# *Mandatory Bylaws Are Permitted Under Delaware Law: An Argument in Favor of Shareholders' Rights*

by

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**Introduction**

For years, shareholder activists have attempted to effect corporate governance reforms through the adoption of bylaws that require a company's board of directors to take certain actions, or to refrain from certain conduct. These so-called "mandatory bylaws," however, have become the subject of significant controversy as part of a long-standing struggle for control between the shareholders, who own publicly traded companies, and the companies' boards of directors, which are statutorily charged with the companies' day-to-day management. As a leader in corporate law, Delaware often has been the forum where such battles have been fought.[1] Over the past several years, commentators examining the subject generally have agreed that a mandatory bylaw impacting the management of a corporation would be declared improper under Delaware law. We disagree and believe that existing case law may be distinguished, and suggest that commentators have misinterpreted Delaware law. Moreover, in the notorious battle between Hollinger International, Inc. and that company's former Chairman and chief executive Conrad Black, Vice Chancellor Strine of the Delaware Court of Chancery recently refused to accept the corporation's argument that certain bylaws adopted by Black as Hollinger's controlling shareholder were invalid because they interfered with the board's managerial authority.[2] Thus, shareholders may have been deterred unnecessarily by the Securities and Exchange Commission ("SEC") from filing mandatory bylaw proposals on governance-related issues that indisputably are proper.

The first part of this article will summarize the SEC's "No-Action" procedure, the initial, and in most cases insurmountable, hurdle for mandatory bylaw proposals. Any bylaw that an individual shareholder wants to submit through the company's proxy statement for consideration and vote by all of the shareholders of a corporation must be reviewed by the SEC for approval. The SEC, purporting to interpret and apply state law, typically rejects mandatory bylaws on the grounds that they are either "inconsistent with state law" or because they affect the "ordinary business" of the company. Accordingly, many mandatory bylaws are struck down by the SEC without ever being seen by the shareholders. We submit that the SEC's interpretations are, in fact, inconsistent with Delaware law, and that the SEC's rejection of mandatory bylaws has done a grave disservice to the investing public.

The second part of this article summarizes Delaware law and how, in our opinion, it has been *mis*interpreted as providing a blanket restriction against mandatory bylaws. We submit that, properly read, Delaware law expressly contemplates shareholder-sponsored bylaws that directly affect the management of the business and affairs of a corporation.

## I. Federal Law

Most shareholder-sponsored bylaws never see the light of day. Usually, it is prohibitively expensive for an individual shareholder to bear the cost of launching his or her own proxy contest, and thus most shareholders submit proposed bylaws to the company for inclusion in the company's own proxy materials that are sent to all of the shareholders. The obstacle presented by this approach, however, is that companies can seek permission from the SEC to exclude shareholder proposals from their proxy statements under certain circumstances. If the SEC agrees with the company, it issues what's called a "No-Action" letter, meaning that the SEC states that it will not recommend any enforcement action against the company if the shareholder proposal is excluded. Thus, and typically in cases of controversial mandatory bylaws, the SEC holds what is, in essence, a veto power that prevents novel shareholder sponsored bylaws from ever being considered by the company's stockholders. Accordingly, in our analysis of mandatory bylaws, our inquiry begins with the SEC's "No-Action" procedure - the locus of trench warfare over shareholders' efforts to submit proposed bylaws for shareholder approval.

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## A. SEC "No-Action" Procedure – Where Most Battles Are Fought

Congress has delegated to the SEC the task of regulating proxy solicitations and thereby regulating one important avenue of management's communication with shareholders. Section 14(a) of the Securities Exchange Act of 1934 ("1934 Act") renders unlawful the solicitation of proxies in violation of the SEC's rules and regulations, which are codified at 17 C.F.R. §240.14a-1 *et seq.* Section 14(a) and the SEC's implementing regulations seek "to prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation."[3]

SEC Rule 14a-8[4] addresses the procedures for submitting shareholder proposals, prescribes when a company must include a shareholder's proposal in the company's proxy statement, and lists the circumstances under which a shareholder proposal may be excluded by the company. When a company objects to the inclusion of a proposal and wishes to omit it from the company's proxy statement, the company must file with the SEC (1) a copy of the proposal, (2) any statement in support of the proposal submitted by the proponent, and (3) a statement of "the reasons why the [company] deems such omission to be proper in the particular case."[5] Procedurally, Rule 14a-8(b)(1) requires, among other things, that to be eligible to submit a proposal, the shareholder "must have continuously held at least $2,000 in market value, or 1%, of the company's securities entitled to be voted on the proposal at the meeting for at least one year prior to the date on which the [shareholder] submitted the proposal."[6]

If the SEC agrees with the company, it issues a letter indicating that it will not recommend an enforcement action against the company if it excludes the shareholder proposal from the corporation's proxy statement. Once in receipt of this "No-Action" letter, companies generally refuse to submit a shareholder-sponsored proposal for consideration in the company's proxy statement, and the proposal dies at that point without ever having been seen by the other shareholders of the company.

Rule 14a-8 includes provisions that permit the company to exclude certain shareholder proposals from the proxy based on the subject matter of the proposals. Specifically, in question-and-answer format, the Rule lists thirteen grounds upon which a company may rely to exclude a shareholder proposal from the company's proxy.[7] The SEC frequently permits the exclusion of shareholder proposals seeking the adoption of mandatory bylaws, which direct board action, under three of these exceptions: subsection (i)(1), which permits the exclusion of proposals that relate to subjects that "are not a proper subject for action" under laws of the company's state of incorporation[8]; subsection (i)(2), which permits the exclusion of proposals that, if implemented, would cause the corporation to violate applicable state or foreign law[9]; and subsection (i)(7) which permits the exclusion of proposals involving the "ordinary business" (*i.e.*, management) of the corporation.[10] The exclusion of mandatory bylaw proposals under these exceptions, however, arises from the SEC's erroneous application of state law principles.

### 1. Inconsistent with State Law

Rule 14a-8(i)(1) provides that a corporation may exclude a shareholder proposal "[i]f the proposal is not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization."[11] Similarly, Rule 14a-8(i)(2) provides that a corporation may exclude a shareholder proposal "[i]f the proposal would, if implemented, cause the company to violate any state, federal, or foreign law to which it is subject."[12] Applying these so-called "state law" exclusions, the SEC has stated that companies bear the burden of proof in justifying the exclusion of shareholder proposals, and requires companies relying on these exclusions to provide an opinion of counsel explaining how the proposal violates state law.[13] In practice, however, the SEC has used these exclusions as a bar to mandatory bylaws proposed by shareholders.[14]

In 1976, the SEC added an interpretative note to the state law exclusion explaining the SEC's belief that, under subsection (i)(1), shareholder proposals that purport to direct a board of directors to take certain action generally violate state law and may be excluded on that basis alone:

> *Note to paragraph (i)(1):* Depending on the subject matter, some proposals are not considered proper under state law if they would be binding on the company if approved by shareholders. In our experience, most proposals that are cast as recommendations or requests that the board of directors take specified action are proper under state law. Accordingly, we will assume that a proposal drafted as a recommendation or suggestion is proper unless the company demonstrates otherwise.

The SEC's interpretation in this regard is confirmed in the SEC's public release announcing the adoption of the 1976 changes to Rule 14a-8. In that release, the SEC explained its belief that most state corporate codes delegate the responsibility for managing the "business and affairs" of a corporation to the board of directors. According to the SEC, "[u]nder such a statute, the board may be considered to have exclusive discretion in corporate matters, absent a specific provision to the contrary in the statute itself, or the corporation's charter or by-laws. Accordingly, proposals by security holders that mandate or direct the board to take certain action may constitute an unlawful intrusion on the board's discretionary authority under the typical statute."[15] "On

the other hand," the SEC observed, "proposals that merely recommend or request that the board take certain action would not appear to be contrary to the typical state statute, since such proposals are merely advisory in nature and would not be binding on the board even if adopted by a majority of the security holders."[16] Based on this exclusion, the SEC routinely has permitted companies to exclude shareholder proposals advocating the adoption of bylaws that would direct a company's board to take certain actions, or to refrain from taking certain actions, unless the proposal is rephrased as a request instead of a command.[17]

In 1993, the California Public Employees' Retirement System ("CalPERS") sought to introduce a proposal to the shareholders of Pennzoil Corporation that would have established a three-member shareholder committee to review the activities of Pennzoil's board of directors and to prepare an annual report to the shareholders to be included in the company's yearly proxy statement. Relying on an opinion from a Delaware firm, the SEC determined that "a by-law provision authorizing the expenditure of corporate funds, effected by shareholders without any concurring action by the Board of Directors, is inconsistent with Section 141(a) of the Delaware General Corporation Law unless otherwise provided in the company's certificate of incorporation or the Delaware General Corporation Law."[18] Further, when CalPERS asked the SEC to reconsider its decision in that regard, the SEC determined that such a proposal would be "inconsistent" with Delaware law *even if* it was rephrased as a *request* that the *directors* themselves adopt a bylaw establishing the shareholder committee, because the bylaw would purport to restrict the directors' ability to repeal it.[19] The SEC stated:

> The staff has reconsidered its position and has determined that even if the proposal is made precatory, there is a substantial question as to whether, under Delaware law, the directors may adopt a by-law provision that specifies that it may be amended only by shareholders. We take this position notwithstanding the fact that the Company's restated certificate of incorporation authorizing the directors to make, alter, amend or repeal the by-laws, specifically authorizes the by-laws to limit the authority of directors to make, alter, amend or repeal the by-laws. Therefore, given the questionable validity of such a by-law amendment, the proposal does not appear to be a proper subject for shareholder action under state law.[20]

In response to a request for a No-Action letter from General DataComm Industries, however, the SEC backed off from its decision in *Pennzoil*. In the fall of 1998, General DataComm requested a No-Action letter permitting the company to exclude a shareholder proposal for a mandatory bylaw amendment to prohibit the repricing of stock options without shareholder approval. Specifically, the company made two arguments of relevance here: (i) that the repricing of stock options was within the "ordinary business" of the corporation and thus the proposal was improper under Rule 14a-8(i)(7), and (ii) that the proposal was improper under state law and excludable under 14a-8(i)(1) because the repricing of options was not a proper subject for shareholders to address through the bylaws.[21] The SEC rejected the request. First, the SEC determined that "widespread public debate concerning option repricing" and "increasing recognition that [option repricing] raises significant policy issues," precluded any finding that option repricing was within the "ordinary business" of the corporation.[22] Second, noting the lack of any "compelling state law precedent," the SEC determined "not to express any view with respect to the application of rule 14a-8(i)(1) to the proposal."[23]

Since *General DataComm*, the SEC has appeared to change position yet again, to accept the argument that mandatory bylaws run afoul of state corporate law. For example, in February of 2000, Novell, Inc., sought a No-Action letter from the SEC permitting it to exclude from its proxy materials a shareholder proposal pursuant to which the shareholders would amend the company's bylaws to preclude the adoption of any "poison pill" shareholders' rights plan without prior shareholder approval. Specifically, the company presented an opinion from a Delaware law firm that such a bylaw, if implemented, would be an improper subject for shareholder action under Rule 14a-8(i)(1) because "it purports to delegate to shareholders authority over a rights plan which Delaware law provides is within the exclusive province of the Company's board of directors."[24] Without citing a single case to support its point, the Delaware firm baldly pronounced that "[t]he Proposal would require the Company to redeem the rights or terminate its rights plan and prohibit it from adopting another such plan without stockholder approval. These matters are clearly within the purview of the Board under Section 141(a), which cannot be circumvented by a by-law. Accordingly, the Proposal is not a proper subject for action by the stockholders of the Company and, if implemented, would violate Delaware law."[25] Blindly accepting the representation of the company's Delaware counsel, the SEC agreed, stating: "[t]here appears to be some basis for your view that Novell may exclude the proposal under rule 14a-8(i)(1). We note that in the opinion of your Delaware counsel, Morris, Nichols, Arsht & Tunnell, implementation of the proposal would be an improper subject for shareholder action under Delaware law."[26]

The SEC accepted a similar argument in February 2003, from Advocat Inc.. Advocat Inc. sought a No-Action letter permitting the exclusion of a proposal (albeit not a proposed bylaw) *requiring* the termination of

a shareholders' rights ("poison pill") plan.[27] Although the SEC *rejected* the company's argument that the decision to maintain a poison pill was the exclusive province of management under Delaware law,[28] it nonetheless determined that the company could exclude the proposal unless it was rephrased as a request instead of a command.[29]

The SEC has applied a similar interpretation of Rule 14a-8(i)(2). Based on its observation that state law generally delegates managerial authority to a company's board of directors, the SEC has permitted the exclusion of shareholder proposals that, if implemented, would encroach on the alleged "right" of the directors to manage the corporation, even if phrased as precatory resolutions. For example, the SEC permitted Mattel, Inc. to exclude a shareholder proposal that *requested* the company to adopt a bylaw which, if implemented, would *require* shareholder approval for the company to adopt or maintain any poison pill shareholder rights plan.[30] Specifically, Mattel's Delaware counsel argued that any restriction on the directors' supposed "right" to adopt and implement stock option plans must be included in the company's certificate of incorporation - not the bylaws. Thus, Mattel's lawyers argued, any attempt by the shareholders to restrict the directors' ability to implement stock option plans through bylaws would improperly impinge on the directors' managerial responsibilities under Delaware law.[31] The SEC agreed.[32]

## 2. "Ordinary Business"

The second exclusion relied upon to exclude shareholder proposals advocating the adoption of mandatory bylaws is SEC Rule 14a-8(i)(7), the so-called "ordinary business" exception. Rule 14a-8(i)(7) permits the company to exclude shareholder proposals that relate to "Management functions: If the proposal deals with a matter relating to the company's ordinary business operations."[33] The Rule does not define the term "ordinary business operations," but generally speaking, day-to-day issues constitute "ordinary business," while other matters, such as those affecting corporate policy, executive compensation, the accounting treatment for stock options, takeover defenses and dividends, do not. For example, the SEC has refused to exclude shareholder proposals advocating bylaws that relate to compensation of senior management,[34] certain employment matters,[35] accounting,[36] dividends,[37] shareholders' rights plans,[38] the overall business plan of a corporation,[39] or societal and environmental concerns.[40] In contrast, the SEC has allowed the exclusion of shareholder proposals addressing compensation issues for the general workforce of a corporation, employee evaluations,[41] production supplies,[42] and the selection of an independent auditor.[43]

The ordinary business exclusion was adopted as part of the SEC's amendments to the proxy rules in 1954, in order to clarify the general proposition that determining whether a given proposal is a "proper subject" for shareholder action essentially turns on an interpretation of the law of the company's state of incorporation.[44] Shortly after the "ordinary business" exclusion (then identified as "Rule X-14A-8") was adopted, the SEC explained its purpose to Congress as follows:

> *The policy motivating the Commission in adopting the rule . . . is basically the same as the underlying policy of most State corporation laws* to confine the solution of ordinary business problems to the board of directors and place such problems beyond the competence and direction of the shareholders. The basic reason for this policy is that it is manifestly impracticable in most cases for stockholders to decide management problems at corporate meetings.
>
> . . . While Rule X-14A-8 does not require that the ordinary business operations be determined on the basis of State law, the premise of Rule X-14A-8 is that the propriety of . . . proposals for inclusion in the proxy statement is to be determined in general by the law of the State of incorporation . . . *Consistency with this premise requires that the phrase 'ordinary business operations' in Rule X-14A-8 have the meaning attributed to it under applicable State law. To hold otherwise would be to introduce into the rule the possibility of endless and narrow interpretations based on no ascertainable standards.*[45]

Once again, the "ordinary business" exclusion of Rule 14a-8(i)(7), like the "state law" exclusions of Rules 14a-8(i)(1) and (2), therefore, turns on the proper application of the law of the corporation's home state.[46] In this regard, the "ordinary business" exclusion of Rule 14a-8(i)(7) should be interpreted as the substantive equivalent of Rules 14a-8(i)(1) and (2) in that it purports to permit the exclusion of certain shareholder proposals which, if implemented, would violate state law provisions that delegate managerial authority over a corporation's daily operations to the board of directors.[47] Put another way, if subsection (i)(7) of Rule 14a-8 is designed to mirror state laws that delegate managerial (or "ordinary business") responsibility to the board of directors, the SEC's "state law" exclusion in subsections (i)(1) and (i)(2) should be considered duplicative. Each provision is intended to preclude shareholder proposals that, if adopted, would violate state law's delegation of managerial authority to the board of directors.

The SEC, however, has interpreted the subsections slightly differently. Typically, the SEC has interpreted subsection (i)(7) as precluding *only* shareholder proposals that pertain to day-to-day management, and has permitted such proposals that relate to "extraordinary matters," even if unquestionably managerial in nature.[48] For example, in 1987, the SEC refused to permit Santa Fe Southern Pacific Corporation to exclude a shareholder proposal that "recommended" that the board redeem

rights issued under a poison pill, specifically rejecting the company's argument that the adoption of a poison pill was within the "ordinary business" of the corporation: "This Division does not concur in your view as to the applicability of Rule 14a-8(c)(7) [the 'ordinary business' exception] to the proposal. Accordingly, we do not believe that the Company may rely on Rule 14a-8(c)(7) as a basis for omitting the proposal."[49] The SEC's application of the "ordinary business" exception in this regard, therefore, stands in marked contrast to its application of the state law exceptions discussed above. Although the SEC correctly recognizes that defensive mechanisms such as poison pill shareholders rights plans are not within the "ordinary business" of a corporation, it nonetheless has permitted the exclusion of mandatory bylaw proposals addressing such plans based on the reasoning that such a bylaw, if adopted, would run afoul of state law.[50]

However, the SEC's view of what constitutes "ordinary business" under subsection (i)(7) is very expansive. The SEC consistently has permitted companies to exclude shareholder proposals that would establish rules for the conduct or locations of the annual meeting, regardless of whether the proposal advocates the adoption of a bylaw or merely a resolution by the shareholders, and without regard to the law of the subject company's state of incorporation.[51]

Thus, applying a restrictive view of Delaware law and its own notions of what constitutes the "ordinary business" of corporations, the SEC has excluded proposals on subjects that the SEC deems to be within the managerial province of the directors. Further, the SEC consistently has required shareholder proposals to be phrased as requests, reasoning that a commands by the shareholders to directors somehow improperly restrict the directors' managerial discretion. Finally, the SEC has determined that some areas - such as general employee compensation - are simply "off limits" to shareholders, and may not be addressed even through precatory bylaw amendments. In so applying this view of Delaware law, the SEC has effectively emasculated mandatory shareholder bylaw proposals and has unfairly impaired a significant aspect of the shareholder franchise. In this regard, the SEC is simply wrong. The following section explains why, properly interpreted, a shareholder proposal that advocates the adoption of a bylaw that either requires or precludes board action is perfectly acceptable under Delaware law.

## II. DELAWARE LAW

### A. Bylaws

"The power to make and amend the bylaws of a corporation has long been recognized as an inherent feature of the corporate structure."[52] The bylaws of a corporation are "the self-imposed rules and regulations deemed expedient for . . . the . . . convenient functioning" of the corporation.[53] Under Delaware law, bylaws are subordinate to the certificate of incorporation and statutory law,[54] and must be reasonable in their application.[55] In its 1976 interpretative release, the SEC itself acknowledged that the typical state corporate code gives the board the responsibility for managing the business of the corporation "absent a specific provision to the contrary in . . . the corporation's . . . *by-laws*."[56] Determining whether a shareholder-sponsored bylaw is permissible, therefore, involves balancing the statutory rights of the shareholders to adopt bylaws against the statutory obligation of the directors to manage the business of the corporation. One commentator explained this debate as follows:

> Shareholders have recently begun presenting proposals to amend company bylaws through a binding shareholder vote. The validity of these proposals has been a hotly contested issue between management and shareholder groups, especially with regard to the redemption of poison pill anti-takeover defenses. State corporate law generally grants shareholders the unilateral right to amend corporate bylaws. The grant of similar powers to the board of directors in a company's articles of incorporation or bylaws usually does not divest this right, although a charter provision may explicitly deny shareholders the power to initiate a bylaw amendment.
>
> State law usually has not imposed express limits on the substance of corporate bylaws or shareholder--initiated amendments to the bylaws. Thus, shareholders arguably may address through bylaw amendments any aspect of the business or affairs of the corporation or the respective rights and powers of the board and shareholders that is not barred explicitly by state law or the corporation's certificate of incorporation. At some point, however, this broad shareholder power to adopt or amend corporate bylaws must yield to the board's authority to manage the business and affairs of the corporation. The problem becomes one of drawing the exact line between the respective authorities of directors and shareholders under the relevant state law.[57]

The DGCL does not in fact draw any line restricting the ability of shareholders to directly affect the management of their corporations. Indeed, those courts that have addressed the issue have been less inclined than the SEC to accept corporations' arguments that the delegation of managerial authority to directors necessarily restricts the ability of shareholders to adopt bylaws. In *International Brotherhood of Teamsters General Fund v. Fleming Companies, Inc.*,[58] the Oklahoma court, applying Oklahoma law (which is substantially similar to Delaware law), held that shareholders could enact a bylaw that required shareholder approval for implementation of any

shareholders rights plan. The court reasoned that Oklahoma's corporate code (like the Delaware General Corporation Law ("DGCL")) provides that "the corporation" may adopt rights plans, but does not specifically limit such authority to the "board of directors."[59] Thus, the court held, because shareholders may adopt bylaws, shareholders may adopt bylaws that restrict the corporation's ability to implement shareholder rights plans.[60]

The *Fleming* decision has been heavily criticized, with critics of shareholder activism suggesting that the case was wrongly decided and would not withstand scrutiny under Delaware law.[61] In *General DataComm Indus. Inc. v. State of Wisconsin Investment Board*,[62] however, the Court of Chancery expressly noted that the question of whether shareholders may restrict directors' managerial authority has not been resolved by any Delaware court.[63] Most recently, in *Hollinger Int'l v. Black*, the Court of Chancery suggested in dicta that shareholders may adopt bylaws that "pervasively and strictly regulate the process by which boards act, subject to the constraints of equity."[64]

Similarly, courts have not hesitated to apply state law in interpreting the "ordinary business" exclusion, and have reversed the SEC when its interpretations are at odds with established case law. In *Amalgamated Clothing and Textile Workers Union v. Wal-Mart Stores, Inc.*,[65] for example, the court, relying upon the 1976 Interpretive Release standard and Delaware law, refused to defer to an SEC No-Action Letter stating that Wal-Mart could exclude from its proxy materials a shareholder proposal requiring the company to prepare and distribute reports about its equal employment opportunity and affirmative action policies, because the proposal involved substantial policy considerations rather than day-to-day employment matters.[66]

As explained below, Delaware law does not, in fact, place any restriction on the subject matter of shareholder-sponsored bylaws, and does not, in any respect, require that bylaws proposed by the shareholders be precatory in nature.

### 1. Section 109

Section 109 of the DGCL provides that the *shareholders* of a corporation have the authority to adopt or amend the corporation's bylaws: "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* . . ."[67] Moreover, even though the certificate of incorporation may extend this right to the board of directors, "[t]he fact that such power has been so conferred upon the directors or governing body, as the case may be, shall not divest the stockholders or members of the power, nor limit their power to adopt, amend or repeal bylaws."[68] Thus, the DGCL is clear that it is within the shareholders' authority to adopt bylaws for the corporation.

Section 109(b) imposes the only limitations on the subject matter of bylaws. It states as follows:

> *(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.[69]

Section 109(b), then, clearly authorizes bylaws "relating to the business of the corporation" or "the conduct of its affairs." Whether a bylaw relating to the "business or affairs" of a corporation would withstand scrutiny, therefore, depends on whether the bylaw is inconsistent with the certificate of incorporation or inconsistent with law. This is hardly an unusual proposition. In *Hollinger*, for example, the Court of Chancery noted as follows:

> Stockholders are invested by § 109 with a statutory right to adopt bylaws. By its plain terms § 109 provides stockholders with a broad right to adopt bylaws 'relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees.' This grant of authority is subject to the limitation that the bylaws may not conflict with the law or the certificate of incorporation.[70]

Without reference to a particular certificate of incorporation, therefore, the shareholders' statutory right to adopt bylaws is constrained only by applicable law and principles of equity.

### 2. Other Sections of the DGCL Authorizing Bylaws

The DGCL specifically authorizes bylaws on many subjects. Under Section 141, bylaws may regulate the size of the board, establish director qualifications, specific quorum and voting requirements, and regulate board committees.[71] Likewise, Section 142 permits bylaws to specify the number, titles, and duties of officers, prescribe the method for choosing officers and their terms, and establish the rules for filling vacancies in any office.[72] And under Sections 211 and 212, bylaws may specify the date and time of shareholder meetings, establish the quorum and vote requirements for action at such meetings, and authorize persons other than the board of directors, including shareholders, to call special meetings.[73] Shareholder resolutions proposing a binding bylaw on many subjects have been upheld by the Delaware courts. For example, in *Franz*, the Supreme Court of Delaware upheld a bylaw adopted by a majority shareholder that required attendance of all directors for a

quorum and unanimous director approval for any board action.[74]

### 3. Section 141(a)

Under Section 141(a) of the DGCL, the responsibility for the management of the business and affairs of the corporation is delegated to the board of directors. Section 141(a) provides as follows:

> *(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*. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.[75]

Delaware courts have interpreted Section 141(a) as constituting a statutory delegation of managerial[76] authority to the board of directors: "It is elementary that under Delaware law, the directors of a corporation rather than its shareholders manage the business and affairs of the corporation."[77] Indeed, in *Quickturn Design Systems v. Shapiro*,[78] the Delaware Supreme Court suggested that any limitations on the board of directors' statutory authority to manage the affairs of the corporation must be contained in the certificate of incorporation: "One 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. *Section 141(a) requires that any limitation on the board's authority be set out in the certificate of incorporation.*"[79] Seizing upon this language, commentators generally agree that any attempt by shareholders to affect the management of the "business or affairs" of the corporation by bylaw would conflict with Section 141(a) and would be invalid.[80]

## B. Delaware Law Does Not Preclude Mandatory Shareholder-Sponsored Bylaws

As previously discussed, the DGCL specifically authorizes bylaws on many subjects and at least some shareholder bylaws have been explicitly and implicitly upheld by Delaware courts. Commentators have suggested that shareholder-adopted bylaws in many areas should withstand scrutiny even if *Quickturn* may be applied to bar bylaws in certain cases involving "management."[81] Nonetheless, the SEC's hostility to mandatory bylaw proposals may have persuaded shareholders that even these types of bylaws are improper. Yet, not only are some - in the areas discussed above - clearly proper, but the arguments made about the application of *Quickturn* do not stand up under scrutiny.

First, there is no provision in the DGCL that requires all bylaws be precatory, and the SEC's creation of a "precatory" requirement under Rule 14a-8(i)(1) has no basis in state law.[82] The proper focus should be on the *subject matter* of the proposed shareholder action, and whether a particular proposal runs afoul of state law is not resolved simply based on whether the shareholder proposal is phrased in precatory or mandatory terms.

Second, the language in *Quickturn* that "any limitation on the board's authority be set out in the certificate of incorporation" is pure dictum. *Quickturn* involved a challenge to a so-called dead-hand poison pill. A dead-hand poison pill provides that only the members of the board when the pill was adopted, or their designated successors, may vote to redeem the rights issued thereunder. The Court in *Quickturn* held that *directors* lacked the authority to restrict the judgment of subsequent members of the board, and therefore the dead-hand provision was unlawful. Thus, the issue in *Quickturn* was not the propriety of a bylaw, let alone a shareholder bylaw.[83] Indeed, one Delaware Court specifically has noted that *Quickturn* did *not* resolve the issue of the validity of binding shareholder bylaws under Delaware law.[84]

Third, the argument that shareholder-adopted bylaws affecting the management of a corporation would be deemed invalid depends on the proposition that Section 109(b) is constrained by Section 141(a), and that Section 141(a) provides an absolute delegation of managerial authority to directors. Under this analysis, the language in Section 109(b) that a bylaw may contain "any provision, not inconsistent with law" refers to and is restricted by the language in Section 141(a), which delegates to the board of directors the authority to manage the "business and affairs" of the corporation.[85] This reading perceives a conflict between the two statutes and decides, somewhat arbitrarily, that the provisions of Section 141(a) necessarily trump the language of Section 109(b).

It is, however, possible to interpret the two sections so they are consistent with each other. Indeed, statutes "must not be construed in isolation but must be read *in pari materia* with related statutes . . . [and] [i]n attempting to reconcile inconsistencies between the several statutes literal or perceived interpretations which yield mischievous or absurd results are to be avoided."[86] We believe that an appropriate reading of Section 141(a) does not necessarily prohibit shareholders from exercising their rights under Section 109 to adopt bylaws that directly affect the "business and affairs" of the corporation.

1. **It is well established that shareholder action may affect the management of the corporation.**

The first flaw in the argument against shareholder adopted mandatory bylaws is that it fails to acknowledge the indisputable point that shareholders, in fact, *can* affect the management of the corporation. In *Lehrman v. Cohen*,[87] for example, the court observed that there is no problem with shareholders delegating managerial authority through the certificate of incorporation:

> It is well settled, of course, as a general principle, that directors may not delegate their duty to manage the corporate enterprise. *But there is no conflict with that principle where, as here, the delegation of duty, if any, is made not by the directors but by stockholder action under ' 141(a), via the certificate of incorporation.*[88]

Indeed, the Delaware Supreme Court acknowledged as much in *Quickturn*: "Section 141(a) requires that any limitation on the board's authority be set out in the certificate of incorporation."[89] And in *Hollinger*, the Court of Chancery observed that in the hierarchy of corporate governance, bylaws trump resolutions of the board of directors.[90] The question, then, is not *whether* shareholder action may direct the "business and affairs" of a corporation, because certainly it can. The only question is *how*. Thus, the premise that Section 141(a) provides an absolute, ironclad delegation of managerial authority to the board of directors is incorrect.

2. **Section 141(a) explicitly provides that the board of directors' responsibility for management of the corporation may be restricted Aas otherwise provided in the DGCL.**

The second, more obvious flaw in with the argument against mandatory shareholder-adopted bylaws is that it ignores the plain terms of the relevant statute. Section 141(a) provides that the board of directors has the authority to manage the affairs of the corporation "*except as may be otherwise provided in this chapter or* in its certificate of incorporation."[91] Because Section 109 specifically allows the shareholders to enact bylaws "relating to the business of the corporation [or] the conduct of its affairs,"[92] and because Section 109 of the DGCL is in the same "Chapter" as Section 141(a), there is no conflict between the statutes and no need to elevate one statute over the other. Indeed, under a plain reading of the statutes, it appears that shareholders should be entitled to enact bylaws that address "business and affairs" of a corporation, and thus "otherwise" restrict the board of directors' responsibilities to do so.

The only Delaware court that appears to have addressed this issue agreed. In *Hollinger v. Black*, the controlling shareholder of a publicly traded corporation executed a written consent adopting bylaws that purported to limit the board's ability to implement anti-takeover devices, as part of an effort to force a sale favored by the majority shareholder. The Court of Chancery ultimately struck the bylaws as being patently inequitable, but in doing so specifically rejected the company's argument that the bylaws somehow violated Section 141.[93]

Nevertheless, several commentators and practitioners have argued that shareholders may *not* use bylaws to affect the management of a corporation, despite Section 141(a)'s explicit terms restricting the board's managerial responsibility "as may be otherwise provided in this chapter or [the] certificate of incorporation." Indeed, even in *Hollinger*, the Court of Chancery noted that "there has been much scholarly debate about the extent to which bylaws can – consistent with the *general* grant of managerial authority to the board in § 141(a) – limit the scope of managerial freedom a board has[.]"[94] Professor Lawrence A. Hamermesh, of the University of Delaware's Widener School of Law, for example, has argued as follows: "When Section 141(a) refers to limitations on board authority 'provided in this chapter,' it does not refer to all by-laws that could conceivably be adopted pursuant to the general authority conferred by section 109(b). Rather, section 141(a) is more naturally read to refer to statutes that address its specific subject matter - the allocation of managerial power to the board of directors - and which clearly and explicitly depart from that allocation by providing for management by persons other than directors."[95] Other commentators and practitioners have agreed, suggesting (without any textual or legal support) that Section 141(a)'s supposed delegation of managerial authority to the directors may be restricted by the shareholders "as otherwise provided in this chapter" *only* in the context of close corporations.[96] This theory is unconvincing, and tortures the plain language of the statute.[97]

First, Title 8 of the Delaware Code, entitled "Corporations" is divided into three chapters.[98] Chapter 1 is the General Corporation Law, or the "DGCL." The DGCL, in turn, is divided into 17 subchapters.[99] Section 109 is contained in "Subchapter I. Formation;" Section 141(a) is contained in "Subchapter IV. Directors and Officers." Both sections, however, are contained within "Chapter 1. General Corporation Law."

Professor Hamermesh's argument that the reference to "this chapter" in Section 141(a) must be read as limited to provisions relating to "the allocation of managerial power to the board of directors" ignores the fact that only "Subchapter IV" relates to director and officer authority. Had the legislature intended Section 141(a)'s reference to "this chapter" to be limited to "Subchapter IV," it presumably would have said so. Indeed, even within the DGCL where the legislature intended to limit a statute's application to a particular subchapter, it plainly expressed

that intent.[100] In fact, Delaware has *at least* 1,486 statutes in which the legislature referred to a specific subchapter within the Delaware Code.[101] This calls into question Professor Hamermesh's suggestion that a more "natural reading" of Section 141(a) limits the term "this chapter" to "this subchapter." There is absolutely no textual support for the suggestion that Section 141(a) provides an absolute ironclad delegation of managerial authority to directors that may not be modified by the shareholders through their ability to amend a company's bylaws pursuant to Section 109. To argue otherwise improperly twists the language of Section 141(a).

Second, there is no support in Delaware caselaw for the proposition that a board's managerial authority may not be constrained by the shareholders' right to adopt and amend bylaws. Although Delaware courts repeatedly have observed that the directors are statutorily authorized to manage the day-to-day operations of a company,[102] never has any Delaware court ruled that the shareholders' right to adopt and amend bylaws under Section 109 is somehow constrained by the managerial responsibilities that are delegated to the directors under Section 141(a). Indeed, the Court of Chancery's observation in *General DataComm*,[103] confirmed that the question of whether shareholders may restrict directors' managerial authority has not been resolved by any Delaware court.[104] And the Court of Chancery's refusal to strike the shareholder-adopted bylaws in *Hollinger* as violative of the directors' managerial responsibilities[105] demonstrates that the shareholders' right to adopt bylaws is not constrained by Section 141(a). Thus, any suggestion that Delaware law necessarily precludes shareholder-adopted bylaws that affect the management of a corporation is simply wrong.[106]

### 3. Shareholder adopted bylaws should not implicate concerns relating to directors' abandonment of their fiduciary duties to the corporation.

One possible way to reconcile the apparent conflict between the statutes, and to distinguish the case law that is relied upon by those opposed to shareholder adopted bylaws, is to distinguish between the concepts of delegation and abdication. Most Delaware cases addressing the scope of the managerial responsibility of the board of directors have been in the context of directors' improperly delegating or abandoning that responsibility or restricting the ability of future boards to act in accordance with their fiduciary duties.[107]

Indeed, in *Rosenblatt v. Getty Oil Co.*,[108] the Court of Chancery explained that the problem with such cases was that the *directors* improperly abdicated their fiduciary duties to the corporation: "In each such case, the directors surrendered the ability to use their best judgment in the future on action to be taken in the name of the corporation. That was the flaw that made their actions unlawful as I read those cases."[109]

A board may not take it upon itself to abdicate or delegate its fiduciary responsibility to manage the corporation absent a provision to the contrary in the certificate of incorporation. That is the situation dealt with in *Quickturn*. There, the problem was *not* that the shareholders infringed on any supposed managerial authority of the board of directors, but that the board of directors unlawfully restricted the actions of future members of the board by preventing them from voting to redeem the rights plan they created. That is a far cry from concluding that shareholders - the corporate owners - may not restrict the bounds within which their board representatives may exercise their authority.[110] In other words, the situation where a *director* improperly abandons his or her duties to the shareholders and the corporation is fundamentally different from the situation where the shareholders, through their majority action, tell the director what he or she can or cannot do.[111]

## E. Even If Quickturn Does Apply, What Are Its Limits?

As noted, Section 141(a) has been interpreted broadly,[112] but its reach is not unlimited.[113] Another plausible interpretation of *Quickturn* stands for the proposition that directorial authority over the *day-to-day* affairs of the company may be restricted only in the certificate while limitations on *extraordinary matters* may be appropriately addressed by mandatory shareholder bylaws. This is similar to the distinction used by the SEC in applying the "ordinary business" exclusion of Rule 14a-8(i)(7).[114] This, of course, has led to litigation over what events are sufficiently mundane as to qualify as "ordinary business" under subsection (i)(7).[115] Nevertheless, if the ordinary-extraordinary distinction were applied, shareholder-sponsored bylaws that directed board action on a host of subjects would be permissible, including poison pills.[116]

## CONCLUSION

The widely-held belief that mandatory bylaws are somehow precluded under Delaware law appears to be greatly overstated. A close examination of the relevant provisions of the Delaware General Corporation Law reveals that mandatory bylaws are permissible and appropriate, and there is no prohibition against shareholders adopting such bylaws for the corporations that they own. Shareholder activists, therefore, should be encouraged to exercise their rights to directly affect the governance and management of their companies, and should not be swayed by nay-sayers who opine that the shareholders' role should be passive and limited to making mere suggestions to management. Because the DGCL specifically gives the shareholders the power to

adopt bylaws that directly affect the management of the corporation, shareholders who desire to effect governance changes, to protect and enhance the value of their investment, should not hesitate to exercise that power.[117]

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## ENDNOTES

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[1] This article focuses on Delaware law because Delaware is the recognized leader in our corporate law. The state is home to the vast majority of Fortune 500 corporations, which incorporate in Delaware to take advantage of arguably the most flexible and advanced laws governing corporations and business entities in the nation. Delaware's Court of Chancery has produced over 200 years' worth of legal precedent in corporation and business entity law.

[2] *Hollinger Int'l, Inc. v. Black*, C.A. No. 183-N, 2004 WL 360877, *46-48 (Del. Ch., Feb. 26, 2004).

[3] *J.I. Case Co. v. Borak*, 377 U.S. 426, 431 (1964).

[4] 17 C.F.R. §240.14a-8.

[5] 17 C.F.R. §240.14a-8(d).

[6] *See e.g., JDS Uniphase Corp.*, SEC No-Action Letter, 2003 WL 21693586, at *2 (July 18, 2003) (SEC rejected the shareholder's proposal, in part, for failure to meet minimum stock ownership requirements of Rule 14a-8(b)(1)).

[7] Rule 14a-8(i) states, in its entirety, as follows:

(i) *Question 9*: If I have complied with the procedural requirements, on what other bases may a company rely to exclude my proposal?

(1) *Improper under state law*: If the proposal is not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization;

Note to paragraph (i)(1): Depending on the subject matter, some proposals are not considered proper under state law if they would be binding on the company if approved by shareholders. In our experience, most proposals that are cast as recommendations or requests that the board of directors take specified action are proper under state law. Accordingly, we will assume that a proposal drafted as a recommendation or suggestion is proper unless the company demonstrates otherwise.

(2) *Violation of law*: If the proposal would, if implemented, cause the company to violate any state, federal, or foreign law to which it is subject;

Note to paragraph (i)(2): We will not apply this basis for exclusion to permit exclusion of a proposal on grounds that it would violate foreign law if compliance with the foreign law would result in a violation of any state or federal law.

(3) *Violation of proxy rules*: If the proposal or supporting statement is contrary to any of the Commission's proxy rules, including §240.14a-9, which prohibits materially false or misleading statements in proxy soliciting materials;

(4) *Personal grievance; special interest*: If the proposal relates to the redress of a personal claim or grievance against the company or any other person, or if it is designed to result in a benefit to you, or to further a personal interest, which is not shared by the other shareholders at large;

(5) *Relevance*: If the proposal relates to operations which account for less than 5 percent of the company's total assets at the end of its most recent fiscal year, and for less than 5 percent of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the company's business;

(6) *Absence of power/authority*: If the company would lack the power or authority to implement the proposal;

(7) *Management functions*: If the proposal deals with a matter relating to the company's ordinary business operations;

(8) *Relates to election*: If the proposal relates to an election for membership on the company's board of directors or analogous governing body;

(9) *Conflicts with company's proposal*: If the proposal directly conflicts with one of the company's own proposals to be submitted to shareholders at the same meeting;

Note to paragraph (i)(9): A company's submission to the Commission under this section should specify the points of conflict with the company's proposal.

(10) *Substantially implemented*: If the company has already substantially implemented the proposal;

(11) *Duplication*: If the proposal substantially duplicates another proposal previously submitted to the company by another proponent that will be included in the company's proxy materials for the same meeting;

(12) *Resubmissions*: If the proposal deals with substantially the same subject matter as another proposal or proposals that has or have been previously included in the company's proxy materials within the preceding 5 calendar years, a company may exclude it from its proxy materials for any meeting held within 3 calendar years of the last time it was included if the proposal received:

(i) Less than 3% of the vote if proposed once within the preceding 5 calendar years;

(ii) Less than 6% of the vote on its last submission to shareholders if proposed twice previously within the preceding 5 calendar years; or

(iii) Less than 10% of the vote on its last submission to shareholders if proposed three times or more previously within the preceding 5 calendar years; and

(13) *Specific amount of dividends*: If the proposal relates to specific amounts of cash or stock dividends.

[8] *See, e.g., Novell, Inc.*, SEC No-Action Letter, 2000 WL 223715, *10 (Feb. 14, 2000) (permitting exclusion, under Rule 14a-8(i)(1), of shareholder proposal to amend company's bylaws to require shareholder approval for the adoption or maintenance of any poison pill shareholder rights plan unless rephrased as request, accepting opinion of Delaware counsel that proposed bylaw was improper subject for shareholder action).

[9] *Mattel, Inc.*, SEC No-Action Letter, 2002 WL 833515, *44 (Mar. 25, 2002) (permitting exclusion of bylaw recommending adoption of bylaw requiring shareholder approval for adoption or extension of poison pill shareholders rights plan).

[10] *See, e.g., Lucent Technologies Inc.*, SEC No-Action Letter, 2003 WL 22850012, *10 (Nov. 26, 2003)(excluding mandatory bylaw relating to general compensation of all employees as "ordinary business"); *compare ConAgra Foods, Inc.*, SEC No-Action Letter, 2003 WL 21698390, *13 (rejecting company's argument that shareholder proposal regarding compensation of "senior executives and corporate directors" related to the company's "ordinary business" for purposes of Rule 14a-8(i)(7)); SEC Division of Corporate Finance: Staff Legal Bulletin No. 14A - *Shareholder Proposals* (Jul. 12, 2002), *available at* http://www.sec.gov/interps/legal/cfslb14a.htm (companies may not rely on Rule 1a-8(i)(7) to exclude shareholder proposals concerning: (1) compensation plans for senior executives and directors; (2) compensation plans for senior executives, directors, and the general workforce, if proposal seeks to require shareholder approval for any plan that would have a material dilutive effect on existing stockholders; and (3) compensation plans for the general workforce (not directors or senior executives), if the proposal seeks to require shareholder approval for any plan that would have a material dilutive effect on existing stockholders).

[11] 17 C.F.R. §240.14a-8(i)(1).

[12] 17 C.F.R. §240.14a-8(i)(20)

[13] *See* SEC Division of Corporate Finance: Staff Legal Bulletin No. 14 - *Shareholder Proposals* (July 13, 2001), *available at* http://www.sec.gov/interps/legal/cfslb14.htm ("The company has the burden of demonstrating that it is entitled to exclude a proposal, and we will not consider any basis for exclusion that is not advanced by the company. We analyze the prior no-action letters that a company and a shareholder cite in support of their arguments and, where appropriate, any applicable case law. We also may conduct our own research to determine whether we have issued additional letters that support or do not support the company's and shareholder's positions. Unless a company has demonstrated that it is entitled to exclude a proposal, we will not concur in its view that it may exclude that proposal from its proxy materials.").

[14] *See, e.g., Longview Fibre Company*, SEC No-Action Letter, 2003 WL 22965427, at *3 (Dec. 10, 2003)(pursuant to Rule 14a-8(i)(1), SEC permitted exclusion of bylaw proposal to split company into three parts, accepting argument that mandatory nature of the proposal violated state law); *Novell, Inc.*, SEC No-Action Letter, 2000 WL 223715, *1 (February 14, 2000) (permitting exclusion of proposal for shareholders to amend the company's bylaws to preclude the adoption of any "poison pill" shareholders' rights plan without prior shareholder approval.

[15] *Adoption of Amendments Relating to Proposals by Security Holders*, SEC Release Nos. 12999, 19771, 34012999, 35019771, 1976 WL 160347, *7 (1976).

[16] *Id.*

[17] *See, e.g., Novell, Inc.*, SEC No-Action Letter, 2000 WL 223715, *10 (Feb. 14, 2000) (permitting exclusion of shareholder proposal to amend company's bylaws to require shareholder approval for the adoption or maintenance of any poison pill shareholder rights plan unless recast with precatory language); *see also Longview Fibre Company*, 2003 WL 22965427, at *3 (Dec. 10, 2003)(applying Washington law, and permitting exclusion of mandatory bylaw recommending splitting the company into three parts unless recast with precatory language); *Farmer Bros. Co.*, 2003 WL 22869579, at *16 (Nov. 28, 2003)(applying California law, and permitting the exclusion of a mandatory bylaw restoring cumulative shareholder voting unless recast with precatory language).

[18] *Pennzoil Company*, SEC No-Action Letter, 1993 WL 52187, *32 (Feb. 24, 1993) ("*Pennzoil I*") (permitting company to exclude proposal under former Rule 14a-8(c)(1), which appears now as Rule 14a-8(i)(1)).

[19] *Pennzoil Company*, SEC No-Action Letter, 1993 WL 87871, *15 (Mar. 22, 1993) ("*Pennzoil II*")

[20] *Id.*

[21] *General DataComm Indus., Inc.*, SEC No-Action Letter, 1998 WL 883796, *5-7 (Dec. 9, 1998). General DataComm also argued that the proposal's supporting statement was false and misleading and excludable under Rule 14a-8(i)(3). The SEC rejected this argument as well. *Id.* at *8.

[22] *Id.* 1998 WL 883796 at *7.

[23] *Id.* ("We note that your counsel and the proponent's counsel have cited sections 109, 122(15), 141, 152, 153, 157 and 161of the Delaware General Corporation Law as potentially controlling the implementation of the proposal. However, neither counsel for you nor counsel for the proponent has opined as to any compelling state law precedent. In view of the lack of any decided legal authority, the Division has determined not to express any view with respect to the application of rule 14a-8(i)(1) to the proposal."); *see also Union Carbide Corp.*, SEC No-Action Letter, 1999 WL 58519, *13 (Feb. 5, 1999) (Applying New York law, which is similar to applicable Delaware law, and rejecting company's request for permission to exclude proposal advocating shareholder-adopted bylaw to require shareholder approval for changing the expiration date on or adopting any new poison pill, the SEC stated: "Neither counsel for you nor the proponent has opined as to any compelling state law precedent. In view of the lack of any decided legal authority we have determined not to express any view with respect to the application of rules 14a-8(i)(1) and 14a-8(i)(2) to the revised proposal.").

[24] *Novell, Inc*, SEC No-Action Letter, 2000 WL 223715, *1 (Feb. 14, 2000).

[25] *Id.* at *7.

[26] *Id.* at *10.

[27] *Advocat Inc.*, SEC No-Action Letter, 2003 WL 1903833 (Apr. 15, 2003).

[28] *Id.* at *10 ("Assuming the proponent has revised the proposal in the above manner, we are unable to concur in your view that Advocat may exclude the proposal under rule 14a-8(i)(2). Accordingly, we do not believe that Advocat may exclude the proposal from its proxy materials in reliance on rule 14a-8(i)(2).")

[29] *Id.* at *9 ("There appears to be some basis for your view that Advocat may exclude the proposal under rule 14a-8(i)(1) as an improper subject for shareholder action under applicable state law. It appears that this defect could be cured, however, if the proposal were recast as a recommendation or request to the board of directors. Accordingly, unless the proponent provides Advocat with a proposal revised in this manner, within seven calendar days after receiving this letter, we will not recommend enforcement action to the Commission if Advocat omits the proposal from its proxy materials in reliance on rule 14a-8(i)(1). Assuming the proponent has revised the proposal in the above manner, we are unable to concur in your view that Advocat may exclude the proposal under rule 14a-8(i)(2).").

[30] *Mattel, Inc.*, SEC No-Action Letter, 2002 WL 833515, *44 (Mar. 25, 2002).

[31] *Id.* at *44 (Mar. 25, 2002)("We note that in the opinion of your Delaware counsel, Richards, Layton & Finger, implementation of the proposal would cause Mattel to violate state law. Accordingly, we will not recommend enforcement action to the Commission if Mattel omits the proposal from its proxy materials in reliance on rule 14a-8(i)(2)"); *Atlas Air Worldwide Holdings, Inc.*, SEC No-Action Letter, 2002 WL 1058533, *29 (April 5, 2002) (same); *see also Toys "R" Us, Inc.*, SEC No-Action Letter, 2002 WL 1058521, *24 (April 9, 2002) (The shareholder proposal and the company's arguments were identical as in *Mattel* and *Atlas Air*, except the proposal requested the *shareholders*, as opposed to the *company*, to adopt the challenged bylaw. The SEC also permitted the company to exclude the proposal under Rule 14a-8(i)(2)).

[32] This highlights another problem with the SEC's No-Action procedure. The SEC freely admits that it does not resolve requests for no-action letters based on the subject matter of the proposals. *See* SEC Division of Corporate Finance: Staff Legal Bulletin No. 14 - *Shareholder Proposals* (Jul. 13, 2001), *available at* http://www.sec.gov/interps/legal/cfslb14.htm ("We consider the specific arguments asserted by the company and the shareholder, the way in which the proposal is drafted and how the arguments and our prior no-action responses apply to the specific proposal and company at issue. Based on these considerations, we may determine that company X may exclude a proposal but company Y cannot exclude a proposal that addresses the same or similar subject matter."). This process can result in seemingly inconsistent determinations. For example, *Advocat, Inc.*, 2003 WL 1903833 (Apr. 15, 2003), *Citigroup, Inc.*, 2003 WL 282531 (Jan. 27, 2003), and *Mattel, Inc.*, 2002 WL 833515 (Mar. 25, 2002), each involved proposals requiring shareholder approval of poison pill shareholders rights plans. In *Advocat* and *Citigroup* the proposal "recommended" that the directors terminate the plans or seek shareholder approval. The SEC refused to permit the companies to exclude these proposals. In *Mattel*, however, the proposal "requested" the adoption of a *bylaw* that would prevent adoption or maintenance of poison pill without shareholder approval. The SEC permitted the Mattel proposal to be excluded, accepting Mattel's lawyers' argument that any restriction on the directors' authority to adopt and implement rights plans must be set forth in the certificate of incorporation. Thus, the SEC apparently believes that the shareholders can recommend that a poison pill be dismantled, but that any restriction on the directors' supposed right to adopt defensive mechanisms must be set forth in the certificate of incorporation, not the bylaws.

[33] 17 C.F.R. §240.14A-8(i)(7).

[34] *ConAgra Foods, Inc.*, SEC No-Action Letter, 2003

WL 21697390, *13 (July 18, 2003)(shareholder proposal to modify stock option plans for directors and senior executives not "ordinary business").

[35] *See, e.g., The Coca-Cola Co.*, SEC No-Action Letter, 2003 WL 122319 (Jan. 7, 2003) (shareholder proposal to amend company's diversity and equal employment policies was not "ordinary business"); *The Bear Stearns Cos., Inc.*, SEC No-Action Letter, 2002 WL 31890965 (Dec. 27, 2002) (proposal that all stock options to senior executives shall be performance-based was not excluded under "ordinary business" exception).

[36] *See, e.g., Otter Tail Corp.*, SEC No-Action Letter, 2002 WL 31890982 (Dec. 27, 2002) (proposal that stock options be expensed when granted and reported in the financial statements, not footnotes, was not "ordinary business").

[37] *See Sonoma West Holdings, Inc.*, SEC No-Action Letter, 2000 WL 1182875 (Aug. 17, 2000) (decision on whether to pay dividends was not within the company's "ordinary business").

[38] *See Santa Fe Southern Pacific Corp.*, SEC No-Action Letter, 1987 WL 107638 (Feb. 19, 1987) (SEC determined that a shareholder proposal that "recommended" that the board redeem rights issued under a poison pill could not be excluded from the company's proxy materials, and specifically rejected the company's argument that the adoption of a poison pill was within the "ordinary business" of the corporation).

[39] *Farmer Bros. Co.*, SEC No-Action Letter, 2002 WL 31664455 (Nov. 15, 2002) (shareholder bylaw requiring company to conduct its business as an investment company was not excluded under the "ordinary business" exception); *The Quaker Oats Co.*, SEC No-Action Letter, 2000 WL 381480 (March 28, 2000) (proposal to remove from product line genetically engineered crops, organisms and products was not within the company's "ordinary business").

[40] *See, e.g., Citigroup, Inc.*, SEC No-Action Letter, 2000 WL 235272 (Feb. 17, 2000) (proposal regarding establishment of a "shareholder matching gift plan" whereby the corporation would match any donations by its shareholder of their dividends to charitable organizations was not within the "ordinary business" of the corporation); *Maxxam Inc.*, SEC No-Action Letter, 1998 WL 136417 (Mar. 26, 1998) (proposal that requested company to prepare a report "on strategies for ending all operations that cut, damage, remove, mill or otherwise involve old-growth trees" was not within the "ordinary business" of the company). *See also Johnson Controls, Inc.*, SEC No-Action Letter, 2002 WL 31562565 (Nov. 14, 2002) (proposal requesting company to prepare a report concerning the company's policies and practices related to social, environmental and economic sustainability was not part of the company's "ordinary business"); *Cisco Systems, Inc.*, SEC No-Action Letter, 2002 WL 31097462 (Sept. 19, 2002) (proposal for yearly report describing equipment sold in countries restricting or monitoring Internet access was not "ordinary business").

[41] *Lockheed Martin Corporation*, SEC No-Action Letter, 2004 WL 111564, *10 (Jan. 20, 2004)(proposal to stop "forced distribution of annual employee evaluations" excluded under Rule 14a-8(i)(7)).

[42] *Kraft Foods, Inc.*, SEC No-Action Letter, 2004 WL 111628 (Jan. 16, 2004)(proposal for company to publish report about cost of raw materials excluded as "ordinary business").

[43] *Paccar, Inc.*, SEC No-Action Letter, 2004 WL 111635, *6 (Jan. 14, 2004)(proposal for shareholders to approve any independent auditor excluded as relating to "ordinary business").

[44] 19 Fed. Reg. 246 (1954), quoted in Harold S. Blumenthal and Samuel Wolff, SECURITIES AND FEDERAL CORPORATE LAW, § 24:84 (2d Ed. 2003).

[45] Hearings on SEC Enforcement Problems Before a Subcom. of the Senate Comm. on Banking and Currency, 85th Cong., 1st Sess., pt. 1, at 118 (1957) (emphasis supplied).

[46] Rule 14a-8(i)(2) also extends to the law of foreign jurisdictions.

[47] *Supra* Sec. I.A.1.

[48] *Santa Fe Southern Pacific Corporation*, SEC No-Action Letter, 1987 WL 107638 (Feb. 19, 1987).

[49] *Id.* at *8. *See also Citigroup, Inc.*, SEC No-Action Letter, 2000 WL 235272 (Feb. 17, 2000) (proposal regarding establishment of a "shareholder matching gift plan" whereby the corporation would match any donations by its shareholder of their dividends to charitable organizations was not within the "ordinary business" of the corporation); *Maxxam Inc.*, SEC No-Action Letter, 1998 WL 136417 (March 26, 1998) (proposal that requested company to prepare a report "on strategies for ending all operations that cut, damage, remove, mill or otherwise involve old-growth trees" was not within the "ordinary business" of the company); *Sprint Corp.*, SEC No-Action Letter, 2003 WL 457715, at *38 (Feb. 18, 2003)(applying Kansas law, SEC determined that proposal that directed company to publish report concerning certain executive compensation paid in connection with a failed merger did not relate to "ordinary business" but could be excluded as inconsistent with state law unless amended to include precatory language); *Sonoma West Holdings, Inc.*, SEC No-Action

Letter, 2000 WL 118275 (Aug. 17, 2000) (decision on whether to pay dividends was not within the company's "ordinary business"); *The Quaker Oats Company*, SEC No-Action Letter, 2000 WL 381480 (Mar. 28, 2000) (proposal to remove from product line genetically engineered crops, organisms and products was not within the company's "ordinary business").

[50] *Compare Santa Fe Southern Pacific Corporation*, SEC No-Action Letter, 1987 WL 107638 (Feb. 19, 1987) *with Mattel, Inc.*, SEC No-Action Letter, 2002 WL 833515, *44 (Mar. 25, 2002).

[51] *See, e.g., Citigroup, Inc.*, SEC No-Action Letter, 2004 WL 111634, *5 (Jan. 14, 2004) (permitting a Delaware corporation to exclude a shareholder proposal advocating a resolution establishing time limits for discussions at shareholder meetings); *DPL Inc.*, SEC No-Action Letter, 2004 WL 103229, *3 (permitting Ohio corporation to exclude shareholder proposal for resolution establishing location for annual meeting); *Verizon Communications Inc.*, 2003 WL 122334, *4 (Jan. 9, 2003) (permitting Delaware corporation to exclude shareholder proposal for resolution establishing location of annual meeting); *Commonwealth Energy Corp.*, SEC No-Action Letter, 2002 WL 31655985, *32 (Nov. 15, 2002) (permitting California corporation to exclude shareholder proposal advocating the adoption of a bylaw that would set forth specific procedural rules for conducting the annual meeting); *AmSouth Bancorporation*, SEC No-Action Letter, 2002 WL 63728 *5 (Jan. 15, 2002) (permitting Delaware corporation to exclude shareholder proposal for resolution requiring chairman of annual meeting to permit discussion on subjects for up to thirty minutes).

[52] *Frantz Manufacturing Co. v. EAC Industries*, 501 A.2d 401, 407 (Del. 1985).

[53] *Gow v. Consolidated Coppermines Corp.*, 165 A. 136, 140 (Del. Ch. 1933).

[54] *See Oberle v. Kirby*, 592 A.2d 445,457-58 (Del. 1991); *Prickett v. American Steel and Pump Corp.*, 253 A.2d 86, 88 (Del. Ch. 1969); *State ex rel. Brumley v. Jessup & More Paper Co.*, 24 Del. 370 (1910); *Gaskill v. Glady's Gelle Oil Co.*, 146 A. 337 (Del. Ch. 1929)

[55] *Schnell v. Chris-Craft Industries, Inc.*, 285 A.2d 437 (Del. 1971).

[56] *Supra*, n. 14, and accompanying text.

[57] Randall S. Thomas and Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. Cin. L. Rev. 1021, 1047-48 (1999).

[58] 975 P.2d 907 (Okla. 1999).

[59] Section 1038 of the Oklahoma Corporate Code provides, in relevant part, as follows:

> Subject to any provisions in the certificate of incorporation, every corporation may create and issue . . . rights or options entitling the holders thereof to purchase from the corporation any shares of its capital stock of any instrument or instruments as shall be approved by the board of directors.

OKLA. STAT. tit. 18 O.S.1991 §1038 (1986). This provision is identical to Section 157 of the DGCL, 8 Del. C. §157.

[60] *Fleming*, 975 P.2d at 912. The problem with the *Fleming* decision is that it ignored the primary issue presented by mandatory bylaws. The real question involves the balancing of the rights of shareholders to enact bylaws against the board of directors' statutory obligation to manage the corporation. In its decision, however, the *Fleming* court skirted this issue entirely. Although *Fleming* presents a springboard upon which a litigant in Delaware may build support for mandatory bylaws, by no means does the case provide firm intellectual support. To that end, it is necessary to evaluate the competing statutory bases for shareholders' rights and board of directors' duties under the DGCL.

[61] *See, e.g.*, David W. Ware, *Shareholders' Right to Review the Adoption and Continuation of a Takeover Defense Plan: Is The Fleming Decision Dead On Arrival?*, 2000 U. Ill. L. Rev. 1053 (2000); Gregory V. Varallo, Kelly A. Herring, *Delaware Law & Directors' Duties in Change of Control Transactions*, 1122 PLI/Corp 43, *126-127 (1999).

[62] 731 A.2d 818 (Del. Ch. 1999)

[63] *Id.* at 821 n.1 and 2 and accompanying text.

[64] *Hollinger*, 2004 WL 360877 at *48 n.136.

[65] 821 F. Supp. 877 (S.D.N.Y. 1993).

[66] *Id.* at 890.

[67] 8 Del. C. §109(a) (emphasis supplied)

[68] *Id.*

[69] 8 Del. C. §109(b) (emphasis supplied).

[70] *Hollinger*, 2004 WL 360877 at *47.

[71] 8 Del.C. §141.

[72] 8 Del.C. §142.

[73] 8 Del.C. §§ 211, 212.

[74] 501 A.2d at 407. *See also I.S. Phillips v. Insituform*, No. 9173, 1987 WL16285 (Del. Ch. Aug. 27, 1987) (reaching merits of shareholder bylaws, thus implicitly accepting shareholders' right to impose bylaws concerning director voting.).

[75] 8 Del. C. §141(a) (emphasis supplied).

[76] "The term 'management,' as used in this context, 'relates to supervision, direction and control'" of the corporation. *Canal Capital Corp. v. French*, No. Civ. A. No. 11,764, 1992 WL 159008 (Del. Ch. July 2, 1992).

[77] *Grimes v. Donald*, No. CIV. A. 13358, 1995 WL 54441, *6 (Del. Ch. Jan. 11, 1995) (citations omitted).

[78] 721 A.2d 1281 (Del. 1998)

[79] *Id.* at 1291 (emphasis supplied).

[80] *See, e.g.*, David M. Silk, David A. Katz, *Takeover Law and Practice*, 1228 PLI/Corp 9 (2001) ("It would seem that [mandatory] by-law amendments . . . should be held invalid under Delaware law as an unauthorized infringement on the statutory power of a board of directors to manage the 'business and affairs' of a Delaware corporation. Delaware cases have long made clear that the responsibility of responding to a takeover lies with the Board and may not be delegated to shareholders. The statutory grounding of the *Quickturn* decision supports this reading of Delaware law."); Charles F. Richards and Robert J. Stern, *Shareholder By-Laws Requiring Boards of Directors To Dismantle Rights Plans Are Unlikely To Survive Scrutiny Under Delaware Law*, 54 Bus. Law. 607 (Feb. 1999) ("A shareholder rights by-law, if adopted by shareholders, is not likely to survive scrutiny under Delaware law. Such a by-law would be inconsistent with the bedrock requirement of the General Corporation Law of the State of Delaware (DGCL) that directors, not shareholders, manage the business and affairs of the corporation. Also, it would interfere with the board's obligation to protect the corporation and its shareholders from acquisition offers that the board reasonably believed to be inadequate, coercive, or otherwise unfair. In short, a shareholder rights by-law would conflict with fundamental principles of Delaware law."); Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted Bylaws: Taking Back The Street?*, 73 Tul. L. Rev. 609 (1998). *But 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 (1997) (shareholder bylaws should generally be upheld); Jonathan R. Macey, *The Legality and Utility of the Shareholder Rights Bylaw*, 26 Hofstra L. Rev. 835 (1998) (same).

[81] *See* Hamermesh, *supra* n.80, 73 Tul. L. Rev. 409, 479-86 (suggesting that shareholder adopted bylaws may be proper if they relate to (a) stockholder governance - such as provisions allowing shareholders to convene special meetings for purposes such as removing and replacing directors, expanding the board and amending bylaws; (b) director qualifications - such as placing limits on the number of directorships an individual can hold, establishing restrictions on business or consulting relationships a director may have with the corporation or its affiliates, and establishing experience an individual must have to hold a director position; (c) board governance - such as establishing quorum requirements, vote requirements, and basic rules of procedure; and (d) corporate officers - such as requiring that the president or CEO must be elected by stockholder vote); John C. Coates, IV, and Bradley C. Faris, *Second Generation Shareholder Bylaws: Post-Quickturn Alternatives*, 56 Bus. Law. 1323, 1343-45 (Aug. 2001)(same).

[82] In fact, Vice Chancellor Leo Strine of the Delaware Court of Chancery recently commented that "precatory proposals . . . are an invention of the SEC anyway, and don't even exist under substantive corporate law." Symposium, *Corporate Elections*, 96 (Nov. 2003) *available at* http://www.law.harvard.edu/programs/olin_center/ and http://ssrn.com/abstract=471640.

[83] *Quickturn's* interpretation of Section 141(a) is consistent with prior case law although none of that case law ever considered the impact of Section 141(a) on shareholder bylaws. In *Abercrombie v. Davies*, 123 A.2d 893 (Del. Ch. 1956), *rev'd on other grounds*, 130 A.2d 338 (Del. 1957), for example, the court rejected a stockholder agreement dictating means of director voting because Section 141(a) "does not permit actions or agreements by stockholders which would take all power from the board to handle matters of substantial management policy. This is particularly true absent 100% stockholder approval, which is not present here. Even unanimous stockholder action in this field has limitations." *Id.* 123 A.2d at 898. In doing so, the court explained: "Because [the agreement] tends to limit in a substantial way the freedom of director decisions on matters of management policy it violates the duty of each director to exercise his own best judgments on matters coming before the board . . . a director-agent might here feel bound to honor a decision rendered under the agreement even though it was contrary to his own best judgment." *Id.* at 899. Such an arrangement, the court concluded, would "substantially encroach on the duty of directors to exercise independent judgment." *Id.*

[84] *General DataComm Indus., Inc. v. Wisconsin Inv. Bd.*, 731 A.2d 818, 821-22 (Del. Ch. 1999)

[85] Hamermesh, *supra* n.80, 73 Tul. L. Rev. at 430-31 (1998).

[86] *Watson v. Burgan* 610 A.2d 1364, 1368 (Del.1992) (citing *State Farm Mut. Auto. Ins. Co. v. Wagamon*, 541 A.2d 557, 560 (Del. 1988); *Spielberg v. State*, 558 A.2d 291, 293 (Del. 1989); *Daniels v. State*, 538 A.2d 1104, 1110 (Del. 1988)).

[87] 222 A.2d 800 (Del. 1966).

[88] *Id.* at 808 (emphasis supplied).

[89] 721 A.2d at 1292.

[90] *Hollinger*, 2004 WL 360877 at *47 ("Here, International argues that the Bylaw Amendments run afoul of § 141(c)(2) because that provision does not, in its view, explicitly authorize a bylaw to eliminate a board committee created by board resolution. By its own terms, however, § 141(c)(2) permits a board committee to exercise the power of the board only to the extent 'provided in the resolution of the board .... or in the bylaws of the corporation.' As the defendants note, the statute therefore expressly contemplates that the bylaws may restrict the powers that a board committee may exercise. *This is unremarkable, given that bylaws are generally thought of as having a hierarchical status greater than board resolutions, and that a board cannot override a bylaw requirement by merely adopting a resolution.*" (Emphasis supplied)).

[91] 8 Del. C. §141(a) (emphasis supplied).

[92] 8 Del. C. §109(b)

[93] *Hollinger*, 2004 WL 360877 at *48 n.136 ("I reject International's argument that that provision in the Bylaw Amendments impermissibly interferes with the board's authority under § 141(a) to manage the business and affairs of the corporation. Sections 109 and 141, taken in totality, and read in light of *Frantz*, make clear that bylaws may pervasively and strictly regulate the process by which boards act, subject to the constraints of equity.")

[94] *Hollinger*, 2004 WL 360877 at *47.

[95] Hamermesh, *supra* n.80, 73 Tul. L. Rev. at 430-31 (1998); *see also*, Lawrence A. Hamermesh, *But Is There a Limit on Investors' Power to Run a Corporation? An 'Unidentified Commentator' Responds*, Corporate Law Weekly, August 12, 1999, at 395, 396.

[96] *See* 1 R. Franklin Balotti & Jesse A. Finkelstein, *The Delaware Law of Corporations and Business Organizations* §4.1, at 4-6 (3d ed. 2001) (acknowledging that this phrase of §141(a) "is a fertile field for creative corporate lawyers," but suggesting that §141(a) refers only to provisions of the DGCL relating to close corporations or to restrictions in the certificate); Ernest L. Folk, III, *Folk on the Delaware General Corporation Law* §141.1, at GCL-IV-12-12.2 (4th ed. Supp. 2004-1) (entirely ignoring the language of §141(a) that specifically refers to other provisions in "in this chapter," this commentator acknowledged only two restrictions on the board's managerial authority: (1) provisions of the DGCL relating to close corporations and (2) provisions in the certificate of incorporation).

[97] *See* Jonathan R. Macey, *The Legality and Utility of the Shareholder Rights Bylaw*, 26 Hofstra L. Rev. 835, 867 (1998)(arguing that the delegation of managerial authority to a corporation's board of directors under §141(a) may be limited by the shareholders' right to adopt bylaws under §109(b)); Leonard Chazen, *The Shareholder Rights By-Law: Giving Shareholders a Decisive Voice*, 5 The Corporate Governance Advisor 8, 15-21 (Feb. 1997)("A reading of the two sections does not support the view that Section 141(a) overrides or negates the grant of authority in Section 109(b). While Section 109(b) only permits by-laws to contain provision that are 'not inconsistent with law or with the certificate of incorporation,' Section 141(a) avoids such inconsistency by qualifying any exclusive grant of authority to the board of directors with the phrase 'except as may be otherwise provided in this chapter.' This savings clause leaves room for by-laws adopted by stockholders pursuant to Section 109(b).").

[98] The three chapters of Title 8 are as follows:

Chapter 1. General Corporation Law

Chapter 5. Corporation Franchise Tax

Chapter 6. Professional Service Corporations

[99] The 17 subchapters of the DGCL (Chapter 1) are as follows:

I. Formation

II. Powers

III. Registered Office and Registered Agent

IV. Directors and Officers

V. Stock and Dividends

VI. Stock Transfers

VII. Meetings, Elections, Voting and Notice

VIII. Amendment of Certificate of Incorporation; Changes in Capital and Capital Stock

IX. Merger, Consolidation or Conversion

X. Sale of Assets, Dissolution and Winding Up

XI. Insolvency; Receivers and Trustees

XII. Renewal, Revival, Extension and Restoration of Certificate of Incorporation or Charter

XIII. Suits Against Corporations, Directors, Officers or Stockholders

XIV. Close Corporations; Special Provisions

XV. Foreign Corporations

XVI. Domestication and Transfer

XVII. Miscellaneous Provisions

[100] *See, e.g.*, 8 Del. C. §§344, 345, 346, 348, 356, 377, 378, 384, 385.

[101] This figure is based on a computerized search of all unannotated Delaware statutes in the Westlaw database "DE-ST" using the following search criteria: te(subchapter!) %("chapters, subchapters and sections" or "subchapter, chapter or part" or "part, chapter and subchapter").

[102] *See, e.g.*, *Maldonado v. Flynn*, 413 A.2d 1251, 1255 (Del. Ch. 1980), *rev'd on other grounds sub nom.*, *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981) ("[T]he board of directors of a corporation, as the repository of the power of corporate governance, is empowered to make the business decisions of the corporation. The directors, not the stockholders, are the managers of the business affairs of the corporation.").

[103] 731 A.2d 818 (Del. Ch. 1999).

[104] *Id.* at 821 n.1 and 2 and accompanying text.

[105] *Hollinger*, 2004 WL 360877 at *46-48.

[106] For example, last year, in connection with AOL Time Warner Inc.'s request for a No-Action letter permitting the exclusion of a proposal that would have provided access to the company's proxy to any director candidate nominated by a shareholder with 3% or more of the company's outstanding stock, the company presented the opinion of a Delaware law firm which argued that shareholders may only affect the management of a company in the context of a close corporation. *AOL Time Warner Inc.*, SEC No-Action Letter, 2003 WL 942784, *14 (Feb. 28, 2003). The only case cited by the Delaware counsel in support of that proposition, *Chapin v. Benwood Found., Inc.*, 402 A.2d 1205 (Del. Ch. 1979), *aff'd sub nom.*, *Harrison v. Chapin*, 415 A.3d 1068 (Del. 1980), however, stands for no such thing. In *Chapin*, the Court held that the *directors* of a corporation "may not delegate to others those duties which lay at the heart of the management of the corporation." 402 A.2d at 1210. This holding has nothing to do with whether the shareholders themselves may restrict the directors' managerial authority through bylaws enacted pursuant to Section 109 of the DGCL.

[107] *See, e.g.*, *In re Bally's Grand Derivative Litigation*, No. CIV. A. 14644, 1997 WL 305803 (Del. Ch. June 4, 1997) (holding that the directors improperly delegated their managerial responsibilities by causing the corporation to enter into a contract whereby the corporation ceded "uninterrupted control or/and responsibility for the operation" of the corporation's casino to a third party); *Chapin v. Benwood Foundation, Inc.*, 402 A.2d 1205 (Del. Ch. 1979), *aff'd*, 415 A.2d 1068 (Del. 1980) (holding that directors improperly restricted the ability of future board members to fulfill their fiduciary obligations by purporting to designate their successors, rather that allowing successor to be determined by a future vote, as provided in the bylaws).

[108] 8 Del. J. Corp. L. 366, 1983 WL 8936 (Del. Ch., Sept. 19, 1983),

[109] 8 Del. J. Corp. L. at 391, 1983 WL 8936 at *18.

[110] *See Lehrman*, 222 A.2d at 808.

[111] A limit on this rule appears to be that shareholders may not eliminate a director's ability to exercise fiduciary judgment. In *Abercrombie v. Davies*, 123 A.2d 893 (Del. Ch. 1956), *rev'd on other grounds*, 130 A.2d 338 (Del. 1957), for example, the court rejected a stockholder agreement dictating means of director voting because Section 141(a) "does not permit actions or agreements by stockholders which would take all power from the board to handle matters of substantial management policy. This is particularly true absent 100% stockholder approval, which is not present here. Even unanimous stockholder action in this field has limitations." *Id.* 123 A.2d at 898. In doing so, the court explained: "Because [the agreement] tends to limit in a substantial way the freedom of director decisions on matters of management policy it violates the duty of each director to exercise his own best judgments on matters coming before the board . . . a director-agent might here feel bound to honor a decision rendered under the agreement even though it was contrary to his own best judgment." *Id.* at 899. Such an arrangement, the court concluded, would "substantially encroach on the duty of directors to exercise independent judgment." *Id.* Under this analysis, bylaws which simply require shareholder votes on items such as poison pills, repricing of options or certain types of employment agreements might pass muster because they do not force the directors to do anything but simply reserve for shareholders the right to make a decision in a particular area. *See* John C. Coffee, Jr., *The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?*, 51 U. Miami L. Rev. 605, 615 (1997).

[112] *See Abercrombie*, 123 A.2d at 899 (holding that shareholder agreement violated Section 141(a) because it infringed on the directors' responsibility to manage the business and affairs of the corporation).

[113] *See Frantz Manufacturing*, 501 A.2d at 401 (holding that shareholder adopted bylaw requiring unanimous director action was valid).

[114] SEC Rule 14a-8(i)(7), 17 C.F.R. §240.14a-8(i)(7).

[115] *See, e.g.*, *Costco Wholesale Corp.*, SEC No-Action Letter, 2003 WL 22965433, at *35 (Dec. 11, 2003) (proposed bylaw establishing code of ethics excluded as

relating to company's "ordinary business"); *Telular Corp.*, SEC No-Action Letter, 2003 WL 22900984, at *18 (Dec. 5, 2003) (proposal that requested the appointment of an independent committee to evaluate strategic alternatives for maximizing shareholder value deemed excludable as relating to the company's "ordinary business"); *ConAgra Foods, Inc.*, SEC No-Action Letter, 2001 WL 637580 (June 8, 2001) (SEC determined that a proposed bylaw which provided that stock options issued to directors, officers or employees would not vest unless the exercise price of such options exceeded the growth rate of the S&P 500 from date the options were issued to the date they were to vest, was properly excluded from the proxy statement as within the company's "ordinary business"); *SONICblue Incorporated*, SEC No-Action Letter, 2001 WL 306189 (Mar. 23, 2001) (SEC determined that the selection of independent auditors is within the corporation's "ordinary business").

[116] *See supra* n.34-40, and accompanying text.

[117] The final question is how to get the issue of the propriety of mandatory bylaws before a Delaware court. Because the SEC typically permits companies to exclude shareholder-proposed mandatory bylaws at the No-Action stage, it will be imperative to get a court to squarely address the propriety of such shareholder proposals in order to persuade the SEC to reverse its course. In this regard, there appears to be three options: *First*, an SEC No-Action letter is a statement of opinion, and is not entitled to the deference afforded administrative rulings. *Amalgamated Clothing*, 821 F. Supp. at 890. Thus, if a board of directors refuses to include a proposed bylaw in proxy materials to be sent to stockholders, a shareholder could commence an action compelling its inclusion under Rule 14a-8. *Int'l Brotherhood of Teamsters General Fund v. Fleming Companies, Inc.*, 975 P.2d 907 (Okla. 1999). *Second*, if a corporation agrees to include the proposed bylaw in the proxy materials, but also includes prefatory statements to the effect that the proposal is illegal, the action may be deemed ripe for adjudication as the prefatory statements may be an impediment to the free exercise of the shareholders' right to vote. Or, the statements could be challenged as false and misleading under Rule 14a-9. *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991) (Court held that directors' statements of reasons, opinions and beliefs in proxy solicitation are "statements with respect to material facts" and, if false or misleading, could form the basis of a shareholders' action against the directors). However, litigation at this stage may not result in a ruling on the legality of the bylaw itself. A court could find that the language on legality is misleading because the issue is an open one and strike it on that basis without reaching the merits. *Third*, if a bylaw is adopted by a majority of shareholders, but the corporation refuses to implement or comply with the bylaw based on its alleged illegality, the shareholders would have a cause of action against the directors arising from their failure to do so. Such a scenario would place the legality of the proposed bylaw squarely before a court.