"PRIVATE ORDERING" TAKEN A TAD TOO FAR

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INTRODUCTION

I am quite a fan of *Private Ordering with Shareholder Bylaws*[1] by D. Gordon Smith, Matthew Wright, and Marcus Kai Hintze. I agree both with the general thrust of their suggested reforms and with the two main policy reasons they give to justify those reforms. However, I think they go too far in the direction of empowering shareholders. Indeed, while I do not believe the status quo is perfect (is the status quo ever perfect?), we have reached a point where no major changes to either state or federal statutes or rules are necessary. Both Delaware and the Securities and Exchange Commission (SEC) have made some important recent moves. The best response is to watch incremental developments in corporate practice and case law. Depending on how these go, further legislative or administrative responses may be necessary, but not if things go well.

The authors argue that we should expand the scope for private ordering in public corporations by making it easier for shareholders to adopt bylaws. They identify two kinds of benefits from this increased private ordering. Micro-benefits occur within one corporation as the shareholders are able to hold directors more accountable. Macro-benefits occur across corporations, as they learn from the varied experiments of others. These are precisely the right reasons to push for expanded shareholder power. I draw upon the same values, labeled as accountability and freedom of contract, in my own recent work on shareholder empowerment in the context of the debate over proxy access.[2]

But there are countervailing concerns and problems that expanded shareholder power could create. This suggests that we want an intermediate degree of shareholder empowerment that best balances the benefits and costs. I argue that the status quo strikes that balance pretty well, and that the authors would upset the balance too far in the direction of shareholder empowerment.

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1. D. Gordon Smith, Matthew Wright, & Marcus Kai Hintze, *Private Ordering with Shareholder Bylaws*, 80 FORDHAM L. REV. 125 (2011).

2. *See* Brett H. McDonnell, *Setting Optimal Rules for Shareholder Proxy Access*, 43 ARIZ. ST. L.J. 67, 85 (2011).

I. FINDING THE RIGHT BALANCE

Although the values of accountability and experimentation argue for an expansive shareholder bylaw power, there are countervailing considerations that counsel some concern. Special interest shareholders (like union or public employee pension funds) or those with no economic stake in the corporation (the empty voting problem) may use the power in ways that hurt shareholder interests. Unlimited shareholder power to intervene in all corporate affairs risks destroying the grant of centralized authority which is at the heart of the public corporation.[3] Overly strong shareholder power could hurt other corporate constituencies, such as employees and creditors.

The authors point to several constraints on private ordering. But these constraints have their own limits. Yes, a majority of shareholders must approve a bylaw, but shareholders will not always be well informed about the interests of bylaw proponents, and the growing influence of shareholder advisory services may exacerbate the problem if those services do not do their jobs well. Certificate provisions may limit the bylaw power. However, that may prove too blunt an instrument—one that can either be avoided by clever drafting if the certificate provision is too narrow, or that may block too many bylaws if the certificate provision is too broad. I think the authors are too sanguine that the effects of certificate provisions included in corporations at the time of an IPO will be appropriately priced; the evidence on IPO pricing does not necessarily support such optimism.[4] Director counter-bylaws are another potential limit that may over-shoot the mark. If they are allowed (an uncertain point under Delaware law), boards will be able to de-fang all shareholder bylaws they do not like. As the authors note, I have argued before that market pressure may stop directors from doing this.[5] I hope that is so, but if not, shareholder activists may need to push Delaware to follow the Model Business Corporation Act and not allow board bylaws to undo shareholder bylaws, in which case this limit would cease to exist. Finally, the limits of Rule 14a-8 on shareholder bylaws are pretty weak; of all the procedural limits, only the 120-day advance notice limit has any real bite.

The mix of benefits and costs that come with the shareholder bylaw power, combined with the limits on the various constraints that the authors discuss, suggest that the law should strike a balance in defining the ability of shareholders to use bylaws to constrain boards. Stephen Bainbridge, following Kenneth Arrow, rightly emphasizes that the law needs to balance authority with accountability.[6] The representative system of a board elected

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3. *See* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 559–60 (2003).

4. *See generally* Lucian Arye Bebchuk, *Why Firms Adopt Antitakeover Arrangements*, 152 U. PA. L. REV. 713 (2003); Michael Klausner, *Institutional Shareholders, Private Equity, and Antitakeover Protection at the IPO Stage*, 152 U. PA. L. REV. 755 (2003).

5. *See* Brett H. McDonnell, *Shareholder Bylaws, Shareholder Nominations, and Poison Pills*, 3 BERKELEY BUS. L.J. 205, 262 (2005); Smith, Wright, & Hintze, *supra* note 1, at 178 n.382.

6. *See generally* KENNETH J. ARROW, THE LIMITS OF ORGANIZATION (1974); Bainbridge, *supra* note 3.

by shareholders does that. The board has authority to make most business decisions, but shareholders elect the board. Where Bainbridge goes wrong is in upsetting the balance by constantly presuming that authority should trump accountability wherever the two conflict.[7] To make that accountability work, shareholders need to be able to shape the basic structure through which the governance system works.

In defining the scope of the bylaw power, this suggests one or two guiding distinctions that I have endorsed in the past.[8] Shareholders should not have the power to make or second-guess ordinary business decisions. But they should be able to create bylaws that set rules of corporate governance and procedures which the board must follow. As we shall see, state and federal law have reached a point that reflects this desirable balance, and the authors push shareholder power too far in suggesting reforms that upset this balance. Let us look to state and federal developments, and the authors' critiques of those developments, in turn.

II. *CA, INC.* IS NOT THAT BAD

The main state law development, which the authors discuss at length, is *CA, Inc. v. AFSCME Employees Pension Plan*,[9] the Delaware Supreme Court's first extended analysis of the scope of the shareholder bylaw power. That case has two main sections in its argument and holdings, and the authors criticize both sections. I find those criticisms off base for one section, and on target but ultimately overstated for the other.

The first section of *CA, Inc.* holds that the shareholder bylaw at issue was a proper subject for shareholder action under Delaware law. In so doing, it for the first time gave some guidance as to the proper scope of shareholder bylaws. It argued that "a proper function of bylaws is not to mandate how the board should decide specific substantive business decisions, but rather, to define the process and procedures by which those decisions are made."[10] The authors criticize this distinction as unsupported by the statutory language describing the general bylaw power. But as I have argued elsewhere at some length, the procedural–substance distinction is in fact a plausible interpretation of that power.[11] The authors also argue that the court "has now invited litigation of the nature of bylaws, without much guidance on how to distinguish procedural and substantive bylaws."[12] However, the procedure–substance distinction is an old one in the law, one that many courts have elaborated upon over the years. Delaware courts operate in the common law tradition, and are quite experienced at applying

7. *See* Brett H. McDonnell, *Professor Bainbridge and the Arrowian Moment: A Review of* The New Corporate Governance in Theory and Practice, 34 DEL. J. CORP. L. 139 (2009).

8. *See* McDonnell, *supra* note 5, at 216–18; *see also* John C. Coffee, Jr., *The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?*, 51 U. MIAMI L. REV. 605, 613–15 (1997).

9. 953 A.2d 227 (Del. 2008).

10. *Id.* at 234-35.

11. *See* McDonnell, *supra* note 5, at 217.

12. Smith, Wright, & Hintze, *supra* note 1, at 153.

general standards to specific facts. As I have said elsewhere, "Applying broad, vague principles to particular circumstances is utterly central to the identity of Delaware courts in the area of corporation law. If Delaware courts cannot be trusted to do that task well, there is a much bigger problem than just how to develop the law in this one area."[13]

Moreover, the court does not necessarily limit bylaws to only procedural matters; it calls this *a* proper function. That holds open the possibility that there are other possible functions. In addition to the process–substance distinction, the courts could elaborate that bylaws can be used to structure the basic governance features of a corporation, again in contrast to being used to dictate particular business decisions. Especially if so interpreted, *CA, Inc.* would then reflect the optimal balance of authority and accountability described above. The authors' suggested changes to sections 109(b) and 141(a) of the Delaware General Corporation Law (DGCL) would upset that balance. They do not identify any major bylaw ideas that would advance shareholder interests at low cost to corporate operations but that would be prohibited by Delaware law under the *CA, Inc.* interpretation.

The second section of *CA, Inc.* holds that the bylaw nonetheless violates Delaware law because under some circumstances it might force the corporation's directors to violate their fiduciary duty.[14] It reaches this conclusion by referencing cases in which corporate boards attempted to bind themselves, and belittles the distinction between a board binding future boards and shareholders binding a board. The authors write: "It is hard to imagine how the court found this argument persuasive."[15] Indeed, it is hard to adequately describe how bad the reasoning is here relative to the general high quality of Delaware court opinions.[16]

And yet, the practical effects of this bungled logic are probably not too bad. Shareholders can avoid this problem by including a fiduciary duty carve-out in their bylaws. Such carve-outs do create the risk that a board will use them to get around the bylaw. However, doing so would be a blatant slap in the face to shareholders, and boards are unlikely to try it unless they are rather desperate. Moreover, attempts to exercise the carve-out are likely subject to strict *Blasius*[17] scrutiny, so that boards will have to struggle to justify themselves.

Furthermore, it may be that the fiduciary duty analysis of *CA, Inc.* does not apply to bylaws that are valid under more specific statutory grants of authority as opposed to the general grant of authority under section 109(b). If so, many useful bylaws will not even require fiduciary duty carve-outs. That includes the very election reimbursement bylaw at issue in *CA, Inc.*,

13. Brett H. McDonnell, *Bylaw Reforms for Delaware's Corporation Law*, 33 DEL. J. CORP. L. 651, 667 (2008).

14. *See CA, Inc.*, 953 A.2d at 238.

15. Smith, Wright, & Hintze, *supra* note 1, at 154.

16. I have had a go at it myself. *See* McDonnell, *supra* note 2, at 98–99.

17. Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988) (holding invalid actions taken for the primary purpose of impeding the shareholder franchise unless those actions are shown to have a compelling justification).

which was subsequently given a specific statutory grant of authority under the new section 113. So, while I agree with the authors' recommendation that the Delaware Supreme Court revisit its precedent on this point, if the court ignores that recommendation, which seems likely, I do not foresee huge problems for shareholder activists.

In sum, the obstacles to shareholder exercises of the bylaw power that the authors identify in their analysis of *CA, Inc.* are not too serious on close inspection. The first half of the opinion strikes a good balance between authority and accountability. The second half of the opinion is silly, but harmless. Or at least mostly harmless.

III. THE SEC GOT IT MOSTLY RIGHT (EVEN IF THE D.C. CIRCUIT DID NOT)

In order to be able to afford to get bylaw proposals before fellow shareholders, proposers need to be able to place their proposals in the corporate proxy using Rule 14a-8. For decades, the misbegotten "relates to an election" exclusion prevented shareholders from using Rule 14a-8 to propose bylaws setting the rules for shareholder elections. The SEC's recent proxy access rules wisely eliminated this exclusion (more or less), and the D.C. Circuit's recent decision in *Business Roundtable v. SEC*[18] does not change that.

The *Business Roundtable* case strikes down the new proxy access rule for shareholder nominations to the board. Like the authors, I supported that rule, although I believed it should have allowed shareholders to opt out of the rule in any direction they wanted. In striking down the rule, the D.C. Circuit rather arbitrarily and capriciously imposed a cost-benefit requirement that provides little guidance as to what the agency must do to justify a rule in a way that the court finds adequate. I fear that this will make rulemaking to implement new financial regulations under the Dodd-Frank Act[19] more costly, time-consuming, and uncertain.

Although I regret the loss of the new Rule 14a-11, I do not mourn it much. It was a close call whether the SEC should have imposed a proxy access default rule at all, and the rule it chose allowed access for such a limited group of shareholders that I doubt it would have been used much anyway (very few shareholders in public corporations hold three percent of a company's shares for three years). Given the stringency of that rule, what really mattered was amending Rule 14a-8 to allow shareholders to create their own more generous rules, and as mentioned, that change remains in place.

The authors recommend eliminating the "ordinary business" exclusion in Rule 14a-8.[20] They condemn it as unduly vague. Vague it certainly is, and the SEC undoubtedly reverses itself with some regularity as it decides that some previously excluded topics have become the subject of enough public

18. 647 F.3d 1144 (D.C. Cir. 2011).

19. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

20. *See* Smith, Wright, & Hintze, *supra* note 1, at 185-87.

interest so that proposals on those topics should be allowed. But excluding matters that are part of ordinary business quite closely tracks the distinction, which I suggest above strikes a good balance between authority and accountability. The exclusion's flexibility allows the SEC to gauge the markets and ask what sorts of proposals seem to be of present concern to a large number of shareholders and what kinds of proposals reflect overly pushy activists using the Rule in a way that is imposing too large a burden on companies. The resulting uncertainty has some costs, but those are mitigated by the no-action letter process. At relatively low cost, companies and shareholders can get guidance from the SEC on particular proposals, and the accumulation of no-action letters creates some precedential value, which further reduces uncertainty.

CONCLUSION

For those keeping score, I have supported the third of the authors' recommended legal changes (revisiting Delaware precedent on fiduciary duty), but argued against their first (amending DGCL section 141(a)), second (amending DGCL section 109(b)), and fourth (amending Rule 14a-8) recommended changes. What other changes would I then recommend myself?

None, for now.[21] Both state and federal law on shareholder bylaw proposals have reached a pretty good set of rules. They are not perfect; the Delaware precedent on fiduciary duty being inconsistent with most bylaws is silly, and either state or federal law should probably create a default rule for shareholder access to the corporate proxy to nominate board candidates, as the SEC tried to do with Rule 14a-11.

But these are not huge barriers to shareholder action. For now, we should live with them. Let us see how shareholder activists use the shareholder bylaw power and Rule 14a-8 to propose new bylaws, including those governing proxy access. Experience may show that we need to tinker with the rules more. If Delaware courts use the procedure–substance distinction to strike down useful, non-harmful bylaws, the authors' suggested changes to sections 109(b) and 141(a) may be needed. Should the SEC regularly allow companies to exclude useful bylaw proposals under the "ordinary business" exclusion, the time may come to eliminate that exclusion. Should boards aggressively use counter-bylaws to neuter shareholder bylaws, and should the Delaware courts hold those counter-bylaws are valid, we may need to push to amend Delaware law to follow practice in other states and allow shareholder bylaws to restrict such board counter-bylaws.

I think there is quite a good chance, though, that none of these legal changes will be needed. The authors do not point to any significant and useful bylaw proposals that would be struck down under the current regime. If Delaware courts, the SEC, and boards follow and develop current rules

21. Though I have recommended other statutory changes in the past. *See* McDonnell, *supra* note 13.

wisely, those rules should create a proper balance in defining the shareholder bylaw power.