's set of options, so long as the set remains sufficiently large for the board to easily achieve its desired outcomes? Such proscriptions will improve corporate governance when their value to shareholders exceeds the cost of their imposition upon the board. Since circumscribing bylaws, by definition, only minimally impact the set of options from which the board can choose, they can improve corporate governance—not by "increasing" shareholder power, but by improving the quality of the board's actions.

II. THE ENFORCEABILITY AND VALIDITY OF CIRCUMSCRIBING BYLAWS IN DELAWARE

The leading bylaw authority in Delaware is the 2008 case *CA, Inc. v. AFSCME Employees Pension Plan*.[117] There, the Court analyzed the validity under Delaware law of a shareholder-proposed bylaw (the "Reimbursement Bylaw") that purported to require the board of

(arguing that when investors modify the default rules of corporate governance, "they almost always . . . select[] charter provisions that strengthen director control over the firm").

116. *Cf.* Gagliardi v. TriFoods Int'l, Inc. 683 A.2d 1049, 1052-55 (Del. Ch. 1996) (describing the business judgment rule as a way of encouraging directors to make risky investments that, in aggregate, enrich the shareholders).

117. 953 A.2d 227 (Del. 2008).

directors to reimburse the proxy expenses of any director who was elected to the board while running on a "short slate"—i.e. a candidate group numbering less than half the board seats.[118] Procedurally, the *CA* case came to the Court via a certification process in which the Court was asked to answer two distinct questions. The first was whether the Reimbursement Bylaw was a "proper subject" for shareholder bylaws, which the Court interpreted as the question of whether the Reimbursement Bylaw was within the "scope or reach" of the shareholders' § 109 residual bylaw power.[119] The second question concerned the interaction between § 109(b) and § 141(a), which as discussed above in Part I.A., inheres in every inquiry about the validity of any shareholder-enacted bylaw meant to be enforceable against the board.[120] Together, the two questions form a two-pronged test: Prong One requires a bylaw to be within the scope of the bylaw power, and Prong Two that it does not interfere with § 141(a).

The *CA* opinion failed to articulate coherent principles of bylaw validity under either prong. As one of the justices later admitted, the Court was rushed by the procedural posture of the case and its approach to the case was "not necessarily the best way it could have been handled."[121] The problem was not the outcome of the case, but rather that the Court's express reasoning failed to identify and discuss the factors that it ultimately found to be dispositive. The Court framed the Prong One issue as "whether [the bylaw] is one that establishes or regulates a process for substantive director decision-making, or one that mandates the decision itself,"[122] but its actual Prong One analysis of the Reimbursement Bylaw did not turn on process-orientation at all. On

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118. *Id.* at 240. Normally, a bylaw is not needed for directors' proxy contest expenses to be reimbursed; directors who win control the board and will vote for reimbursement. A short slate, however, does not have voting control, and can obtain reimbursement only with approval of potentially hostile incumbent directors.

119. *Id.* at 231.

120. *Id.* at 231. Technically, the question certified was whether the Reimbursement Bylaw would cause the Company to "violate any Delaware law." *Id.* at 241. However, the only law that was even implicated was § 141(a), and that was the law on which the Court exclusively focused. *Id.*

121. *See* Ursaner, *supra* note 5, at 507-08 (recounting a talk given by Justice Jacobs at Harvard Law School, in which he stated that "if we had more than two weeks and were not under the pressure of time . . . we might have been able to write [the opinion] better," and admitted that the Court's approach was not necessarily "the best way it could have been handled").

122. *CA, Inc.*, 953 A.2d at 231.

Prong Two, the Court relied on far-fetched hypotheticals[123] to justify a complex and unconvincing explanation of the relationship between the shareholder bylaw power and the directors' fiduciary duties.

A careful analysis of the opinion shows that the Court was really interested in whether proposed bylaws are circumscribing or controlling. The two prongs simply reflect two aspects of that inquiry. Section A demonstrates that Prong One addresses the bylaw's purpose—in particular, whether that purpose was to circumscribe the board's discretion (in which case it would be a proper subject for shareholder action) or to control or bind the board's discretion (in which case it would not). Section B shows that Prong Two deals with the bylaw's actual effect: it serves to invalidate any bylaws that are—whatever their purpose—functionally controlling the board. As the Reimbursement Bylaw was circumscribing in purpose but controlling in effect, the Court upheld it on the first question but invalidated it on the second.

A. *CA* PRONG ONE: CIRCUMSCRIBING PURPOSE

The Court's response to the first question was troubled from the outset. As noted above, it characterized the issue as "whether [the bylaw] is one that establishes or regulates a process for substantive director decision-making, or one that *mandates* the decision itself."[124] This appears to be an attempt at a dichotomous classification, except that its purported categories are different in kind and not close to exhaustive. Circumscribing bylaws, for instance, are not necessarily process-oriented, but they also do not mandate any decision by the board. Conversely, it is possible for a bylaw to force a certain policy upon the board via regulation of the decision-making process—for instance, by requiring unanimous director consent for the company to put in place a poison pill when one member of the board is staunchly opposed to poison pills in principle.[125] Classifying bylaws in this way is

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123. *Id.* at 240 n.34. One of the more absurd hypotheticals was that of a competitor of a company running a short slate of directors in order to gain access to the firm's sensitive internal information. Even if such a scenario did come to pass, the reimbursement of the competitor's proxy expenses would be a trifle compared with the firm's legal and financial costs.

124. *Id.* at 235 (emphasis added).

125. *Cf.* Frantz Mfg. Co. v. EAC Indus., 501 A.2d 401 (Del. 1985) (upholding a unanimous consent bylaw that had the effect of thwarting a substantive decision of the board).

analogous to dividing peppers into two categories: "spicy" or "green."[126] The taxonomy is not up to its assigned task.

Not surprisingly, the language of process and substance also fails to accurately describe the case holding. After all, the Court held that the Reimbursement Bylaw fell into the "process" category, even though it did not even address any decision-making process at all. It was apparently enough that the bylaw's *context* involved process, and that its substantive content addressed a "legitimate" substantive issue, as the following excerpt expressly explains:

> The context of the Bylaw at issue here is the process for electing directors—a subject in which shareholders of Delaware corporations have a *legitimate and protected interest*. The purpose of the Bylaw is to promote the integrity of that electoral process by facilitating the nomination of director candidates by stockholders or groups of stockholders . . . . The Bylaw would *encourage* the nomination of non-management board candidates by *promising* reimbursement of the nominating stockholders' proxy expenses if one or more of its candidates are elected. In that the shareholders also have a *legitimate interest*, because the Bylaw would facilitate the exercise of their *right* to participate in selecting the contestants.[127]

It is not hard to see that the Court never really engaged the concept of process-orientation here. If bylaw validity turns on the legitimacy of shareholder interests, then whether it regulates process is not a dispositive factor. Nor should it be. For instance, a bylaw that required the board to consult with shareholders before making any significant business decision would be purely process-oriented, and yet one doubts that the Court would consider that to be within the scope of bylaws.[128]

Moreover, the proffered distinction between process regulation and substantive mandates would contravene a rarely-discussed clause of the text of § 109(b). That section in full states that the "bylaws may contain any provision . . . relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its

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126. Of course, peppers can be both green and spicy, whereas red bell peppers are neither.

127. CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 237 (Del. 2008) (emphasis added).

128. This "consultation bylaw" could only fail—as it must—under *CA* prong one. Prong two focuses on the bylaw's consistency with law. There is no statute in the DGCL that would be violated by a requirement that the board listen to shareholders before making a decision. Section 141(a) would be satisfied, since the board would still make the decision, and thus would manage the firm's business and affairs.

stockholders, directors, *officers or employees*;"[129] similarly, § 142(a) commands that "the titles and duties" of the corporation's officers are specified by the bylaws.[130] These provisions simply cannot be reconciled with a rule that restricts bylaws to the establishment or regulation of decision-making processes. Employees have no defined corporate governance function or any default rights, so to the extent that a bylaw "relates" to their "rights or powers," it must do so by expanding or abridging employees' rights created by the board. Neither option is process-oriented. A bylaw that defines the duties of the officers would undoubtedly have a process dimension, since it would specify *who* makes certain decisions. But one would be hard pressed to argue that it would be only process-oriented; after all, if a bylaw confers upon the corporate secretary the duty of taking attendance at board meetings, that would seem to commit the board to the substantive policy of taking attendance, which it might not want to do.

The Court's confusion lies entirely in the first of the two proposed categories. The second category—bylaws that "mandate the decision itself"—simply refers to controlling bylaws. Logic thus suggests that the first category really consists of circumscribing bylaws; then we would have a dichotomy between controlling and circumscribing bylaws that is both complete and coherent.[131] This, in turn, explains the Court's approval of the Reimbursement Bylaw's purpose. It did not seek to force a particular policy on the board, but only to establish a threat of removal sufficiently credible[132] to encourage the board to engage shareholders' concerns.[133] Whether it remained fully true to that purpose was a question reserved (and answered in the negative) for Prong Two.

A trace of this controlling/circumscribing logic is clearly visible in the Court's emphasis on the shareholders' "legitimate and protected"

129. DEL. CODE ANN. tit. 8, § 109.

130. DEL. CODE ANN. tit. 8, § 142(a) ("Every corporation organized under this chapter shall have such officers with such titles and duties as shall be stated in the bylaws . . . .").

131. That is, all bylaws can be characterized as controlling or circumscribing, since the latter is defined as the absence of the former, and by the same token, no bylaw can fall into both categories.

132. For reasons discussed *supra* note 101 and accompanying text, removal of the entire board is often not an attractive option for shareholders.

133. The Reimbursement Bylaw did ultimately fail as a circumscribing bylaw for reasons discussed below in Part II.B. However, the *purpose* of establishing a credible threat of director removal is circumscribing.

interest. In Delaware, promoting the integrity of the electoral process has long meant something more than protecting the casting of ballots—it has occasioned substantive restrictions on the behavior of the board.[134] For instance, directors may not intentionally interfere with the outcome of a shareholder vote, at least on matters pertaining to the election of directors, unless they can provide a compelling justification for doing so.[135] Nor can they buy votes or similarly use corporate funds to induce shareholders to support their election. [136] These doctrines cannot be characterized as *either* process-oriented *or* substantive: they at once regulate electoral procedures and shape the powers and duties of the board, via circumscription rather than control. The democracy-promoting rule of *Blasius*, for instance, requires nothing of the board; it merely invalidates a limited subset of possible board responses to a hostile bid—namely intentional interference with a shareholder vote.[137] By contrast, shareholder attempts to use *Blasius* to curtail the board's discretion have been rebuffed.[138]

It is also notable that the Court so heavily emphasized that the shareholders' bylaw power is no mere default rule. Twice it observed that, per the express language of §109(b), the bylaw power cannot be eliminated or even narrowed by the certificate of incorporation;[139] and then added an additional footnote "to reiterate" the salience of the relevant statutory language.[140] As argued above in Part I.A., the inalienability of the bylaw power strongly indicates that it was intended

134. *See supra* note 127 and accompanying text.

135. *See* MM Co. v. Liquid Audio, Inc. 813 A.2d 1118, 1131 (Del. 2003) (upholding the *Blasius* rule that the board may not "act with the primary purpose . . . of impeding . . . the franchise" unless it can present a "compelling justification" for doing so).

136. *See, e.g.*, Portnoy v. Cryo-Cell Int'l, 940 A.2d 43, 73-74 (Del. Ch. 2008) (holding that "the use of a corporate asset . . . by the management slate to secure a vote for itself" is a breach of fiduciary duty); Schreiber v. Carney, 447 A.2d 17 (Del. Ch. 1982) (subjecting vote buying transactions to a rigorous test of entire fairness). Of course, the board may use corporate money to *persuade* shareholders to vote for them. The line between advocacy and purchase is a thin one that has not yet been resolved.

137. Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988).

138. *See, e.g.*, Stroud v. Grace, 606 A.2d 75 (Del. 1992) (holding that *Blasius* does not restrict the board's power to reject unqualified nominees to the board, even if replacement nominees are not permitted).

139. CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 231 (Del. 2008); for the statutory text, see *supra* note 28 and accompanying text.

140. *CA, Inc.*, 953 A.3d at 234 n.13.

to protect an important interest.[141] It is hard to believe that the Court would so heavily emphasize that the bylaw power cannot be curtailed if it really conceived of bylaws as trivial lists of logistical procedures. It clearly contemplated a more significant principle,[142] even if it could not precisely articulate what it had in mind.

Other bylaw cases also support the distinction between circumscribing and controlling, as well as make clear that the operative principle of bylaw validity applies outside the narrow context of electoral procedures. For instance, in *Frantz Manufacturing. Co. v. EAC Industries*[143] incumbent management was attempting to issue equity to an entity it controlled so as to wrest control away from an investor that had newly acquired a majority share of the company's stock.[144] In a response approved by the Court, the new controlling shareholder amended the bylaws to block this action.[145] In *Airgas, Inc. v. Air Products, Inc.*,[146] the shareholders attempted to give themselves a not-entirely-illusory ability to vote in favor of a hostile tender offer and thus circumvent the board's *de facto* insuperable defense of "just saying never."[147] This circumscribing bylaw was ultimately invalidated, but not

141. See text accompanying notes 36-48.

142. *CA, Inc.*, 953 A.3d at 234. To be sure, the inalienability of the bylaw power does not, in itself, offer any rule of decision, nor did the Court imply that it could. *See id.* at 234 (noting that the language of § 109(b) is "only marginally helpful in determining what the Delaware legislature intended to be the lawful scope of the shareholders' power to adopt, amend and repeal bylaws").

143. 501 A.2d 401 (Del. 1985).

144. *Id.* at 407.

145. *See id.* (noting that "the bylaw amendments were a permissible part of EAC's attempt to avoid its disenfranchisement as a majority shareholder"). In this case, the shareholder already had one seat on the board, and so it could achieve a veto over any disenfranchisement by means of an arguably procedural bylaw that prohibited the board from acting without unanimous consent of all members.

146. 8 A.3d 1182 (2010).

147. *Id.* at 1187. The bylaw would have moved an annual meeting of Airgas to a date in January, only four months after the prior year's annual meeting at which a third of the incumbent directors were replaced. *Id.* The purpose of the bylaw was to hasten a vote to replace another third (and create a majority on the board in favor of the acquisition by Air Products) before Air Products would be forced to withdraw its offer. *Id.* at 1187-88. Without such accelerated voting, hostile bids are hopeless: the defense mechanism of a poison pill plus a classified board has never been defeated. As the Chancery Court held in a subsequent opinion, "just saying never" is beyond the legitimate power of the board. *See* Air Prods. & Chems., Inc. v. Airgas, Inc., 16 A.3d 48, 127-29 (Del. Ch. 2011).

because it exceeded the shareholders' authority; it merely contradicted an explicit charter provision, and presumably would have been valid under a different charter.[148] In short, bylaws have been found to fall within the scope of § 109(b) when their purpose is to prevent the board's from defeating legitimate shareholder interests—regardless of whether the bylaws are process-oriented or pertain to elections.

It is instructive to examine *Frantz* in more detail. In that case, the board attempted to issue equity to an entity it controlled in order to dilute the voting power of a shareholder who had just obtained a controlling stake.[149] The shareholder amended the bylaws to require unanimous consent among directors for any corporate action—a strategy that was effective in blocking the equity issuance, because the newly controlling shareholder had already been seated and could veto that action.[150] Thus, the shareholder was protected by a "procedural" bylaw. Suppose, by contrast, that the shareholder had not yet been seated on the board. Does the corporate law really prevent such an investor from using a bylaw to prevent the board from diluting his or her voting power?[151] It

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148. *Airgas, Inc.*, 8 A.3d at 1186-87. To be specific, the corporate charter provided that a given class of directors would serve until the "annual meeting of stockholders to be held in the third year following the year of their election." *Id.* at 1188. In practice this had always meant that directors served three-year terms, and the Court found the provision to be ambiguous as to whether the directors' terms could be shortened by moving the date of the annual meeting. *Id.* Because charters are in the nature of a contract, the court used methods of contract interpretation to determine the intent of the drafting parties, which was to establish three-year terms. *Id.* at 1190. Hence a bylaw shortening the tenure of one class to 28 months (*see supra* note 147) conflicted with the certificate and was therefore invalid. *Airgas, Inc.*, 8 A.3d at 1188-93. Importantly, the Court's reasoning relied exclusively on the law of contract interpretation. *Id.* at 1190-92. Nowhere in the opinion does the Court exhibit any doubt that the bylaw was a proper exercise of the § 109(b) power. *Id.* at 1188-93. Had the certificate clearly indicated that the directors' terms lasted only until the annual meeting date—for instance, if the certificate stated that directors were 'elected to hold office for a term of variable length expiring on the date of the third annual meeting after their election,'—the bylaw would have been valid. *Id.*

149. Frantz Mfg. Co. v. EAC Indus., 501 A.2d 401, 402 (Del. 1985).

150. *Id.* at 402-03.

151. A shareholder diluted in this way would likely sue the board for breach of duty. Whether that suit would be effective, though, is highly uncertain. The closest case on point—Benihana of Tokyo v. Benihana, 906 A.2d 114 (Del. 2006)—would cut against a challenge to the equity issuance. There, the board issued new equity in such a way as to destroy the majority control held by the plaintiff-shareholder, and with it any real threat to the board's job security. *Id.* at 116-17. The trial court had found that the board did not act with an entrenching purpose, even though two board members had discussed

seems more likely that the Court would approve a bylaw functionally equivalent to the *Frantz* procedural trick—for instance, something similar to the No First Vote bylaw described above, which prevents newly issued equity from voting in the first meeting after issuance[152]—without regard to its "substantive" nature.

Indeed, No First Vote fits very comfortably within the explanation given in *CA* for why the Reimbursement Bylaw was within the scope of the § 109(b) power. To again recite that language:

> The context of the Bylaw at issue here is the process for electing directors—a subject in which shareholders of Delaware corporations have a legitimate and protected interest. The purpose of the Bylaw is to promote the integrity of that electoral process by facilitating the nomination of director candidates by stockholders or groups of stockholders. [153]

Each of the last two sentences applies easily to No First Vote, and arguably with greater force than to the Reimbursement Bylaw. Surely a majority shareholder has an even more legitimate and protected interest in removing (by proxy vote) directors who would try to deprive it of its majority stake. Similarly, it would promote the integrity of the electoral process to prevent management from tipping the outcome by issuing new equity to an entity it controls (or a friendly third party) just in advance of the election.[154] In other words, No First Vote satisfies the

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issuing equity for just such a purpose but a few months before. *Id.* at 121-22. The Court accepted these conclusions, again without questioning the board's motives. *Id.* The point here is not that *Benihana* was incorrectly decided, but rather a much simpler point: majority shareholders can not really count on the courts to protect their majority stake against dilutive actions by a hostile board.

152. *See supra* note 67 and accompanying text.

153. CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 237 (Del. 2008). Recall also the statement that concluded the previous paragraph in that opinion: "[w]hether or not a bylaw is process-related must necessarily be determined in light of its context and purpose." *Id.* at 236-37.

154. *Cf.* Portnoy v. Cryo-Cell Int'l, 940 A.2d 43 (Del. Ch. 2008). In this case, the incumbent board, in response to a proxy contest it was losing, the board conferred company assets—in that case, a second seat on the board—to shareholders who purchased shares in the open market and voted for the incumbent slate. *Id.* at *46-48. The Chancery Court invalidated this vote-buying arrangement. *Id.* While *Portnoy* does not express the issuance of new equity, it is not a long throw from rewarding a shareholder with a board seat for buying shares, and selling newly issued equity to a white knight.

articulated standard—or the closest thing to a standard that the Delaware courts have issued—for bylaw validity under Prong One, though it is not a process-oriented provision. It does so because it barely imposes on the board's discretion. By any measure, it simply offers to all majority shareholders the anti-dilution protection fortuitously (at least in part) available to the *Frantz* shareholder by virtue of being seated before the other board members initiated their mischief.

Here another advantage of BG becomes apparent: it permits shareholders to protect themselves ex ante, rather than relying on expensive litigation to seek protection from the courts. The board's anti-dilution efforts in *Frantz* were bound to fail. The *Frantz* court strongly implied that it would have upheld the majority shareholder's rights if, lacking a bylaw in its favor, it had run to court alleging impermissible entrenchment.[155] The remedy would have been in equity under the venerable rule of *Schnell v. Chris-Craft Industries, Inc.* that "inequitable action does not become permissible simply because it is legally possible."[156] If this were going to be the outcome, then why not permit the shareholder to use the mechanism that leads to the lowest transaction costs? Judicial resolution of the issue is expensive; bylaw resolution would be cheap, as soon as Delaware articulates an express, coherent standard for bylaw validity.

B. *CA* Prong Two: Circumscribing Effect

The test of Prong One—whether the proposed bylaw is a "proper subject" for bylaws by virtue of circumscribing purpose—is merely the first half of the overall question of bylaw validity. Section 109(b) also requires that bylaws cannot be "inconsistent with law or the certificate of incorporation." The "law" that cannot be contravened includes the delegation of managerial authority to the board of directors under § 141(a)—which is to say that bylaws can be invalid simply by too deeply infringing upon managerial duties and prerogatives.[157] In fact, before

155. Of course, *Frantz* was decided many years before the unfavorable precedent of *Benihana,* discussed *supra* note 151. Thus, the landscape is murkier now. To be sure, a diluted majority shareholder would not be without favorable precedent, but more certain protection for the investor's property right would be better.

156. 285 A.2d 437, 439 (Del. 1971).

157. *See, e.g.*, Quickturn Design Sys. v. Shapiro, 721 A.2d 1281, 1291 (Del. 1998) (invalidating provision that would "impermissibly deprive any newly elected board of both its statutory authority to manage the corporation under 8 Del. C. § 141(a) and its concomitant fiduciary duty pursuant to that statutory mandate").

CA, this limitation on bylaw validity was almost the exclusive focus of academic commentary.[158] In light of the lack of clear guidance from the courts, commentators were left either to attempt to extract a bit of sustenance from the barren statutory edifice,[159] and/or to speculate about where the corporate law would (or should) draw the line between permissible and impermissible infringements upon managerial prerogatives.[160] Fortunately, courtesy of *CA*, we now have the benefit of explicit guidance from the Court, though it requires careful scrutiny. This guidance tells us that the theory of inconsistency in Prong Two merely extends the "scope or reach" inquiry, testing whether a bylaw intended to be circumscribing actually operates as such.

As noted previously, the question addressed in *CA* was the validity of a controlling bylaw that *required* the board to reimburse certain proxy contest expenses. The Court was concerned that the command of the bylaws would force the board to act contrary to its fiduciary duties. In particular, it would require reimbursements that no board could possibly authorize in good faith, such as when "the proxy contest is motivated by personal or petty concerns, or promote[s] interests that do not further, or are adverse to, those of the corporation."[161]

The Court's focus on the action-forcing nature of the Reimbursement Bylaw was so complete that it seemed unable to provide another reasonable example of how the bylaw's command would interfere with the board's fiduciary duties. It offered the far-fetched[162] hypothetical of a competitor running a director slate in order to gain

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158. *See, e.g.*, John C. Coates IV & Bradley Faris, *supra* note 1, at 1329-30 (arguing that the § 141(a) prohibition on measures that restrict the board's exercise of fiduciary duties "bodes ill" for the prospective validity of bylaws); *id.* at 1329 n.28 (listing articles that analyze the validity of bylaws under § 141(a)).

159. *See, e.g.*, Brent H. McDonnell, *supra* note 10 (attempting to find a general pattern in the statutory provisions that specifically authorize bylaw resolution of certain topics); Gordon, *supra* note 1, at 546 (noting that sections 109(b) and 141(a) form a "recursive loop" in which each section confers power on the board or the bylaws except as provided by the other, thus permitting any division of authority between bylaws and the board to be consistent with the statutes).

160. *See, e.g.*, Coffee, *supra* note 34, at 614.

161. CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 240 (Del. 2008).

162. *See* Ursaner, *supra* note 5, at 546. The fact that the Court had to rely on such a far-fetched hypothetical also suggests that it went too far in declaring the bylaw to be *facially* invalid. *Id.* It could just as easily have upheld the bylaw as valid on its face, and potentially invalid as applied to any situation where it might have required directors to breach their fiduciary duties.

access to the confidential information that comes with board representation.[163] Surely this scenario borders on the absurd: it is inconceivable that a competitor could ever be successful in such an endeavor, and if it somehow pulled it off, the reimbursement of its proxy expenses would be far from the most pressing concern of either the company or the corporate law.[164] The use of such a hypothetical suggests that the Court did not want to imply invalidity for any bylaw that did not *mandate* reimbursement. If it had so intended, it could simply have reasoned that (1) the board exercises its business judgment over proxy reimbursement, and thus (2) it could deny reimbursement for any reason it deemed appropriate. No absurd fact patterns would be required—only a simple explanation that bylaws cannot have any constraining effect on the board's decision making. The fact that it eschewed that simple reasoning strongly suggests that it was articulating a distinction between (invalid) controlling bylaws and (presumably valid) circumscribing ones.

More support for this interpretation comes from the Court's analogy of the Reimbursement Bylaw to "contractual arrangements that *commit* the board of directors to a course of action that would preclude them from fully discharging their fiduciary duties."[165] As this language indicates, these contractual arrangements tend to be controlling restrictions; in cases like *Paramount*,[166] *Omnicare*,[167] and *Capital Re*,[168] boards had tried to bind themselves to merger transactions,[169] much as

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163. *CA, Inc.*, 953 A.2d at 240 n.34.

164. If it were even remotely possible for shareholders to elect such "Manchurian candidates" to the board, one might wonder if the shareholder franchise is worth the "assiduous" protection it currently receives. *See* MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1127 (Del. 2003). One might also suspect that the courts would be able to prevent such directors from being seated. As the Delaware courts note from time to time, "inequitable action does not become permissible simply because it is legally possible." *See, e.g.*, Hollinger Int'l v. Black, 844 A.2d 1022, 1078 (Del. Ch. 2004) (citing Schnell v. Chris-Craft Indus., Inc*.*, 285 A.2d 437, 439 (Del. 1971)). In other words, multiple systems would have to suffer complete failure before the situation the Court hypothesizes could even arise.

165. *CA, Inc.*, 953 A.2d at 238 (emphasis added).

166. Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34 (Del. 1994).

167. Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003).

168. ACE Ltd. v. Capital Re Corp., 747 A.2d 95 (Del. Ch. 1999).

169. In each case, the acquiring company forced the target to finalize the merger by making it legally impossible for the target to accept another offer. In *Paramount*, the merger agreement contained a "no shop" provision prohibiting the target from discussing any third party bid unless it was unsolicited and fully financed; in *Capital*

the Reimbursement Bylaw tried to bind the board to a certain type of financial transaction. As those controlling restrictions were invalid, so too would be controlling bylaws.

Unfortunately, there's a catch that must be explained. The *CA* Court also analogized the Reimbursement Bylaw to the slow-hand poison pill, a seemingly circumscribing limitation on board power that was invalidated in *Quickturn*.[170] The slow-hand pill prohibited the board from redeeming the pill during the six-month period following a change of control in the company,[171] but otherwise left the board completely free to engage in any other type of strategic business transaction.[172] Its purpose was to protect existing directors (who, by refusing to redeem the company's poison pill, were thwarting an acquisition attempt) from being removed from office in a proxy contest sponsored by a frustrated hostile bidder.[173] While a slow-hand pill would not offer ironclad protection,[174] the delay would further lengthen the acquisition process, increase its cost, and thus discourage takeover bids.

If *Quickturn* really intended to apply broadly to any circumscribing self-disablement of board power (and if *CA* really intended to extend the analogy between the slow-hand pill and the Reimbursement Bylaw that far), then BG argument would be in some danger. But two critical and distinctive features of the slow-hand pill explain *Quickturn's* holding, and counsel strongly in favor of a narrow reading of that case. First, the

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Re, the merger agreement permitted the target to entertain other bids only if outside counsel opined that the board's fiduciary duties so required; and in *Omnicare*, the target was required to put the merger agreement to the shareholders' vote, the majority of which had already been committed in favor of the merger. Each target board was effectively bound, with no real ability to pursue any other course of action.

170. Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281, 1291-92 (Del. 1998).

171. *See id.* at 1287-88. Technically, it only prohibits the pill from being redeemed in order to facilitate a transaction with the person who sponsored the proxy context. If a new bidder emerged, the board could redeem the pill to permit that transaction to proceed.

172. *Id.* at 1291-92.

173. *Id.* at 1283.

174. The protection was less than total because the bidder could still elect new directors who, after six months, would presumably redeem the pill. But as Air Products discovered in its attempted hostile takeover of Airgas, bidder-nominated directors do not always do the bidder's bidding. *See* Air Products, Inc. v. Airgas, Inc., 16 A.3d 48, 89 (Del. Ch. 2011) (noting that the three directors nominated by Air Products and elected in a subsequent proxy contest voted with the incumbent board members to reject Air Products' offer and to maintain Airgas' poison pill).

slow-hand pill relied on a contract with shareholders to restrict the board's authority to redeem it.[175] That is, it embedded the slow-hand feature into the contractual terms of the shareholder "rights" distributed to shareholders in the poison pill.[176] It would have been simpler for the board to bind itself with a bylaw or resolution requiring a six-month wait before redemption, but any such provision could be reversed by the bidder's board after a successful proxy contest. Hence, the slow-hand feature had to be embedded in a contract that the new directors could not unilaterally alter. Only then would it have any meaningful deterrent effect.

Functionally speaking, then, the slow-hand pill was an effort by the board of directors to manufacture for itself a power specifically denied to it by the corporate law. Not only does the DGCL not provide any means for a board to bind itself, but a line of precedent dating back almost a century holds unambiguously that directors may not contractually burden their vote as directors, either to each other, to the shareholders or to a third party.[177] The slow-hand pill purported to avoid this problem by permitting the board to use the corporation's contract power as an almost perfect substitute for the vote-binding power denied to individual directors. Thus, in invalidating the slow-hand pill, the Court correctly invoked § 141(a)—i.e. the original grant of power to the board.[178] In doing so, the Court focused on a slightly different facet of

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175. *See Quickturn*, 721 A.2d at 1292.

176. A poison pill consists of a set of warrants distributed via dividend to shareholders that permit the shareholders to purchase of a large number of stock shares at a discount price in the event that any person or group of people acquires a large block of stock. The blockholder, however, is not permitted to exercise this option. As a result, when other shareholders exercise their options, the new blockholder will be diluted at a steep financial loss. The warrants distributed as part of the pill contain a number of contractual terms, including a provision for redemption by the board—and, in the case of the slow-hand pill, a slow-hand feature. For a detailed description of a poison pill, *see* Moran v. Household International, Inc., 500 A.2d 1346, 1352-61 (Del. 1985).

177. *See, e.g.*, Abercrombie v. Davies, 123 A.2d 893, 899 (Del. Ch. 1956), *rev'd on other grounds*, 130 A.2d 338 (Del. 1957) (holding that "this Court cannot give legal sanction to agreements which have the effect of removing from directors in a very substantial way their duty to use their own best judgment on management matters"); Chapin v. Benwood Foundation, 402 A.2d 1205, 1206, 1211 (Del. Ch. 1979) (invalidating an attempt by a board to "legally bind itself in advance to name designated persons to fill vacancies on the board of trustees as such vacancies occur" because directors may not alienate their duty to use their best business judgment); *cf.* McQuade v. Stoneham, 263 N.Y. 323, 331 (1934) (prohibiting directors from agreeing ex ante to retain the services of a corporate officer).

178. *See Quickturn*, 721 A.2d at 1291-92.

the slow-hand chicanery: that the pill attempted to limit the board's power by directorial fiat, when the law clearly requires that any such limitations be set forth in the certificate.[179] But the fundamental deficiency is the same no matter what specific theory is invoked: the slow-hand pill attempted to arrogate to the board a power it did not have.

It follows, then, that *Quickturn* has little direct bearing on the validity of shareholder-approved bylaws. The bylaws, after all, are passed pursuant to § 109(b), which expressly authorizes the shareholders to do what the board cannot: contravene the business judgment of the board on some matters. The central issue in bylaw validity is not *whether* the board's discretion can be circumscribed, but rather the *extent* to which it can be circumscribed.[180] To put the issue differently, the § 141(a) limiting provision undergirding *Quickturn* thrusts in a different direction from the limiting provision of § 109(b). The former countenances any substantive reduction of the board's discretion, but requires a specific and relatively demanding procedure to be followed—i.e. certificate amendment. Section 109(b), by contrast, says nothing of procedure, but countenances a much narrower set of restrictions on the board. That *Quickturn* found a procedural deficiency in the board's disablement does not imply anything about whether a bylaw would impermissibly encroach on the board's powers.

Why, then, did the *CA* court cite to *Quickturn* and analogize the bylaw to the slow-hand pill? The Court appeared to be focusing on an important common feature of the slow-hand pill and the bylaw: both tightly constrained the board's discretion over matters to which they applied. Indeed, the whole passage from the opinion reads:

> *Quickturn* involved [a] binding contractual arrangement[] that the board of directors had voluntarily imposed upon themselves. This case involves a binding bylaw that the shareholders seek to impose involuntarily on the directors in the specific area of election expense

179. *See id.* at 1291 (holding that "[s]ection 141(a) requires that any limitation on the board's authority be set out in the certificate of incorporation").

180. To reiterate, if bylaws cannot circumscribe the board's discretion at all, then they would have no legal effect. They would be functionally equivalent to shareholder resolutions. *See, e.g.*, Hollinger Int'l, Inc. v. Black, 844 A.2d 1022, 1080 (Del. Ch. 2004). Such a legal characterization would make a mockery of legislature's decision to make the bylaw power inviolable. In any event, the DGCL specifically authorizes bylaws to circumscribe the board's direction in many provisions, and the courts have held that the board's power can be limited by valid bylaws. *Id.* at 1077-80.

> reimbursement. Although this case is distinguishable in that respect, *the distinction is one without a difference*. The reason is that the internal governance contract—which here takes the form of a bylaw—is one that would also *prevent* the directors from exercising their *full managerial* power in circumstances where their fiduciary duties would otherwise *require* them to deny reimbursement to a dissident slate.[181]

Crucially, the Court here relies on the mandatory nature of the reimbursement bylaw, and specifically that it requires the board to act a certain way independent of the factual context.[182] As the Court explains, the distinction between contractual binding and bylaw binding is "without a difference" because in both cases, the directors retain no discretion to exercise any business judgment.[183]

Here the Court invokes the second feature of the slow-hand pill that should render *Quickturn* inapplicable to circumscribing bylaws: the slow-hand pill may have been circumscribing in form, but it was controlling in substance. That the slow-hand pill excessively constrained the board's discretion was made amply clear in *Quickturn* itself:

> This Court has held 'to the extent that a contract, or a provision thereof, purports to *require* a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable.' . . . .[184]
>
> The Delayed Redemption Provision would prevent a new Quickturn board of directors from . . . redeeming the Rights Plan to facilitate a transaction that would serve the stockholders' best interests, even under circumstances where the board would *be required* to do so because of its fiduciary duty.[185]

The Court did not use the "require" language carelessly. Generally speaking, a hostile bidder that goes so far as to mount a proxy contest will be the only party interested in paying full value for the target company.[186] Thus, in most hostile bids, the only options are 'no sale' or

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181. CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 239 (Del. 2008) (emphasis added).

182. *Id.* at 239.

183. *Id.*

184. *Quickturn*, 721 A.2d at 1292 (emphasis added).

185. *Id.* at 1292-93 (emphasis added).

186. It is always possible that a new bidder could emerge with a superior bid. In such a case, however, the slow-hand feature would bind the board's discretion in a different way entirely; the board would be unable to conduct an auction contest between

'sale to the hostile bidder.' By taking the latter off the table, the slow-hand pill would have effectively bound the directors to the 'no sale' option—even if their fiduciary duties would have required them to complete the transaction.

A true circumscribing bylaw, by contrast, permits the board to pursue a variety of strategies not only in theory, but in fact as well. Thus, neither of the factors on which *Quickturn* turned—the use of contracts to invent a procedure for the board to bind itself and the heavily binding nature of the restriction itself—would be applicable. The relevance of *Quickturn* to circumscribing bylaw rests in its demonstration that the Court will pursue a substance-over-form analysis in analyzing restrictions on board power. Indeed, this same point was made in the *CA* scope or reach analysis, where the Court wrote:

> Because the Bylaw is couched as a command to reimburse ("The board of directors shall cause the corporation to reimburse a stockholder"), it lends itself to CA's criticism. But the Bylaw's wording, although relevant, is not dispositive of whether or not it is process-related. The Bylaw could easily have been worded differently, to emphasize its process, as distinguished from its mandatory payment, component. By saying this we do not mean to suggest that this Bylaw's reimbursement component can be ignored.[187]

In short, the effect of a provision cannot be determined from its face.

One loose end still remains: the phrase "full managerial power" in the excerpt cited above.[188] When the Court explained the invalidity of the Reimbursement Bylaw as a matter of preventing "the directors from exercising their *full managerial power* in circumstances where their fiduciary duties would otherwise *require* them" to act differently, did the Court mean to imply that *all* of the board's once-extant powers must remain permanently available?[189] It likely did not; if that was in fact the

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the two bidders, as its ability to close a transaction with the first bidder would be disabled. *See* Gordon, *supra* note 1, at 533-34. Furthermore, since the new bid is a superior offer, the board would likely breach its *Revlon* duties by rejecting it. Thus, the slow-hand feature would bind the board a single course of action: accepting the new bid on the terms initially proposed.

187. CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 236 (Del. 2008).

188. *See supra* note 181 and accompanying text.

189. *See supra* note 181.

law, a company could, for instance, never commit to specific performance in a contract, as doing so would require directors to alienate their power to efficiently breach. Furthermore, the words "full power" do not normally imply that an actor possesses all theoretically available powers, but rather only those powers needed to do something in particular. Indeed, in the last forty years, the Delaware Supreme Court has used the phrase "full power" in fifteen other cases;[190] in every single one, it described someone having the "full power . . . to" achieve some end.[191] In many of those cases, the Court was referring to a board delegating its "full power" to a committee of the board, in which cases the "full power" being delegated was necessarily less than the absolute sum of the board's powers.[192] In short, the phrase "full managerial power" is subject to an implied qualifier, without which it lacks an ascertainable meaning.

The most logical reading is that "full managerial power" implies the need for a substance-over-form analysis, designed to make sure that the board retains its discretion in fact, and not just in form. The "full power" formulation originated in *Quickturn*, where the Court explained that the slow-hand pill was invalid because it "prevents a newly elected board of directors from *completely* discharging its fiduciary duties to protect *fully* the interests" of the company and its shareholders.[193] This less opaque passage reveals the issues about which the Court was principally concerned. Recall that the slow-hand pill purported to permit the board to freely exercise its discretion in all respects other than redeeming the pill. But the Court considered that discretion illusory, taking away the most important power (pill redemption) without

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190. I am examining the Court's usage, and thus not including cases where the phrase "full power" only appeared in a quoted document.

191. *See, e.g.*, Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1055 (Del. 2004) (describing how a special litigation committee often "is vested with the *full power* of the board *to* conduct an extensive investigation) (emphasis added); *In re* Appeal of Infotechnology, Inc., 582 A.2d 215, 221 (Del. 1990) (noting that a trial court has "*full power to* employ the substantive and procedural remedies available *to properly control* the parties and counsel before it") (emphasis added).

192. Some of the powers of the board cannot be delegated to a committee. *See* DEL. CODE ANN. tit. 8, § 141(c)(2) (2014) (noting that the board may not delegate to a committee the power to amend the bylaws or any power "in reference to . . . approving or adopting, or recommending to the stockholders, any action or matter . . . expressly required . . . to be submitted to stockholders for approval").

193. Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281, 1292 (Del. 1998).

providing an effective substitute for permitting a merger to proceed.[194] In other words, the board could not fully protect the shareholders because it could not enable them to take advantage of an adequate takeover offer—or, put another way, the board would be unable to completely discharge its duties because it was "prevent[ed] . . . from . . . facilitat[ing] a transaction that would serve the stockholders' best interests, even under circumstances where the board would be required to do so."[195]

In other words, the language of "full managerial power" and "completely discharging" is fully consistent with the central concept of BG. The board's power may be circumscribed, but only if its ability to effectively exercise its business judgment is preserved. As *CA* noted, whether the disablement comes from the board or from the shareholders is irrelevant[196]—what matters is that the board has latitude to pursue its ends by reasonably substitutable means.

C. POST-*CA* DEVELOPMENTS

Though *CA* remains the leading case on bylaw validity, its influence may be dwindling. As a formal matter, it has not been overturned, modified, or even questioned by any Delaware court. It was also notably absent in the most recent bylaw case decided by the Delaware Supreme Court: *ATP Tour, Inc. v. Deutscher Tennis Bund*.[197] Like *CA*, *ATP* decided certified questions referred to the Court from a federal authority. Unlike *CA*, *ATP* said as little as possible. It is a minimalist opinion holding that fee-shifting bylaws—i.e. bylaws that require plaintiff shareholders to reimburse corporations for costs and fees incurred in defending unsuccessful litigation[198]—are not facially

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194. *See id.* at 1291-92 (explaining that while the slow-hand pill "limits the board of directors' authority in only one respect . . . it nonetheless restricts the board's power in an area of fundamental importance to the shareholders—negotiating a possible sale of the corporation").

195. *Id.* at 1292-93.

196. *See supra* note 181 and accompanying text.

197. 91 A.3d 554 (Del. 2014).

198. Technically, the defendant corporation in *ATP* was non-stock, and the certified question made reference to that technicality. *Id.* at 557. The Court, however, very quickly made clear that the same rules apply to both types of organizations. *Id.* at 557 n.10 ("[T]he provisions of the Delaware General Corporation Law, including § 109(b), apply to non-stock corporations and all references to the stockholders of a corporation are deemed to apply to the members of a non-stock corporation.").

invalid. That is, such bylaws fall within the scope of § 109(b). *ATP* also reminded the federal district court of the long-standing principle that bylaws need not be enforced if they were adopted for improper purposes or if their enforcement would operate inequitably in a specific case.[199] The opinion did not elaborate upon that basic hornbook rule.

It is impossible that the Court failed to notice the obvious tension between the outcomes in *ATP* and *CA*. *ATP* instructed the district court to do precisely what the Court itself did not do in *CA*: uphold and enforce a bylaw despite the possibility that a situation might arise in which the bylaw could operate invalidly or inequitably. It is also highly unlikely that the Court intended to overrule *CA sub silentio*. *ATP* did not purport to articulate any new rules of law; much of its analysis simply restated the facts and holdings of old cases such as *Schnell v. Chris-Craft Industries* and *Frantz Manufacturing*.[200] Moreover, the procedural context renders a silent overturning almost unthinkable. The certification process exists so that state courts can clarify their law to the federal courts that need to apply it; it would make no sense for the Delaware Supreme Court to have used this particular occasion to confuse everyone else. Until we are given a more explicit statement, we must assume that *ATP* and *CA* are meant to be consistent.

The distinction between circumscribing and controlling bylaws offers one way of harmonizing the two decisions. The bylaw in *ATP* did not require any action by the board, and thus could not at all compromise the directors' discretion. In fact, the ATP bylaw did not even apply to board action at all. The distinction between *CA* and *ATP* is likely not so simple as the difference between a bylaw that does or does not affect the board. As mentioned above, *ATP* approvingly cited to *Frantz* and *Hollinger International v. Black*, cases addressing bylaws that restricted board action. Of course, one might attribute this inconsistency in the case law to outcome-orientation on the part of the courts. It would not be unfair to characterize the Delaware courts as currently enthusiastic about bylaws that attempt to reduce a company's litigation costs.[201] The *CA* court, by contrast, did not bother to recount

199. *Id.* at 558.

200. *Id.*

201. In 2013, the Chancery Court upheld forum-selection bylaws that required shareholder derivative suits to be heard in Delaware courts. *See* Boilermakers Local 154 Ret. Fund v. Chevron Corp., 73 A.3d 934 (Del. Ch. 2013). As the court approvingly explained, such bylaws intend to eliminate the costs to the company of multi-forum litigation. Fee-shifting bylaws also attempt to reduce litigation costs, by making the litigation more risky for the plaintiffs.

any laudable effects that might have resulted from the Reimbursement Bylaw. It is hardly implausible that the tension between the cases is the product of this enthusiasm gap. This Article, though, takes legal reasoning seriously; on that level, the distinction between circumscribing and controlling bylaws seems to account well enough for the tension between the two cases.

The interpretation of *CA* proposed by this Article is also consistent with an observation by Vice Chancellor Laster in *Klaassen v. Allegro Development Corporation*.[202] In discussing the effect of the board's failure to notice a meeting as required in the bylaws, the Vice-Chancellor cited what he saw as:

> [T]he general rule that the stockholders, through bylaws, may dictate the process that directors use to manage the corporation, so long as the restrictions are not so onerous as to interfere with the board's power to manage the corporation under Section 141(a).[203]

To be sure, "onerous" is not the most precise of expressions; the Vice Chancellor appears to be using the word as a synonym for "discretion-limiting," as discretion-limiting restrictions would in fact interfere with the board's power. Thus, the Vice Chancellor recites one of the central assertions of bylaw governance and the circumscribing bylaw theory: that the shareholders' bylaw power is not defined by subject matter (i.e. meeting dates, quorum, etc.) but rather by the degree of interference with the board's managerial discretion. That he cited *CA* in support of this "general rule" supports the interpretation of that case offered in this Article. However, I will stop short of contending that the Vice Chancellor endorses bylaw governance. It is enough to say that his perception of the corporate law is consistent with BG theory.[204]

D. *UNISUPER*'S (EVENTUAL) ACCEPTANCE OF CIRCUMSCRIBING BOARD RESTRICTIONS

The previous section demonstrated that *CA* and other relevant Delaware precedent can be interpreted to validate circumscribing bylaws. The courts have also addressed—and validated—corporate

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202. No. 8626-VCL, 2013 WL 5739680 (Del. Ch. Oct. 11, 2013).
203. *Id.* at *19.
204. It is not consistent with every theory. Advocates of director primacy likely take issue with Laster's formulation and contest that it constitutes any sort of general rule.

actions that are functionally equivalent to circumscribing bylaws. This suggests that the BG theory is firmly established within Delaware corporate law, and is not merely the product of a single opinion.

The most interesting of these precedents is the pair of opinions issued by Chancellor Chandler in *UniSuper, Ltd v. News Corp*.[205] The first opinion in the case ("*UniSuper*")[206] was the Chancellor's original ruling on the defendant corporation's motion to dismiss. The second opinion ("*UniSuper* I-L")[207] certified the first decision for interlocutory review by the Delaware Supreme Court. The first opinion used reasoning that neither engaged nor commented upon the concept of board circumscription, but that reasoning proved deficient in a number of ways. Perhaps for that reason, *UniSuper I-L* largely jettisoned the arguments on which *UniSuper* relied. The *UniSuper I-L* opinion—which the Delaware Supreme Court left undisturbed by declining an interlocutory appeal—analyzed the case as a question of whether the board's discretion. In defending his original opinion, the Chancellor in essence confirmed the validity of circumscribing bylaws, even as applied to substantive managerial issues.

The facts of the case revolved around a contract between News Corp. and a group of its Australian institutional shareholders. In that contract, News Corp. had assumed certain corporate governance responsibilities in exchange for the shareholders' assent to its reincorporation in Delaware.[208] One of the terms of that contract was a

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205. The first opinion was the original decision on the defendant's motion to dismiss, and can be found at 2005 Del. Ch. LEXIS 205 (Del. Ch. Dec. 20, 2005). The second opinion 2006 Del. Ch. LEXIS 11 (Del. Ch. Jan. 19, 2006) certified the decision for interlocutory review.

206. No. 1699-N, 2005 Del. Ch. LEXIS 205 (Del. Ch. Dec. 20, 2005).

207. No. 1699-N, 2006 Del. Ch. LEXIS 11 (Del. Ch. Jan. 19, 2006). As described below, the interlocutory opinion defended the original decision, but only by essentially abandoning the reasoning of the first opinion in favor of an analysis that closely resembles a theory of circumscribing bylaws. *Id.*

208. *Id.* at *4-6. Technically speaking, the agreement that formed the basis of the contract was not obtained by shareholders, but rather by an organization called ASCI, described by the court as "non-profit organization that advises Australian pension funds on corporate governance." *UniSuper*, 2005 Del. Ch. LEXIS 205, at *3. It seems as if ASCI was negotiating on behalf of its clients, who were institutional investors. More importantly, the agreement it obtained allegedly bound the company to a course of conduct, which of course applies to all shareholders equally. *Id.* Thus, the complaint was filed by a group of institutional investors, not by ASCI. *Id.* at *12. In any event, the court treated the agreement as one between institutional shareholders and the company,

pill-redemption agreement ("PRA"), according to which the company agreed not to implement a poison pill defense for longer than one year without obtaining majority shareholder approval. Soon after reincorporation, News Corp. was subject to a hostile bid; in response, it adopted a poison pill, and one year later, the company extended the pill's duration without obtaining shareholder approval. In response to litigation by shareholders seeking to enforce the original agreement, the board argued that the PRA was illegal under § 141(a).[209] The Chancellor disagreed, and found the contract to be enforceable.[210] His ruling meant that the shareholders were able to prevent the board from implementing a poison pill.

There is little reason to think that *UniSuper* would have been decided differently had the PRA taken the form of a bylaw and not a contract. Indeed, bylaws have a stronger claim to validity than contracts like the PRA: whereas the latter can be implemented with only the support of a small minority interest, bylaws require the assent of a shareholder majority. To be sure, the PRA was a joint agreement between (a few) shareholders and the board. Perhaps it might be contended that the bilateral nature of the agreement put it on a different footing than bylaws adopted unilaterally by shareholders. Such an argument would run afoul of *Quickturn*, which established that the board could not conjure a special ability to bind its future judgment simply by embedding the restriction in a contract.[211] It would be

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without any regard to the difference—if any—between the identities of the plaintiffs and the investors on whose behalf ASCI originally acted. *See id.* at *4-8.

209. *UniSuper*, 2005 Del. Ch. LEXIS 205, at *23-26.

210. More specifically, enforceable to the extent that an actual contract had been breached. The existence of any contract between the board and the shareholders was an issue in dispute in the case. *See UniSuper I-L*, at *16-17. This uncertainty arose from the fact that the agreement at issue was not formalized; rather, it was orally negotiated behind closed doors, and then memorialized in a News Corp. press release to the public. *Id.* at *17. The company claimed that it was bound only to adopt a board policy (which it did), and the subsequent repeal of that policy breached no obligation. *Id.* Since the opinion was issued in response to a motion to dismiss, the court accepted the plaintiffs' allegations that the press release also promised the maintenance of that policy or, in the alternative, that the board had agreed to do so in a separate oral contract. *Id.* at *16-17. Since the court based its opinion on the assumption that a contract existed, the analysis here will follow suit. *See id.* at *15-22.

211. *See supra* notes 175 & 176 and accompanying text. The contract in question in *Quickturn* was the option contract that comprised the poison pill extended by the company to its shareholders.

senseless to waver from that rule just because the party negotiating the contract is a shareholder minority. To the extent that the distinction between contract and bylaw makes any difference, it should work in favor of bylaw validity: the collective agreement of a shareholder majority should have a greater claim to legitimacy than a policy effected by a minority shareholder interest. If a restriction can be valid so long as *some* shareholders negotiate for it, why require the shareholders' participation in the first place? A board can always find a few shareholders to sign on the dotted line in exchange for private benefits. If this were to be sufficient, then the directors would in effect be permitted to bind themselves.

On its own terms, *UniSuper* relied on reasoning that erred on several basic points of law. While the outcome of the case was clear—the Chancellor rejected the company's argument that constraints on board action necessarily violate § 141(a) whenever they limit, in any fashion, the board's discretion[212]—the original reasoning that supported this conclusion cannot withstand serious analysis. Indeed, the first *UniSuper* opinion reads like an outcome in search of a theory.[213] This is important because Chancellor Chandler would later revise his reasoning in an opinion certifying an interlocutory appeal; the logic of that opinion was (1) defensible on the merits and (2) not coincidentally, fully consistent with BG. To fully appreciate the significance of his revisions, it is useful to briefly review how his original opinion went wrong.

His first mistake was to disregard Delaware law on poison pills, presumably unintentionally. He wrote:

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212. The company also argued that the board's decision to agree to the terms of the contract violated its fiduciary duties. This argument is, strictly speaking, not relevant to circumscribing bylaws, which do not require the board to agree and thus do not implicate the board's duties. Thus, only the § 141(a) argument is addressed here. That said, the two arguments substantially overlap and the analysis of this section can be applied to the fiduciary issue with only minor modifications.

213. *UniSuper* has its defenders, but the defenses support the point advanced here. Professor Smith, for instance, has lauded *UniSuper* as an example of privately ordered corporate governance, in which the allocation of power between board and shareholders is determined on a firm-by-firm basis. *See* Smith, *supra* note 22, at 188 (concluding that *UniSuper* "evinces the potential of private ordering to benefit shareholders in public corporations"). In other words, like the Chancellor, he focuses on the outcome of the case at the expense of its reasoning. His account of the case is indeed elegant; the point made here is that the outcome can be reached only by means of a legal argument that recognizes the general validity of circumscribing constraints on the board.

> The fact that the alleged contract in this case gives power to the shareholders saves it from invalidation under Section 141(a). The alleged contract with ACSI did not cede power over poison pills to an outside group; rather, it ceded that power to *shareholders*. . . . . [W]hen shareholders exercise their right to vote in order to assert control over the business and affairs of the corporation the board must give way. This is because the board's power—which is that of an agent's with regard to its principal—derives from the shareholders, who are the ultimate holders of power under Delaware law.[214]

Compare that passage with the following excerpt from the 2001 Delaware Supreme Court opinion in *Account v. Hilton Hotels Corp.*[215]

> It is indisputable that Moran established a board's authority to adopt a rights plan. . . . Moran addressed a fundamental question of corporate law in the context of takeovers: whether a board of directors had the power to adopt unilaterally a rights plan the effect of which was to interpose the board between the shareholders and the proponents of a tender offer. *The power recognized in Moran would have been meaningless if the rights plan required shareholder approval. Indeed, it is difficult to harmonize Moran's basic holding with a contention that questions a Board's prerogative to unilaterally establish a rights plan.*[216]

Hilton's facts were not directly on point, but its reasoning should have controlled.[217] Poison pills cannot be used to elicit the best offer price from a bidder if the shareholders can veto their use. The purpose of a pill, after all, is to force the bidder to secure approval from the board, which can negotiate to obtain the bidder's best price.[218] Shareholders, by contrast, can only choose between tendering and not tendering. An important justification for the pill is that it prevents shareholders from choosing to tender so long as the price is *acceptable* even though it

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214. *UniSuper*, at *24-26.

215. 780 A.2d 245, 249 (Del. 2001).

216. *Id.* (emphasis added).

217. In *Hilton*, individual shareholders were seeking to opt out of the pill unilaterally, rather than putting the pill itself to a shareholder vote.

218. *See, e.g.*, Martin Lipton, *Pills, Polls, and Professors Redux*, 69 U. CHI. L. REV. 1037, 1057 n.77 & 1057-58 (2002) (noting that poison pill operates to the benefit of shareholders when it forces potential acquirers to raise their bids in order to convince the target board to endorse the offer and dismantle the pill).

might not be the *maximal* price they could obtain.[219] The board's leverage to bargain for that maximal price disappears if the shareholders can lower (or, in the case of the PRA, choose not to raise) the defenses, since the shareholders might do so in response to any minimally acceptable bid. Whatever the merits of this reasoning, it has consistently been Delaware law for many years, as the Chancellor himself would later acknowledge in his final *Airgas* opinion.[220]

In light of this settled precedent, one might have expected the Chancellor to distinguish *UniSuper* on its facts. Instead, he tried to evade *Hilton's* command with his excursion into agency theory, excerpted above.[221] This approach to the case could never have worked, because directors, simply put, are not agents of the shareholders. To be sure, many scholars use agency theory to provide a compelling normative theory of the nature of the corporation and a useful positive description of the board's fiduciary duties.[222] Agency theory, however, cannot be a complete or fully accurate account of the relationship between shareholders and director, because the corporate law departs from agency law on a number of important issues, such as the distribution of capital[223] and the board's unilateral ability to deploy a poison pill.[224] In any event, *Hilton* itself had specifically rejected an

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219. *Id.* at 1041-42.

220. *See* Air Prods. & Chems, Inc. v. Airgas, Inc., 16 A.3d 48, 57-58 (Del. Ch. 2011) (stating the Chancellor's "personal view [that]Airgas's poison pill has served its legitimate purpose" but admitting that he was bound by precedent that "selection of a time frame for achievement of corporate goals . . . may not be delegated to the stockholders.").

221. *See* UniSuper, Ltd v. News Corp, No. 1699-N, 2005 Del. Ch. LEXIS 205, *33 (Del. Ch. Dec. 20, 2005) (asserting that "[w]here the principal [the shareholders] makes known to the agent [the board] exactly which actions the principal wishes to be taken, the agent must act in accordance with those instructions"). *See also supra* note 214 and accompanying text.

222. The most famous work expounding this view was the seminal paper: Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981).

223. *See* Lynn A. Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667, 677 (2003) (noting that it is "difficult to reconcile" the view that directors are shareholders' agents with the "fundamental reality of corporate law" that shareholders can neither pay themselves dividends nor force the board to do so).

224. *See, e.g.*, Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871, 909 (2003) (noting that "poison pills are adopted unilaterally by the board of directors" and

agency-based view of the board's power, which makes the Chancellor's decision to rely on that normative argument all the more puzzling.

By appealing to agency theory, the Chancellor overlooked a useful, readily available factual distinction. *Hilton* had addressed the board's power to deploy a pill;[225] the issue presented in *UniSuper* was the *indispensability* of that power. While the former question has, as noted above, been engaged frequently by the Delaware courts, the latter question has never been decided. Never has the Court required the board to deploy a pill, nor has it held that the board's power to deploy a pill cannot be compromised.[226] Moreover, News Corp. could not force a merits consideration of the indispensability issue, because it was not yet ripe on the facts of the case presented to the court. After all, the measures that the company retained under the PRA[227] might have been sufficient to fend off hostile bids. In the absence of an actual hostile bid, the court would have neither the occasion nor the means to determine whether the board actually needed the pill to fulfill its fiduciary duties. Had the case been framed this way, existing precedent would have supported the Chancellor's position. The Chancellor could have reached the same result—i.e. rejecting the company's motion to dismiss—

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that "the fact that the pill did not require shareholder approval was one of its main attractions").

225. *See supra* note 216 and accompanying text.

226. Indeed, the Court has implied that the board's power to redeem a pill can be altered in the certificate. *See* Carmody v. Toll Bros., 723 A.2d 1180, 1191 (Del. 1997) (holding that because "the Rights Plan's allocation of voting power to redeem the Rights is nowhere found in the Toll Brothers certificate of incorporation, the complaint states a claim that the 'dead hand' feature of the Rights Plan is . . . statutorily invalid under Delaware law"). It would be bizarre if the power to implement a pill could not be similarly altered in the certificate.

227. For instance, a staggered board is, in itself, an impediment to a hostile takeover, since it would still take the bidder two election cycles to obtain majority representation on the board. *See* DEL. CODE ANN. tit. 8, § 141(k)(1) (providing that directors on staggered boards can be removed only "for cause."). So too do target firms enjoy the protections of § 203, which prevents a 15% holder of a target company's stock from merging with the target for three years, unless it obtains board approval before becoming a 15% holder, acquires 85% of the outstanding stock in its tender offer, or receives the approval of a supermajority of minority stockholders. Neither of the last two conditions is trivial, which alone incentivizes acquirers to negotiate friendly transactions instead of proceeding with a hostile tender offer. *See* DEL. CODE ANN. tit. 8, § 203(a)(2).

without contradicting controlling precedent or relying on ill-considered theories about gap-filling in corporate contracts.[228]

Ultimately, the Chancellor came to embrace this factual distinction in *UniSuper I-L*, when he reconsidered and restated his original *UniSuper* argument. Some commentators have characterized *UniSuper I-L* as a "clarification" of the original opinion,[229] but, in fact, it thoroughly recast the underlying legal analysis. Agency law was completely absent from the discussion of § 141(a), replaced by the following justification for the contract's enforceability:

> The fact (if it is a fact) that the News Corp. board agreed to cede *part of* its authority over a *discrete question* (extension of the Company's poison pill) to the Company's owners (the shareholders at large) . . . .[230]

In the context of the case, this sentence is highly significant. It shows that the reasoning of the original *UniSuper* had been abandoned. A new argument—that the PRA was valid because it so minimally interfered with the directors' overall authority—had become central to the case holding. The original *UniSuper* opinion did not even consider the extent of the board's cessation of power, and implied that the board could have relinquished any amount of its control, so long as it was

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228. In particular, the Chancellor's statement that "[s]hareholders should be permitted to fill a particular gap in the corporate contract if they wish to fill it" so wholly contradicts basic tenets of Delaware law that one supposes he could not really have meant what he wrote. Not even the most ardent proponent of an agency model of the corporation would endorse this statement as an accurate description of the law. For example, shareholders cannot fill the gaps in the corporate contract by deciding to indemnify directors against liability for bad faith actions. *See, e.g.*, Waltuch v. ContiCommodity Servs, Inc., 88 F.3d 87 (2d Cir. 1996). Nor can they expand the scope or strictness of the directors' fiduciary duties. It has never been suggested to or by a Delaware court, for instance, that shareholders can alter the duty of loyalty so that directors are *required* to present corporate opportunities to the board before taking them. *See, e.g.*, Broz v. Cellular Info. Sys., Inc., 673 A.2d 148, 157 (Del. 1996) (holding that "if [a] director or officer believes . . . that the corporation is not entitled to the opportunity, then he may take it for himself" and reiterating that "[i]t is not the law of Delaware that presentation to the board is a necessary prerequisite to a finding that a corporate opportunity has not been usurped"). *Perhaps* such a thing could be done in the certificate, but of course, the certificate is itself the contract, not a gap-filling measure, and it cannot be modified by the shareholders.

229. *See, e.g.*, Frederick Alexander & James Honaker, *Power to the Franchise or the Fiduciaries: An Analysis of the Limits on Stockholder Activist Bylaws*, 33 DEL. J. CORP. LAW 749, 756 n.24 (2008).

230. *UniSuper I-L*, 2006 Del. Ch. LEXIS 11, at *10 (emphasis added).

relinquished to the shareholders. By contrast, *UniSuper I-L* treated the narrowness of the board restriction (and by implication, the retention by the board of most of its authority) as the dispositive factor.

This renewed focus on the extent to which the board's power had actually been compromised was ultimately an endorsement of the theory of circumscribing bylaws. It was this theory that was presented to the Court by the certification order, and thus this theory that the court implicitly blessed by declining to hear the interlocutory appeal. The Court's only response to *UniSuper I-L* was a brief order noting that, even though it "generally . . . gives substantial deference to the trial judge's recommendation" on interlocutory appeals, "the interests of justice are best served if these proceedings are not interrupted by an interlocutory appeal."[231] Had the Court disapproved of *UniSuper*, *CA* gave it a ready opportunity to cabin it to its facts—for instance, by observing that the PRA was an example of a substantive issue unsuitable for bylaw inclusion. Admittedly, only the weakest of inferences can be drawn from the Court's decision not to include *dicta* criticizing *UniSuper* in a subsequent case.[232] Still, what limited evidence that we have points to a judicial acceptance of the circumscribing bylaw theory.

In summary, if *UniSuper I-L* remains the last word on the issue of the validity of shareholder agreements that bind the board, it would seem to weigh in favor of a legal principle under which circumscribing bylaws would also be valid.

CONCLUSION: BG AND FUTURE DEVELOPMENTS

This Article has set forth two interrelated arguments. One lies in the sphere of positive law, and contends that shareholders in fact have more power to enforce substantive bylaws against the board than is commonly assumed. While they cannot control the board, they may circumscribe its authority. The other, more normative argument concerns the implications of that doctrine of bylaw validity for corporate governance.

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231. News Corp. v. UniSuper Ltd., 906 A.2d 138, 139 (Del. 2006). Notably, Professors Hu and Westbrook observe that the Court's decision not to hear the appeal came as "much surprise to the bar." *See* Henry T. C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321, 1389 (2007).

232. It did, after all, describe hypothetical bylaw provisions that would be considered procedural even though they had substantive ramifications. It could have also described, by means of contrast, a bylaw provision that would in fact be considered substantive.

The normative argument cannot be fully appreciated until the issues of positive law are fully resolved. As argued in Part II, the Delaware bylaw case law is messy. The *CA* case purports to articulate a test for bylaw validity, but the test is wholly inadequate. It is based on a distinction between types of bylaws that is both incoherent and incomplete; it exists in significant tension with prior precedent; its exposition relies on far-fetched hypotheticals; and it is not even consistent with the outcome of the case. The Court must revisit the issue. This Article suggests how it might re-articulate the doctrine consistent with both the spirit of *CA* and the holdings of prior case law. This revision turns on the distinction between circumscribing and controlling bylaws, and would hold that the former are presumptively valid, whereas the latter are definitively invalid.