BYLAW REFORMS FOR DELAWARE'S CORPORATION LAW

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ABSTRACT

Written as part of a symposium on the Delaware General Corporation Law (DGCL) in the 21st Century, this article suggests four reforms to the DGCL. Each of these reforms would help solidify the ability of shareholders to effectively adopt bylaws that regulate decision-making procedure and corporate governance. The four reforms are the following:

1. *Amend section 109(b), and perhaps section 141(a), to clarify that bylaws may set procedural and governance rules, but may not be used to make substantive business decisions.*

2. *Amend section 141(a) to provide that shareholder bylaw or certificate provisions may limit board discretion, thereby shielding the board from fiduciary duty liability for actions required or prohibited by the provisions.*

3. *Amend section 157(a) to clarify that bylaws may limit or regulate the ability of boards to adopt poison pills.*

4. *Amend section 109 to clarify that if a shareholder bylaw so specifies, the board may not amend or repeal that bylaw.*

The first, third, and fourth changes are arguably already the rule under existing law, but there is much uncertainty under that law, and these suggested changes would bring more clarity. The second change responds to the Delaware Supreme Court's recent decision in CA, Inc. v. AFSCME Employees Pension Plan.[1]

I. INTRODUCTION

Shareholder bylaw proposals have become an increasingly important part of battles over corporate governance. Among other issues, shareholders

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[1]953 A.2d 227 (Del. 2008).

have tried to use bylaws to put in place rules for majority voting for directors, shareholder nominations of directors, and limits on the ability of boards to adopt poison pills.

For some of these bylaw proposals, their validity, under state law, is unquestionable. For others, however, there is serious ambiguity under existing Delaware law as to whether the proposed bylaws are valid. The law does not clearly spell out rules or principles for distinguishing what matters can be addressed in bylaws, as opposed to matters that must be addressed in the certificate of incorporation. A very recent Delaware Supreme Court decision has started to clear up some of the ambiguity, but in some ways it has actually increased the uncertainty surrounding shareholder bylaws.

Beyond the question of the scope of valid bylaws, there is a further important point of ambiguity in current Delaware law. If shareholders do succeed in amending a corporation's bylaws, can the board of directors then amend or repeal what the shareholders have done? Other jurisdictions make clear that shareholders can prevent this from occurring, but in Delaware it is currently unclear under both statutory law and common law whether shareholders can, in their bylaws, protect against reversal by the board.

Shareholder bylaws, within reasonable limits, present a useful way for shareholders to guard against board opportunism without going too far in usurping board authority. Shareholders have extremely limited ways in which they can actively take initiative to set rules of corporate governance. Bylaw proposals are one of the only tools available to shareholders. Some clarification of the law in this area, to give a reasonable scope for governance bylaws, would be useful.

In particular, this article suggests four changes to Delaware statutes regulating bylaws:

1. Amend section 109(b), and perhaps section 141(a), to clarify that bylaws may set procedural and governance rules, but may not be used to make substantive business decisions.

2. Amend section 141(a) to provide that shareholder bylaw or certificate provisions may limit board discretion, thereby shielding the board from fiduciary duty liability for actions required or prohibited by the provisions.

3. Amend section 157(a) to clarify that bylaws may limit or regulate the ability of boards to adopt poison pills.

4. Amend section 109 to clarify that if a shareholder bylaw so specifies, the board may not amend or repeal that bylaw.

All but the second of these changes are possible results under the existing statutory and case law scheme and all follow from the best interpretations of the existing scheme. There is considerable uncertainty on three of the points, however, with strong arguments both for and against these results. This uncertainty has continued for many years, and it would be useful for the legislature to step in and end it. The Delaware Supreme Court has taken an implausible position on the second suggested amendment.

This article proceeds as follows: Part II provides both policy and legal background. It summarizes the current state of the relevant law in Delaware, and presents policy arguments in favor of the results advocated here. Part III presents the details of the proposed changes to the Delaware statutes.

II. BACKGROUND

Most rules in the corporation law of Delaware, as well as other states, are default rules. That is, an individual corporation may choose to follow a different rule than that which the statute sets forth. The corporation law also explicitly or implicitly prescribes what a corporation must do to opt out of any particular default rule. These rules prescribing how to opt out of the statutory defaults have been called "altering rules."[2] Altering rules regulate how easy or hard it is to opt out of a default rule—that is, how "sticky" the default rule is.[3] Altering rules also help allocate authority among different actors within corporations.

One of the main ways in which corporations alter statutory defaults is through provisions in the certificate of incorporation or in the bylaws. Altering rules may allow a corporation to opt out of the statutory default, either only in the certificate, or in either the certificate or in the bylaws. It matters which method the altering rule allows because amending the certificate requires approval by both the board and stockholders,[4] while amending the bylaws can be done by either the board or the stockholders alone.[5] Thus, an altering rule which allows for altering through the bylaws is less sticky than one which allows for change only through the certificate and not the bylaws. The distribution of authority is also different, though in a rather tricky way; either the board *or* the shareholders can act on their own to amend the bylaws. Thus, bylaw amendments have been an important tool for activist shareholders

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[2]Ian Ayres, *Menus Matter*, 73 U. CHI. L. REV. 3, 6 (2006); Brett H. McDonnell, *Sticky Defaults and Altering Rules in Corporate Law*, 60 SMU L. REV. 383, 393 (2007).

[3]*See supra* note 2.

[4]DEL. CODE ANN. tit. 8, § 242 (2006).

[5]*Id.* § 109(a).

trying to reign in boards, but they are also an important tool for boards trying to solidify their position.

As a result, bylaws have become an important source of political and scholarly debate in recent years. Shareholder activists have tried to use bylaw proposals to seize a degree of power in a variety of ways:

1. Trying to get more control over the process of voting for directors through majority voting and proxy access bylaws.[6]

2. Trying to limit perceived excessive executive compensation through "say on pay" bylaws.[7]

3. Trying to limit the ability of boards to entrench themselves with antitakeover devices through poison pill bylaws.[8]

Scholars sympathetic to shareholder activists have argued for the legality and usefulness of such bylaws.[9] Boards have opposed all of these, not only by seeking negative votes on such proposals, but also by seeking to exclude such shareholder proposals from the corporate proxy materials and by arguing that various shareholder bylaw proposals are invalid under Delaware (or other state) law. Scholars sympathetic to boards have given reasons why an expansive shareholder bylaw power is both unattractive and also does not conform with existing law.[10]

Two main arguments, both drawn from law and economics analyses, argue for giving shareholders broad powers to use bylaws to shape the contours of authority and governance within a corporation. The first argument points to the value of making it easy to experiment and to shape particular rules for each corporation. This argument focuses on the optimal degree of stickiness in altering rules, and maintains that low stickiness is generally best. The second argument points to the importance of controlling

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[6]RISKMETRICS GROUP, 2007 POSTSEASON REPORT: A CLOSER LOOK AT ACCOUNTABILITY AND ENGAGEMENT 3-6 (2007), http://www.riskmetrics.com/pdf/2007PostSeasonReport FINAL.pdf.

[7]*Id.* at 6.

[8]*Id.*

[9]John C. Coffee, Jr., *The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?*, 51 U. MIAMI L. REV. 605, 613-16 (1997); Brett H. McDonnell, *Shareholder Bylaws, Shareholder Nominations, and Poison Pills*, 3 BERKELEY BUS. L.J. 205, 252-53 (2005).

[10]STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 45-48 (2002); Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?*, 73 TUL. L. REV. 409, 467-75 (1998).

the agency costs that come with the separation of ownership and control in large public corporations. This argument focuses on how altering rules allocate authority and maintains that shareholders could use a modest boost of authority over directors and officers.

One of the key early insights in the modern application of economics to corporate law was that much of corporate law provides default rules rather than mandatory rules, and that this is a good thing.[11] Default rules provide a flexibility that is valuable for several reasons. They allow individual corporations to tailor the rules to what is best for them in their individual circumstances.[12] One-size-fits-all rules are likely to be a bad fit for many businesses and default rules should make it easy for them to modify the off-the-rack settings that corporation law provides. Default rules also allow companies to escape statutory rules that have been set poorly. Under a majoritarian approach, the legislature should set most default rules in the way that a majority of companies would prefer. Unfortunately, even if the legislature tries to do so, it will sometimes get things wrong. When that happens, it helps if companies can easily opt out of the poorly set default rules. When many companies then choose to opt out, not only will the individual choices help those companies avoid the costs that follow from a bad rule, but the fact of mass opting out may show the legislature it made a mistake. A related benefit of default rules is that they allow for experimentation, so that individual companies can try out differing approaches. If a particular rule proves successful for the companies that adopt it, others can then adopt that rule, and ultimately the legislature may choose to make it the default rule.

These are well-known benefits of having default rules rather than mandatory rules. Once the focus is on altering rules, and on how easy it is for companies to opt out of the default rules, a straightforward extension of the argument for having default rules suggests that altering rules should be set to allow companies to opt out easily, cheaply, and quickly. As pointed out above, allowing a company to opt out in the bylaws is easier, cheaper, and quicker than requiring it to opt out in the certificate. Thus, the standard arguments in favor of default rules also work as arguments in favor of altering rules that allow opting out through the bylaws.

A second key insight gained from applying economics to corporate law has been an understanding of the agency problems that come from the separation of ownership from control in large public corporations. Although

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[11]FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991); Lucian Arye Bebchuk, Foreword, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1396-98 (1989).

[12]Bebchuk, *supra* note 11, at 1404.

recognized as an issue at least since Berle and Means,[13] modern economics-based scholarship on firms and corporations has usefully understood corporate governance through an agency-cost prism.[14] On this understanding, much of corporate law and corporate governance focuses on controlling and guiding the discretion of directors and officers who have the ability to direct the flow of huge piles of money, which they are supposed to be investing for the benefit of others, but which they may choose to divert for their own personal benefit. If we understand this as the, or at least a, leading goal of corporate law, then it would seem that shareholders should be able to shape the rules of corporate governance within a company on their own, without requiring board approval. Why allow the board a veto over governance rules when controlling that board is one of the main goals of those rules? This has been a key theme of much work by Professor Lucian Bebchuk.[15]

Within the bounds of contemporary American corporate law, the main source for shareholder initiatives to shape corporate governance without board approval is the bylaws.[16] This leads to a natural recommendation of an expansive bylaw power. A complication with this recommendation is that boards can amend the bylaws themselves, without shareholder approval. The board, as well as shareholders, can use an expansive bylaw power, and boards may be more likely than shareholders to frequently amend the bylaws. This problem leads to two suggested solutions. First, one could have more use of provisions that allow a rule to be set by shareholder-enacted bylaws but not board-enacted bylaws. Such provisions are seen occasionally, but rarely, in corporate law.[17] Second, one could allow shareholder-enacted bylaws to forbid

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[13] ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 69-118 (1932).

[14] For key economics literature that has influenced modern legal scholarship, see, e.g., OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM (1985); R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937); Michael C. Jensen & William H. Meckling, *The Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691 (1986). Easterbrook and Fischel played the leading role in incorporating law and economics into contemporary legal scholarship in a series of articles that culminated in their highly influential book. *See* EASTERBROOK & FISCHEL, *supra* note 11.

[15] *See generally* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005).

[16] Professor Bebchuk has called for allowing shareholders to amend the certificate without board approval, a power which shareholders in many other countries have. *See id.* at 865-68. I have much sympathy for that suggestion, but it goes a step further than the proposals here.

[17] *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(d) (2006) (allowing classified boards to be created in the certificate of incorporation, by an initial bylaw, or a bylaw adopted by a vote of the stockholders).

further change by the board to such bylaws, so that where shareholders want to take action, they are able to thereafter block board action on that matter. This is one suggestion discussed in the following part.

Are there any good public-spirited policy reasons, as opposed to special pleading by managers and their allies, to fear a relatively expansive understanding of bylaw power? Three common arguments strike me as the most plausible. First, special interest shareholders may abuse the bylaw power to pursue their own interests at the expense of other shareholders. Second, strong, hard-to-alter board authority may be critical to the economic efficiency of large corporations. Third, a grant of broad authority to the board, combined with powerful fiduciary duties to shareholders, is the central traditional structural characteristic of Delaware corporations.

Two of the leading types of institutional shareholder activists are union pension funds and public employee pension funds. Critics charge that these sort of funds seek to advance specialized group, personal, or political interests that are at odds with the interests of other shareholders.[18] There is some systematic evidence for this in the case of labor union funds,[19] and more anecdotal evidence for both types. However, if one considers the main sorts of shareholder activist proposals today that have a decent chance of passage, they would appear mostly focused on general shareholder interests, including: majority voting, advisory votes on compensation, board declassification, pay for performance, independent board chairs, and rescinding supermajority requirements.[20] Moreover, as Professor Lucian Bebchuk has argued, shareholder activists can succeed only where they can persuade a majority to vote on their side, which greatly reduces the possibility of successful special interest manipulation.[21]

The second argument against an expansive shareholder bylaw power is that entrenched board authority is critical to the efficiency of large corporations. Professor Stephen Bainbridge argues this extensively in a series of

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[18]Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 633-34 & n.88 (2006); *see generally* Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993).

[19]*See* Ashwini K. Agrawal, Corporate Governance Objectives of Labor Union Shareholders: Evidence from Proxy Voting (unpublished manuscript), *available at* http://home.uchicago.edu/~aagrawa1/AGRAWAL_paper.pdf.

[20]*See* RISKMETRICS GROUP, *supra* note 6, at 6.

[21]*See* Bebchuk, *supra* note 15, at 885. Stephen Bainbridge has interesting responses to this argument. *See* Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1756-57 (2006); Brett H. McDonnell, *Professor Bainbridge and the Arrowian Moment: A Review of "The New Corporate Governance in Theory and Practice,"* 34 DEL. J. CORP. L. (forthcoming 2009), *available at* http://ssrn.com/abstract=1248289 (responding to Professor Bainbridge's counterarguments).

articles and books on what he calls "director primacy."[22] His core argument draws heavily on the work of Kenneth Arrow, who argues that there is a tradeoff between authority and responsibility. Effective authority is crucial for an organization with many members, in order to overcome problems of differing information and incentives for differing members. Accountability mechanisms are important to limit abuses of authority. If those accountability mechanisms go too far, however, they undermine the advantages of authority by removing all real power from those in charge—the power to review all decisions at any time differs little from the power to simply make those decisions in the first place.[23]

Professor Bainbridge is right to emphasize the tradeoff between authority and responsibility. He is also perceptive in his analysis of the value of both, and in his insistence that we should not go too far in striving for responsibility at the expense of authority. Too often, however, he uses the existence of a tradeoff to argue against even modest attempts at corporate accountability.[24] Allowing shareholder bylaws to set rules of procedure and corporate governance does not give shareholders power over any and all business decisions. Far from it. Indeed, those of us who advocate bylaws governing such matters explicitly distinguish them from ordinary business decisions, which cannot be made through the bylaws.[25]

A third argument against an expansive shareholder bylaw power stresses the fundamental structural role of directors as corporate fiduciaries. Directors hold the most power and most responsibility within the corporation. The law guards against misuse of this power through the fiduciary duties it imposes upon directors. Shareholders do not have such fiduciary duties; therefore, allowing them to exercise power through the bylaws would give power to unaccountable actors.[26]

Fiduciary duty law, however, provides only an imperfect, incomplete check on board power. Moreover, the Delaware courts have recognized that the shareholder franchise is a key structural fact underlying and legitimizing

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[22]BAINBRIDGE, *supra* note 10, at 191-240; STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 11-12 (2008); Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1, 6-7 (2002); Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 550 (2003).

[23]KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 78 (1974).

[24]McDonnell, *supra* note 21, at 14-17.

[25]Coffee, *supra* note 9; McDonnell, *supra* note 9, at 222-23.

[26]Frederick H. Alexander & James D. Honaker, *Power to the Franchise or the Fiduciaries?: An Analysis of the Limits on Stockholder Activist Bylaws*, 33 DEL. J. CORP. L. 749 (2008).

the broad grant of authority to the board.[27] An important use of bylaws is to bolster the shareholder franchise. Thus, expansive bylaw power is consistent with the traditional division of authority between a board of directors and shareholders in Delaware.

Thus, on policy grounds, shareholders should be able to use bylaws to set basic rules of corporate governance and procedure to be followed in running the company. Shareholders can then tailor the rules of their own company to limit potential board misbehavior, while leaving the board with the authority to make business decisions.[28] What does existing Delaware law say on the subject? That question does not have a clear answer for many bylaws. Many statutory provisions do allow bylaws to govern various specific topics.[29] For instance, bylaws may delegate board powers to committees[30] or authorize classes of persons to call special shareholder meetings.[31] Other statutory provisions mention specific areas where the certificate of incorporation may set rules. By relatively clear negative implication, the failure to mention the bylaws for these topics means that bylaws may not be used to set these rules.[32] For instance, the certificate, but not the bylaws, can allow for removal without cause of directors on classified boards[33] or allow for cumulative voting.[34]

Where no such specific provision exists, the law is much murkier. Commentators have noted a struggle between two general provisions. Section 141(a) gives the board broad authority to manage the affairs of the corporation.[35] Section 109(b), however, provides that 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."[36] The question becomes, where a bylaw would limit board authority in some way, which of these two general provisions governs?

At least until very recently, case law did not provide much guidance in resolving this statutory ambiguity. In at least one case, dealing with "no hand"

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[27]Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659-60 (Del. Ch. 1988).

[28]For more detailed defenses of this position, see McDonnell, *supra* note 9, at 237-48.

[29]For fairly comprehensive listings of such provisions, see *id.* at 219-21; McDonnell, *supra* note 2, at 437-39.

[30]DEL. CODE ANN. tit. 8, § 141(c) (2006).

[31]*Id.* § 211(d).

[32]*See* McDonnell, *supra* note 9, at 219-21 (listing specific provisions governed by bylaws).

[33]DEL. CODE ANN. tit. 8, § 141(k)(1) (2006).

[34]*Id.* § 214.

[35]*Id.* § 141(a).

[36]*Id.* § 109(b).

poison pills, the Delaware Supreme Court took a strong stance that "[s]ection 141(a) requires that any limitation on the board's authority be set out in the certificate of incorporation."[37] This can be seen as a statement that section 141(a) trumps section 109(b) but, as I have argued elsewhere, it is not a very persuasive statement to that effect because it does not directly consider section 109 and because it is, at least in part, wrong.[38] For instance, in a close corporation, a limitation on board authority can indisputably be set out in a shareholder agreement even if that agreement is not put in the certificate.[39]

Other cases suggest a broad scope for bylaws. A case decided in 1933 stated that "the by-laws are generally regarded as the proper place for the self-imposed rules and regulations deemed expedient for its convenient functioning to be laid down."[40] Several more recent cases suggest that bylaws are presumptively valid[41] and give "capacious authority" over a board's processes.[42] In several recent cases, Delaware judges have recognized that this question is open under the statute and remains unresolved in the case law.[43] A case decided after the symposium at which this article was presented has given important new guidance—I shall turn to that case after considering further background.

There has been a fair amount of scholarly writing on this topic as well. Two leading articles on the topic stake out the main alternative approaches to the scope of the bylaw power. Professor Lawrence Hamermesh argues that bylaws can only regulate in areas where specific provisions of the statute specify such a power for the bylaws.[44] Therefore, he seems to give no independent scope to section 109(b).[45] Professor John Coffee argues for a more expansive understanding of the bylaw power. Professor Coffee suggests the following four lines for determining what bylaws can do:

1. Bylaws can govern fundamental corporate matters, but not ordinary business decisions.[46]

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[37]Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281, 1291 (Del. 1998).

[38]*See* McDonnell, *supra* note 9, at 230-31.

[39]DEL. CODE ANN. tit. 8, § 350 (2006).

[40]Gow v. Consol. Coppermines Corp., 165 A. 136, 140 (Del. Ch. 1933).

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

[42]Hollinger Int'l, Inc. v. Black, 844 A.2d 1022, 1080 (Del. Ch. 2004). *See also* McDonnell, *supra* note 9, at 230-35 (providing a more detailed analysis of these cases).

[43]Jones Apparel Group, Inc. v. Maxwell Shoe Co., 883 A.2d 837, 846 (Del. Ch. 2004); Gen. DataComm Indus., Inc. v. Wis. Inv. Bd., 731 A.2d 818, 821 n.1 (Del. Ch. 1999).

[44]Hamermesh, *supra* note 10, at 428-33.

[45]*Id.* at 451-52.

[46]Coffee, *supra* note 9, at 613-14.

2. Bylaws can provide negative constraints, but not affirmative orders.[47]

3. Bylaws can regulate procedure but not substance.[48]

4. Bylaws can regulate corporate governance but not business decisions.[49]

Professor Coffee does not provide much legal argument for his position, but, in a recent article, I supported his basic distinctions (especially the last two) with more detailed legal justification.[50]

The battle over bylaws has been particularly fierce for two kinds of bylaws. The first of these regulates the adoption or modification of poison pills. Poison pills are a central tool in the modern board's kit for blocking unwanted takeovers. If shareholders could use the bylaws to limit the ability of boards to adopt pills, that would significantly change the landscape in the market for corporate control which is one of the main markets that helps constrain managerial opportunism.[51] It is an open question whether, and what kind of, pill bylaws are valid in Delaware. The Oklahoma Supreme Court, interpreting statutory language very close to Delaware's, has held such a bylaw valid,[52] but it is unclear how persuasive Delaware courts would find this. In my previous analysis of the existing state of the law, I found such bylaws to be on the borderline of validity, however, more likely than not invalid.[53] In part, this is because using the general distinctions of bylaw validity—procedure versus substance and corporate governance versus business decisions—the offering of shareholder rights can easily be placed on either side of each distinction. More importantly, the specific statutory provision which allows the creation of poison pills provides that the certificate, but not the bylaws, can limit the ability of companies to create stock-based rights.[54] One can get around this point by arguing that bylaws can regulate the procedure boards use

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[47] *Id.*

[48] *Id.*

[49] *Id.* at 614.

[50] McDonnell, *supra* note 9, at 252-63.

[51] EASTERBROOK & FISCHEL, *supra* note 11, at 162-211; Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112-13 (1965).

[52] Int'l Bhd. of Teamsters Gen. Fund v. Fleming Cos., 975 P.2d 907, 908 (Okla. 1999).

[53] McDonnell, *supra* note 9, at 225-26.

[54] DEL. CODE ANN. tit. 8, § 157(a) (2006).

to create rights plans and not their ability to do so.[55] However, that cuts the salami mighty thin.

The other type of bylaw that has recently received attention concerns voting for directors. Two types of voting bylaws have become popular. One kind provides that, under specified circumstances, some shareholders would be able to use the corporate proxy material to nominate director candidates.[56] This would make it much cheaper and easier for shareholders to nominate their own candidates and, thus, might make boards less self-perpetuating. A second kind of voting bylaw provides for majority, rather than plurality, voting for directors.[57] This would give "vote no" campaigns more bite. In recent years, many companies have adopted some version of majority voting. Delaware law was recently revised to help clarify some problems that arise in connection with majority voting.[58]

Particularly after the recent changes, a properly-drafted majority voting bylaw is unquestionably valid under Delaware law. The statutes are less clear for shareholder nomination bylaws; however, in my earlier article on bylaws, I argued that the balance of the arguments clearly suggests that such bylaws are valid in Delaware.[59]

The case law surrounding bylaws changed after a recent decision in *CA, Inc. v. AFSCME Employees Pension Plan*.[60] The union pension, a leading shareholder activist, proposed a bylaw for inclusion in CA's proxy materials.[61] The proposed bylaw provided that if a shareholder nominated a short slate of board candidates (a slate covering less than half of the positions to be contested in the election), and succeeded in electing at least one of its nominees, the corporation would reimburse the shareholder nominator for reasonable proxy expenses.[62] CA asked the Securities and Exchange Commission (SEC) for a no-action letter allowing it to exclude the proposal.[63] The SEC found that whether or not this bylaw could be permitted depended on Delaware state law.[64] Under Rule 14a-8, a proposal is excludable if it is "not a proper subject for action by shareholders under the laws of the jurisdiction of

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[55]McDonnell, *supra* note 9, at 225.

[56]*Id.* at 211-12.

[57]*See* William K. Sjostrom, Jr. & Young Sang Kim, *Majority Voting for the Election of Directors*, 40 CONN. L. REV. 459, 480-83 (2007).

[58]DEL. CODE ANN. tit. 8, § 216 (2006) (clarifying quorum and voting requirements for corporations).

[59]McDonnell, *supra* note 9, at 251.

[60]953 A.2d 227 (Del. 2008).

[61]*Id.* at 229.

[62]*Id.* at 230.

[63]*Id.*

[64]*CA, Inc.*, 953 A.2d at 230.

the company's organization"[65] or if it "would . . . cause the company to violate any state . . . law to which it is subject."[66] The SEC certified two questions to the Delaware Supreme Court: (1) was the bylaw a proper subject for shareholder action in Delaware, and (2) would the bylaw cause CA to violate any Delaware law?[67]

The Delaware Supreme Court found that the reimbursement bylaw was a proper subject for shareholder action.[68] In doing so, the court specifically avoided formulating a general bright line rule for which shareholder bylaws are, and are not, valid exercises of power.[69] However, it did say that "a proper function of bylaws is not to mandate how the board should decide specific substantive business decisions, but rather, to define the process and procedures by which those decisions are made."[70] Thus, the court basically accepted the procedure versus substance distinction as discussed above. The court had difficulty classifying this bylaw as substance rather than procedure, but in the end characterized it as procedural, in large part because it facilitates a shareholder role in the election of directions, in which shareholders have "a legitimate and protected interest."[71]

The shareholders thus won on the first certified question, but they lost on the second. The court held that, although the bylaw is valid under the Delaware General Corporation Law (DGCL), it violates the common law fiduciary duty imposed on the board.[72] The court reasoned that since it had to rule on the facial validity of the bylaw, rather than as applied in particular circumstances, and found circumstances where the bylaw might violate the common law, the bylaw failed under the second certified question.[73] The court relied upon cases which held that contractual provisions could not require the board to act in ways that violate its fiduciary duties.[74] The court held that the same rule applies to shareholder-adopted bylaws and rejected the union's argument that such a bylaw relieves the board of its duties where the bylaw ties the board's hands.[75] In some cases a shareholder might nominate directors pursuing her own selfish interest, and compensating her might violate the

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[65] 17 C.F.R. § 240.14a-8(i)(1) (2008).
[66] *Id.* § 240.14a-8(i)(2).
[67] *CA, Inc.*, 953 A.2d at 231.
[68] *Id.*
[69] *See id.* at 234 n.14.
[70] *Id.* at 234-35.
[71] *CA, Inc.*, 953 A.2d at 235-36.
[72] *Id.* at 238.
[73] *Id.*
[74] *Id.* (citing Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281 (Del. 1998); Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34 (Del. 1994)).
[75] *CA, Inc.*, 953 A.2d at 239.

board's duties. Since the bylaw would, in such cases, require the board to nonetheless reimburse the shareholder, the bylaw violates Delaware law.

Although the first half of the opinion is a victory for shareholders, the scope of the second half is unclear and ominous. Virtually all bylaws limit board discretion in some way, and with some creativity one should almost always be able to come up with circumstances where doing what the bylaw requires would force the board to act in a way that violates its duty if it had discretion to act as it chose. So what bylaws remain valid under *CA, Inc.*? It seems clear that poison pill bylaws will fail, unless the bylaw includes a fiduciary duty out provision. A more difficult question, however, arises from shareholder access bylaws that lack a fiduciary duty out. My theory is that such a bylaw runs afoul of *CA, Inc.*, because one can argue that the board has a duty to exclude selfish shareholders pursuing their own interests and who want to use the corporate proxy to nominate someone for director. Ultimately, it will take much litigation before the scope of this principle is understood.

Before discussing any suggestions for statutory changes, I note one other important question concerning bylaws that remains open under current statutory and case law. Suppose, for example, shareholders enact a bylaw that limits board power in a way that the board finds unappealing. Assuming that the certificate grants the board the power to amend the bylaws, may the board choose to amend or repeal the shareholder-enacted bylaw? Does the answer to that question differ depending on whether the shareholder bylaw specifically says the board may not amend or repeal it?

In some jurisdictions, the relevant statutes clearly provide that the board may not amend or repeal a shareholder-enacted bylaw if it states that the board may not amend or repeal it.[76] Until recently, nothing in Delaware statutory law clearly speaks to this point. Dictum in one case says that boards can amend a shareholder bylaw;[77] dictum in another case states the contrary.[78] Professor Hamermesh defends the former position;[79] Professor Coffee defends the latter.[80]

The recent majority-voting amendments address this question for that specific type of bylaw. Such amendments provide that a shareholder bylaw,

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[76]*See, e.g.*, MODEL BUS. CORP. ACT § 10.20(b) (2007). *See also* DEL. CODE ANN. tit. 8, § 216 (2006) ("A bylaw amendment adopted by stockholders which specifies the votes that shall be necessary for the election of directors shall not be further amended or repealed by the board of directors.").

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

[78]Am. Int'l Rent A Car, Inc. v. Cross, No. 7583, 1984 Del. Ch. LEXIS 413 (Del. Ch. May 9, 1984).

[79]Hamermesh, *supra* note 10.

[80]Coffee, *supra* note 9, at 616-18.

which varies the voting requirement for board elections, may not be amended or repealed by the board of directors.[81] This might create a negative implication that the board can amend or repeal other kinds of shareholder bylaws. Why else would there be a need to specifically protect this sort of bylaw? The legislative history of the new statutory provision, however, says that it is not intended to affect the answer to the question of the board's power to amend other sorts of shareholder bylaws.[82] Thus, this question remains open for all other shareholder bylaws, besides majority voting bylaws.

III. BYLAW REFORM PROPOSALS

I propose four changes to the DGCL statutes relating to shareholder bylaws. All four proposals are justified by the policy concerns discussed above, which I will elaborate further when I discuss each proposal. Three of the four proposals are already a possible outcome under the existing statute. However, for each proposal there are also alternative interpretations of existing law that have strong support in the academic community.[83] Adopting my proposals would assure that the better interpretations of existing law succeed. I suggest the following four proposals:

1. Codify the procedure/substance and governance/business distinctions to help resolve the tension between sections 109(b) and 141(a) of the DGCL.

2. Amend section 141(a) to provide that shareholder bylaws or certificate of incorporation provisions may limit board discretion, thereby shielding the board from fiduciary duty liability.

3. Amend section 157 to allow shareholder bylaws to regulate the existence of shareholder-rights plans.

4. Amend Delaware's statutes to clearly state that the board cannot amend a shareholder bylaw.

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[81] DEL. CODE ANN. tit 8, § 216 (2006).

[82] "This amendment does not address any other situation in which the board of directors amends a bylaw adopted by a stockholder vote." Synopsis, 2006 Del. Laws c. 306.

[83] *See* Hamermesh, *supra* note 10 (providing the strongest arguments for such positions).

A. *Resolving the 109(b)/141(a) Tension*

As discussed above, where a bylaw impinges on board authority and is not either specifically allowed or disallowed by a particular statutory provision, there is an ongoing debate as to whether section 109(b) allows such a provision or section 141(a) disallows it. I argue above, and in my previous works, that as a matter of both interpretation of current law and on policy grounds, we should allow bylaws that cover procedural matters or help structure governance. Bylaws that regulate substantive business decisions, however, should not be allowed. Although I believe this is the best approach under existing law, some advocate, plausibly, for a more restrictive approach.[84] One way to more clearly write Professor Coffee's approach into law would be to add the following sentence to the end of section 109(b): "The bylaws may not be used to manage the affairs of the corporation in violation of the authority granted to the board of directors under section 141(a) of this chapter, but the bylaws may create procedural rules or set general rules for regulating the governance of the corporation."

This new sentence puts Professor Coffee's strongest two distinctions explicitly into the statute. The specific reference to section 141(a), in the amended language, clarifies the relationship between the two sections.

This suggestion was made at the symposium, and prior to the *CA, Inc.* decision.[85] To the extent that the case has more clearly entrenched the procedure/substance distinction, this statutory change is now less necessary. As discussed above and in my previous work, however, the corporate governance/substance distinction is also useful in drawing the distinction between valid and invalid bylaws. *CA, Inc.* does not make that distinction but it does not exclude it either—it says that defining procedure is "*a* proper function of bylaws,"[86] suggesting there may be others. Also, the court stresses that its holding is case specific, and not intended to formulate a general rule for all cases.[87] So, it remains useful to build the corporate governance distinction into the law along with the procedure distinction.

This suggested statutory language is subject to the criticism that it is general, vague, and hard to apply.[88] What are "procedural rules"? What are "general rules for regulating the governance of the corporation"? But, generality is precisely the needed factor that section 109(b) provides for

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[84] *See id.*

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

[86] *Id.* at 234 (emphasis added).

[87] *Id.*

[88] Hamermesh, *supra* note 10, at 433-44.

bylaws. Other specific provisions in the DGCL give clear guidance for many particular questions.[89] The statutes cannot lay out in full detail all items on which it would be useful for bylaws to govern. Much less can statutes fully anticipate all questions which may arise in the future. There is a real need for a general provision to allow for bylaws that do not fit within the four corners of the more specific parts of the statute. Too much specificity and clarity in this section of the statute is actually unattractive.

So, how then would one get answers to questions about the validity of specific bylaws? Courts would develop precedent applying this general language to specific cases. Indeed, as argued elsewhere, some relevant case law already exists applying these basic distinctions.[90] Applying broad, vague principles to particular circumstances is utterly central to the identity of Delaware courts in the area of corporation law. If Delaware courts cannot be trusted to do that task well, there is a much bigger problem than just how to develop the law in this one area.

There are other possible ways to modify sections 109 and 141 to achieve a similar result. One could rewrite section 109(b) to read: "The bylaws may contain any provision, not inconsistent with the law or with the certificate of incorporation, relating to the corporation's rights or powers or the rights or powers of its stockholders, directors, officers or employees, or to the procedure for governing the corporation." This proposed language drops existing language concerning "the business of the corporation" and "the conduct of its affairs," which rather confusingly seems to allow bylaws in the board's core area of business decisions.[91] It adds the language on procedure. One could supplement this change by adding the following to section 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 *or in its bylaws as provided for elsewhere in this chapter.*"[92] (The italic represents added language.) This proposed language allows for bylaws that limit board authority, but treats the bylaws differently from rules set forth in the certificate. Section 141(a) does not restrict the ability of the certificate to impose limits on board authority.[93] The bylaws, as this is written, could only provide limits under authority granted elsewhere, including in section 109(b).[94]

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[89]McDonnell, *supra* note 2, at 437-39.
[90]McDonnell, *supra* note 9, at 230-35.
[91]DEL. CODE ANN. tit. 8, § 109(b) (2006).
[92]*Id.* § 141(a).
[93]*Id.*
[94]*Id.* § 109(b).

Either way of changing section 109(b) and, perhaps, section 141(a) would be equivalent in intent and effect. The first proposal is a bit cleaner and clearer.

B. *Amend Section 141(a)*

As analyzed above, the recent decision in *CA, Inc. v. AFSCME Employees Pension Plan* has created a serious obstacle to shareholder bylaws. It is not clear how to draw the line between bylaws that may illegally force the board to violate its fiduciary duties in some circumstances, and those that do not. The case leaves the law as unsettled as it was before, though in a somewhat different way. One fix is for shareholders to include fiduciary duty outs in all bylaw proposals that are potentially subject to this objection (which may well be all bylaw proposals, period). This conclusion, however, leaves boards with a degree of discretion that may go against the very point of these bylaws, which seek to limit board discretion in areas where the shareholders do not trust the board.

The Delaware Supreme Court explicitly says that those who support a bylaw like the one in question in *CA, Inc.* "may seek recourse from the Delaware General Assembly."[95] Setting aside the political difficulty, this statement raises a rather difficult question: how can the General Assembly amend the Delaware General Corporation Law to undo the result in *CA, Inc.*? In my opinion, it is not at all clear. One way would be to remove from boards the authority, under section 141(a), to manage the affairs of the corporation. That, though, would throw out the baby with the bathwater—that grant of authority to the board is central to the identity of modern corporate law.

The following sentence, if added to section 141(a), would assist in resolving this issue: "If any provision in the certificate of incorporation, or a bylaw adopted by a vote of the stockholders, limits the discretion of the board of directors to manage the business and affairs of a corporation, the directors shall not be held liable for violating their fiduciary duty to the corporation, on matters where the certificate or bylaw provision prohibit the board of directors from acting as their fiduciary duty would otherwise have required."

This is not a particularly elegant solution, and the exact wording could use some revising. Still, the proposed language does seem to counter the argument in *CA, Inc.* It would essentially write into the statute the argument made by AFSCME that the Delaware Supreme Court rejected. AFSCME argued, in the court's words, "that it is unfair to claim that the Bylaw prevents

[95]CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227, 240 (Del. 2008).

the CA board from discharging its fiduciary duty where the effect of the Bylaw is to relieve the board entirely of those duties in this specific area."[96] The court calls this argument "more semantical than substantive."[97] It is the court's response, however, that is unpersuasive. The whole point of the board's fiduciary duty is to give the board great discretion in running the corporation's affairs, with the expectation that the board will exercise that discretion honestly and in the best interests of the corporation and its shareholders. However, where the beneficiaries of that duty, the shareholders, have decided to limit the board's discretion because they do not trust the board on a particular matter, the need for a fiduciary duty limitation on the board ceases. If a bylaw does indeed fall within the valid scope of the bylaw power, as the first part of *CA, Inc.* held was true for the reimbursement bylaw, then the shareholders have the power to use such a bylaw to limit the board. The suggested amendment to section 141(a) recognizes that invocation of the board's fiduciary duty to limit that bylaw power makes no sense.

Note that the suggested amendment covers only bylaws adopted by a vote of the stockholders. This recognizes the valid principle of cases like *QVC*[98] and *Quickturn*[99] that the court cites in *CA, Inc.* Where the board opts to limit its own future power, there is reason to distrust—the board could well be doing so to entrench itself, as certainly seems to be the case in *Quickturn.* However, where shareholders, not the board, are setting the limits on the board, that concern is not present. The court in *CA, Inc.* did not accept that distinction, but the court does not offer a good policy reason for why the distinction is wrong.[100] In fact, the distinction makes great sense.

C. *Amend Section 157*

Section 157 gives corporations the right to create rights or options to acquire shares of stock.[101] Section 157 is the key statutory source for the authority to create shareholder rights plans, or poison pills.[102] Section 157(a) begins: "Subject to any provisions in the certificate of incorporation, every corporation may create and issue . . . rights or options entitling the holders thereof to acquire from the corporation any shares of its capital stock of any

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[96] *Id.* at 239.
[97] *Id.*
[98] Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34 (Del. 1994).
[99] Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281 (Del. 1998).
[100] *CA, Inc.*, 953 A.2d at 239.
[101] DEL. CODE ANN. tit. 8, § 157(a) (2006).
[102] Moran v. Household Int'l, Inc., 500 A.2d 1346, 1351-53 (Del. 1985).

class or classes . . . ."[103] This references the certificate but not the bylaws, creating a strong negative implication that provisions of this sort must be contained in the certificate and not the bylaws. I have argued that this creates the strongest argument against the use of bylaws to limit the authority of boards to enact poison pills.[104]

On balance, poison pill bylaws would be a useful tool for shareholders to possess. As economists and corporate law scholars have argued for decades, the market for corporate control is potentially one of the most useful limits on director and officer opportunism, and one of the strongest spurs for vigorous and faithful pursuit of shareholder interests.[105] Over the last two decades, Delaware law has made it awfully easy for boards to protect against unwanted takeovers, and poison pills are one critical part of that defense system. Thus, giving shareholders some initiative power to limit the creation of poison pills would be quite useful.

The solution to the section 157(a) obstacle to poison pill bylaws is simple. One should simply add the phrase "or a bylaw enacted by the stockholders" following the phrase "certificate of incorporation" at the beginning of section 157(a).[106] This additional language would negate the argument that bylaws cannot limit the board's ability to create or modify poison pills. I would limit this reference to bylaws adopted by a vote of the stockholders—this device should be used more often, in order to extend a power to shareholders, while limiting the ability of boards to further entrench themselves with the same power.[107]

D. *Amending Shareholder Bylaws*

As discussed above, it remains an open question in Delaware whether the board may amend or repeal a shareholder-enacted bylaw. Nothing in Delaware statutory law clearly addresses this question. Nothing in the case law provides a clear answer either, with dicta in two cases pointing in opposite directions.[108]

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[103]DEL. CODE ANN. tit. 8, § 157(a) (2006).

[104]McDonnell, *supra* note 9, at 225. As I point out above, one may be able to avoid this conclusion by arguing that bylaws may regulate the procedure by which a board adopts or modifies a pill plan, even though they cannot regulate the basic existence or nature of such a plan. The distinction, however, is not easy to maintain.

[105]Manne, *supra* note 51, at 113.

[106]DEL. CODE ANN. tit. 8, § 157(a) (2006).

[107]*See supra* note 17 and accompanying text.

[108]*See supra* notes 58-78 and accompanying text.

Other jurisdictions provide clearer answers. For instance, the Model Business Corporation Act (Model Act) provides that "[a] corporation's board of directors may amend or repeal the corporation's bylaws, unless: . . . (2) the shareholders in amending, repealing, or adopting a bylaw expressly provide that the board of directors may not amend, repeal, or reinstate that bylaw."[109] Thus, under the Model Act, if a shareholder bylaw says nothing on the point, the board may amend or repeal the bylaw, but if the shareholder bylaw specifies that the board may not amend or repeal the bylaw, then the board may not.

The Model Act approach is clearly the sensible answer to this question. Shareholders have the power to amend the bylaws, and part of the point of that power must be to put some constraints on board actions. Yet, given the much greater speed and ease of board action, if the board can simply undo what shareholders have done in amending the bylaws, the shareholder bylaw power will have little point.[110]

There are several slightly varying ways to get at a similar result. I see three basic alternatives:

1. The board can amend a shareholder bylaw unless the shareholder bylaw states the board cannot do so (this is the Model Act's approach).[111]

2. The board cannot amend a shareholder bylaw at all (this is the approach of DGCL section 216 for majority vote bylaws).[112]

3. The board cannot amend a shareholder bylaw unless the bylaw (or perhaps the certificate) provides that the board can so amend.

The second alternative seems like an overly mandatory approach. If the shareholders in a particular corporation want to give the board the power to amend shareholder bylaws, at least for some such bylaws, then why not allow them to do so?

As between alternatives (1) and (3), I am a bit skeptical about general certificate provisions allowing the board to amend shareholder bylaws. We

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[109]MODEL BUS. CORP. ACT § 10.20(b)(2) (2007).

[110]Shareholders might be able to get around this problem by placing procedural limits on the ability of the board to amend a bylaw. Even that, however, is debated as a matter of existing law. *See* Hamermesh, *supra* note 10, at 467-75.

[111]MODEL BUS. CORP. ACT § 10.20 (2007).

[112]DEL. CODE ANN. tit. 8, § 216 (2006).

might well see newly public companies start including such provisions in their certificates at the time of their IPOs, and I doubt that market discipline is sufficiently strong to protect against that reaction. Thus, I would leave the choice for opting in or out of the default rule as a matter for each specific bylaw.

The question remains whether Delaware law should require shareholder bylaws to opt in to a no-amendment rule (alternative (1)) or to opt out of a no-amendment rule (alternative (3)). Alternative (1) creates a bit of a trap for unaware and poorly advised shareholders, who might neglect to include a no-amendment clause without knowledge of the consequences of doing so. On the other hand, alternative (3) creates an opposing trap, both for those drafting shareholder bylaws and perhaps, more importantly, for those voting on them, and it seems unlikely that shareholder bylaw advocates would specifically choose to allow boards to undo their handiwork. Therefore, I prefer alternative (1) slightly over the other alternatives.

The first alternative would probably best be adopted as an amendment to section 109. One could add a new sentence to the end of section 109(a) stating, "The board of directors or governing body may not amend, repeal, or reinstate a bylaw where the stockholders, in amending, repealing, or adopting a bylaw, expressly provide that the board of directors or governing body may not amend, repeal, or reinstate that bylaw."

IV. CONCLUSION

The rules governing what a corporation may and may not accomplish through its bylaws help shape how easily individual companies can tailor their rules, and who gets to decide what those rules include. Bylaw amendments give shareholders their only power of initiative.

To make that power optimally valuable, shareholders should be able to use the bylaws to set procedural and governance rules, including rules governing board nominations and the creation of poison pills. For this shareholder power to be meaningful, the shareholders must be able to guard against immediate board changes to the rules they have set.

The four changes to Delaware statutes which I propose here would conform the law to these ideas. It may be that the existing statutory language already achieves the same result for some of the suggested changes; however, there has been enough uncertainty on these questions for a long enough time that the legislature should step in and clarify that these are indeed the right results under Delaware law.