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The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?

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The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?

JOHN C. COFFEE, JR.*

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What, if anything, can institutional investors do to influence the course and outcome of corporate control contests? The traditional answer was relatively little. To be sure, institutions could tender their shares in a tender offer or vote in a proxy contest to oust the incumbent board, but such a role was essentially reactive and contingent. It required that an offer actually be made before institutions could respond on an after-the-fact basis. Similarly, institutions have occasionally conducted precatory proxy campaigns calling upon the board to redeem its poison pill,¹ but management was free to ignore these requests (and has done so).²

Thus, the practical question is whether institutional investors can take some form of mandatory action in advance of a corporate control contest that effectively constrains management from resisting it. This year, institutions are trying. On several occasions this year, institutional shareholders have taken the initiative and conducted proxy solicitations to adopt a bylaw amendment that, under defined circumstances, would require the corporation's board of directors to redeem its poison pill in the face of a "fair" and fully financed tender offer for all the corpora-

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1. These efforts began in the late 1980s with series of shareholder proposals, advanced pursuant to SEC Rule 14a-8, 17 C.F.R. § 240.14a-8, by public pension funds (most notably CalPERS). See CHOPER, COFFEE & GILSON, *CASES AND MATERIALS ON CORPORATIONS* 525-26 (4th ed. 1995). From time to time, some of these precatory proposals have been successful.

2. For example, in 1996, a 65% shareholder majority of Fleming Companies, Inc. voted in favor of a precatory proxy proposal made by the Teamsters pension fund that Fleming should redeem its poison pill. See *infra* note 21 and accompanying text. On a few recent occasions, corporations have actually voluntarily redeemed their pills in response to such a request, but more often they have ignored such requests. In general, the business judgment rule protects management when it rejects a shareholders request. See *Auer v. Dressel*, 118 N.E.2d 590 (N.Y. 1954); *Spiegel v. Buntrock*, 571 A.2d 767, 772-73 (Del. 1990).

tion's shares.³ If this can be done, the viability of the poison pill as the critical linchpin in management's defense strategy can be substantially undercut. Today, the poison pill can be overcome in most jurisdictions only by a proxy contest that unseats the incumbent directors; however, the target corporation has an effective defense to this technique: namely, the use of a staggered board, which typically stretches out the proxy fight for two elections and often the better part of two years (during which time the target may find other suitors to outbid the original bidder).

Thus, the prospect of a shareholder mandated redemption of the poison pill would significantly shift the balance of the advantage between bidder and target by telescoping the time it takes the bidder to achieve control. Even the more modest prospect that bylaw amendments might provide that poison pills could not be renewed or modified in the future without shareholder approval would have significant impact, because most shareholder rights plans were adopted in the mid to late 1980s and are now coming up for renewal. Thus, the advent of shareholder-passed bylaw amendments restricting defensive techniques could mark a significant new chapter in the continuing saga of the takeover wars.

This background frames the basic question on which this Comment will focus: do shareholders have such a power of initiative? On a doctrinal level, this question forces us to confront the unsettled and murky scope of both the shareholders' and the board's power to amend the bylaws. Although the standard catechism of American corporate governance holds that the directors, not the shareholders, make business decisions⁴, the power of the shareholders to amend the bylaws is at least potentially a partial exception to this rule.⁵ This issue of the effective allocation of power between the board and shareholders breaks down into three subsidiary legal questions: (1) To what extent can shareholders give the board mandatory instructions through the medium of bylaw amendments; (2) can the board respond by repealing shareholder-passed bylaws; and (3) if the board can repeal shareholder-passed bylaws, may shareholders effectively limit this power by use of the procedural provi-

3. See *infra* notes 16-21, 48 and accompanying text.

4. See, e.g., *Buntrock*, 571 A.2d at 772-73; *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1154 (Del. 1989).

5. At common law, the power to adopt, amend or repeal the bylaws was vested solely in the shareholders. Statutory provisions later permitted (but never required) shareholders to delegate this authority to amend bylaws to the board. See REVISED MODEL BUS. CORP. ACT § 10.20 cmt. at 283-84 (1996). While most certificates of incorporation today delegate authority to the board to amend the bylaws, it is clear, at least in Delaware, that this authority does not divest the shareholders of their right to further amend or repeal bylaws. See *infra* note 7 and accompanying text.

sions in the bylaws. On the theoretical level, the idea of shareholder initiatives raises broader issues of corporate governance and has encountered some academic opposition, with at least one critic suggesting that efficiency losses are likely if shareholders can reverse managerial decisions.⁶ Although this Comment finds this critique to be overstated, it suggests that the topic of shareholder initiatives has both practical and theoretical dimensions.

I. SHAREHOLDERS INITIATIVES THROUGH BYLAW AMENDMENTS: THE STATUTORY AND JUDICIAL BACKDROP AND RECENT HISTORY

As with that of many other states, Delaware law contains two very broad, unqualified statements that co-exist in some tension with each other. Section 109(a) of the Delaware General Corporation law provides in relevant part:

After a corporation has received any payment for any of its stock, the power to adopt, amend or repeal bylaws shall be in the shareholders entitled to vote . . . ; provided, however, any corporation may, in its certificate of incorporation, confer the power to adopt, amend or repeal bylaws upon the directors The fact that such power has been so conferred upon the directors . . . shall not divest the stockholders . . . of the power, nor limit their power to adopt, amend or repeal bylaws.”⁷

Section 109(b) then adds: “The bylaws may contain any provision, not inconsistent with law or 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.”⁸ This provision clearly seems to authorize bylaws that limit the board’s authority, and hence at first glance it would seem possible to adopt a bylaw restricting the board’s authority (or denying it altogether) to adopt a shareholder rights plan (or “poison pill”).

Nonetheless, Section 141(a) also contains an equally broad and unqualified statement: “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

6. Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice And Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347 (1991).

7. Del. Code Ann. tit. 8 § 109(a) (1991). For similar provisions, see N.Y. BUS. CORP. LAW § 601 (McKinney 1996); Revised Model Bus. Corp. Act § 10.20 (1996). The last above-quoted sentence in section 109(a) was added in 1974 to make clear that “the granting of authority over bylaws to the board of directors in the certificate of incorporation does not operate to divest or limit the powers of the shareholders to adopt, amend or repeal bylaws.” See DAVID A. DREXLER ET AL., *DELAWARE CORPORATION LAW AND PRACTICE*, § 9.02, at 9-3 (1996).

8. DEL. CODE ANN. tit. 8 § 109(b) (1991).

chapter or in its certificate of incorporation.”⁹ Not only does this provision seemingly make the board the ultimate repository of all corporate power and authority, but it can also be read to require that any deviation from this fundamental rule be expressed in the certificate of incorporation. Alternatively, one can read the phrase “except as otherwise provided in this chapter” as a crossreference to Section 109 and its broad recognition of shareholder authority to adopt and amend bylaws.

The search for a sensible accommodation of these two broad provisions must also recognize that judicial decisions have exhibited some hostility to shareholder attempts to encroach upon the board’s authority.¹⁰ Common law decisions have long recognized that a shareholder resolution, passed at a shareholders’ meeting, directing the board to take a specified action was ineffective (although it could be treated as a valid precatory request).¹¹ It would seemingly elevate form over substance to permit shareholders to do by way of a bylaw amendment what they could not do by way of a shareholder resolution—use bylaw amendments to dictate “ordinary” business practices of the corporation.

What then is the proper function of bylaws? An early Delaware case phrased it this way:

“[T]he by-laws are generally regarded as the proper place for the self-imposed rules and regulations deemed expedient for. . . [the corporation’s] convenient functioning to be laid down.”¹²

In short, the bylaws are the appropriate location for constraints that limit the exercise of corporate power, including by the directors. The key distinction then seems to be between affirmative instructions to take specific actions (which generally seem impermissible) and negative constraints that affect the allocation of power between the board and the shareholders (which generally seem permissible).

This traditional sense, that the shareholders may not mandate specific corporate action seems to have been codified by the SEC in a not entirely consistent series of decisions interpreting Rule 14a-8 under the Securities Exchange Act of 1934. That rule permits shareholders to include a shareholder proposal in the corporation’s proxy statement unless certain exceptions apply, including Rule 14a-8(c)(1)’s exclusion

9. *Id.* § 141(a).

10. Indeed, Professor Gordon has characterized this tendency as amounting to an “absolute delegation” rule. See Gordon, *supra* note 6, at 352. This may be overstated, but the tendency is nonetheless evident.

11. For cases expressing the general rule, see, *Continental Securities Co. v. Belmont*, 99 N.E. 138, 141 (1912) (“As a general rule, stockholders cannot act in relation to the ordinary business of a corporation.”); *Auer v. Dressel*, 118 N.E.2d 590 (N.Y. 1954). But see *SEC v. Transamerica Corp.*, 163 F.2d 511, 516-17, (3rd Cir. 1947).

12. See *Gow v. Consolidated Coppermines Corp.*, 165 A. 136, 140 (Del. Ch. 1933).

for proposals that "under the laws of the registrant's domicile, [are] not a proper subject for action by security holders."¹³ Thus, if state law treats such a shareholder action as a nullity, the proposal can be excluded under this provision (or at least re-interpreted as a merely precatory request for board action).

In 1992, Robert Monks, a leading shareholder activist, sought to include a proposal in Exxon's proxy statement to amend Exxon's bylaws in order to establish a three person shareholder advisory committee ("SAC") that would review Exxon's management and advise the board of shareholder views.¹⁴ This shareholder-elected SAC would have had the power to retain outside advisors, prepare reports and an annual evaluation that would be included in the corporation's proxy statement; its total budget could have run up to \$12 million per year. Despite this arguable encroachment upon the board's authority, the SEC refused to let Exxon exclude the proposal under Rule 14a-8(c)(1).

Because Exxon's counsel argued strenuously that the shareholders' right to amend the bylaws did not permit them to invade the board's authority over the corporation's funds and was necessarily subject to the board's overall power to manage the business and affairs of the corporation, this outcome suggested that the SEC's staff read the power to amend the bylaws broadly. In truth, however, the staff's expressed view was more modest; it concluded, rather tersely, that because the SAC intended only to communicate with the board and shareholders (and not to exercise substantive authority) "the nature and scope of that communication would appear as not involving matters concerning the conduct of the Company's ordinary business operations."¹⁵

Ambiguous as the Exxon no action letter was, it was overshadowed later that year when CalPERS submitted a similar proposal to create an SAC to Pennzoil Corporation for inclusion in its proxy statement.¹⁶ This proposed bylaw had one additional important feature: it could not

13. 17 C.F.R. § 240.14a-8(c)(1).

14. See Exxon Corp., SEC No-Action Letter, 1992 SEC No-Act. LEXIS 281 (Feb. 28, 1992); Henry Lesser, *Shareholder Bylaw Amendment Proposals Under the Proxy Rules: The Impact of the Exxon Letter*, *The Corporate Governance Advisor* 1 (Oct./Nov. 1992); Charles F. Richards, Jr. & Anne C. Foster, *Exxon Revisited: The SEC Allows Pennzoil to Exclude Both Mandatory and Precatory Proposals Seeking to Create a Shareholder Advisory Committee*, 48 *BUS. LAW.* 1509 (1993).

15. Exxon Corp., SEC No-Action Letter, 1992 SEC No-Act. Letter 281, *2 (Feb. 28, 1992).

16. See Pennzoil Corp., SEC No-Action Letter, 1993 SEC No-Act. LEXIS 503 (Mar. 22, 1993). See also Henry Lesser & Ashley G. Gable, *Bylaw Amendment Proposals Since Exxon*, *THE CORPORATE GOVERNANCE ADVISOR* 12-13 (May/June 1996). While Exxon was a New Jersey corporation, Pennzoil was a Delaware corporation. Although this difference could justify a difference in outcome if the statutory provisions were different, nothing in the SEC's analysis in these two "no action" letters suggests that their differing outcomes were based on statutory differences.

be amended or repealed without the approval of shareholders. In early 1993, the SEC staff granted Pennzoil's requested no action letter, thereby permitting the CalPERS proposal to be excluded. The staff seems to have been primarily troubled by a feature that was also present in the Exxon proposal: namely, a shareholder authorization of corporate funds without board approval. In response, CalPERS immediately revised its proposal, making it entirely precatory. Again, the SEC staff permitted the revised proposal to be excluded. This time, the rationale was that the ability of shareholders to adopt a bylaw that could not be amended by the directors raised "a substantial question under Delaware law."¹⁷ Given the "questionable validity of such bylaw amendment"¹⁸ in the SEC staff's view, the proposal could be excluded under Rule 14a8(c)(1).

Although this ruling did not formally reverse the earlier Exxon no action letter, it did seemingly imply that bylaw amendments that either required the expenditure of significant corporate funds or that purported to deny the board the authority to amend the shareholder adopted bylaw could be excluded. Nonetheless, the SEC has continued to require the inclusion in proxy statements of other shareholder proposed bylaw amendments.¹⁹ Apparently, the staff will allow bylaw amendments to specify that a majority of the board must meet a defined standard of independence, although such a shareholder-passed bylaw might well be immediately repealed by the board in the SEC staff's view.²⁰

Given this ambivalence on the part of the SEC staff, institutional investors have not recently made extensive use of the bylaw amendment approach under Rule 14a-8. Instead, in 1996, some have attempted a more frontal approach: namely, a direct proxy solicitation. Because this approach, while more costly, does not rely on Rule 14a-8, it cannot be thwarted by any of the exceptions under Rule 14a-8 (including the "ordinary business" exception under subparagraph (c)(7) as well as the "proper subject" exclusion under subparagraph (c)(1)). Rather, the corporation must, itself, go to court and seek to enjoin the proxy solicitation, or later rely on the board's authority to amend or repeal it.

Although institutional investors have in the past conducted precatory proxy solicitations against the poison pill, the first serious attempt

17. Pennzoil Corporation, SEC No-Action Letter, 1993 SEC No-Act. LEXIS 503 at *1. (Mar. 22, 1993); *see also* Lesser & Gable, *supra* note 16; Richards and Foster, *supra* note 14.

18. Pennzoil Corporation, SEC No-Action Letter, 1993 SEC No-Act. LEXIS 503 at *2. (Mar. 22, 1993).

19. *See* Great Atlantic & Pacific Tea Company, Inc., SEC No-Action Letter, 1993 SEC No-Act. LEXIS 528 (Mar. 26, 1993); General Dynamics Corp., SEC No-Action Letter, 1993 SEC No-Act. LEXIS 108 (Jan. 5, 1994).

20. *See id.*

to adopt a mandatory bylaw amendment requiring a redemption of an existing poison pill appears to have come in 1996. Following Wallace Computer Services, Inc.'s successful takeover defense in 1995 against the tender offer made for it by Moore Corporation²¹ (which defense was successful, notwithstanding the fact that nearly 75% of the Wallace shares were tendered to Moore²²), Guy Wyser-Pratte, a well-known takeover arbitrager who controlled a 2.3% stake in Wallace Computer, commenced a proxy solicitation for a bylaw amendment that would have required the Wallace Computer board in the future to redeem its poison pill if the company received a "fair" takeover proposal, which was defined as a fully financed cash bid at 25% or more above the then market price of the stock.²³ The proxy solicitation was diligently pursued and, for a time, seemed to be winning, but on the eve of the vote a crucial block switched sides and left the insurgents with only 36% of the votes actually cast.²⁴ Nonetheless, a 36% vote in favor of a mandatory bylaw amendment may well be a record outcome for insurgents.²⁵

More recently, Mr. Wyser-Pratte in conjunction with Spear, Leeds & Kellogg, an investment management firm, has inaugurated a second campaign to adopt a similar bylaw amendment. This time the target corporation is Rexene Corporation, which had been pursued by Huntsman Corporation, but the Wyser-Pratte effort seems by all press accounts to be independent of the bidder's efforts.²⁶ Here, the outcome has not yet been decided, but the tactic, if successful, could easily be emulated by others.

The final and latest development involves a judicial decision that runs precisely counter to the SEC's reading of bylaw amendments. On May 1, 1996, a non-binding resolution sponsored by the Teamsters General Fund calling for a shareholder vote prior to the adoption of any poison pill was supported by 65% of the votes cast at the Fleming Com-

21. See *Moore Corp. Ltd. v. Wallace Computer Servs.*, 898 F. Supp. 1089 (D. Del. 1995).

22. See Reed Abelson, *Arbitrager in a New Battle With Anti-Takeover Forces*, N.Y. TIMES, Aug. 20, 1996, at D18.

23. *Id.*

24. See Reed Abelson, *Takeover Decision Declined by Investors*, N.Y. TIMES, Nov. 7, 1996, at D2.

25. Some precatory resolutions requesting redemption of the poison pill have received majority votes.

26. See Reed Abelson, *Market Place: A New Proxy Strategy: Upgrading the Dissident Slate*, N.Y. TIMES, Dec. 10, 1996, at D14. In 1997, the struggle over Rexene became a confused three-way tug-of-war, as the Wyser-Pratte group undertook a proxy solicitation to remove the board and Huntsman announced an intention to make a \$16 per share, all-cash bid. See *Huntsman-Rexene Saga in Final Phase*, Chemical Mkt. Rep., Apr. 28, 1997, at 5, available in LEXIS, News Library, Curnws File.

panies, Inc. annual shareholder meeting.²⁷ Nonetheless, less than two months later, Fleming's board adopted a new 10-year shareholder rights plan.

In response, the Teamsters General Fund drafted a mandatory bylaw amendment that purportedly nullified the new pill and required an after-the-fact shareholder vote to approve any future poison pill. When Fleming declined to include the proposed bylaw amendment in its proxy materials, the Teamsters sued—and won. In January 1997, the United States District Court for the Western District of Oklahoma found that Oklahoma corporate law gave shareholders the right to take such action pursuant to their authority to amend the bylaws and thus that the proposed bylaw was a “proper subject” for shareholder action under Rule 14a-8(c)(i).²⁸ Although Oklahoma law governed Fleming, Oklahoma law in this area is virtually identical to Delaware law. District Court Judge Wayne E. Alley found that the Teamsters' proposal would give shareholders the after-the-fact power to nullify or amend any poison pill adopted by the directors. Because this format gave shareholders an “after-the-fact. . . review of what the directors had done in exercise of their powers under 1038,” he concluded that “this approach toward 1038 and 1013, I think, reconciles those sections.”²⁹

Although Fleming initially appealed, it gave in and in March, 1997 voluntarily cancelled its poison pill.³⁰ But was the district court correct? At first glance, the District Court's rationale may place too much emphasis on timing. The fact that the shareholders only get an after-the-fact review does not, by itself, fully answer the argument that mandatory affirmative instructions represent an impermissible encroachment upon the board's authority. For example, if shareholders claimed the right to review every pricing or purchasing decision made by management, such

27. See Council of Institutional Investors, Council Research Alerts, Vol. 2, No. 3, Jan. 16, 1997 at 1.

28. See *International Bhd. of Teamsters Gen. Fund v. Fleming Companies, Inc.*, No. Civ. 96-165c-A, 1997 U.S. Dist. LEXIS 2980 (W.D. Okla. Jan. 14, 1997). A later decision in this same case also refused to stay the court's injunction pending Fleming's appeal. See *International Bhd. of Teamsters Gen. Fund v. Fleming Companies, Inc.*, No. Civ. 96-165c-A, 1997 U.S. Dist. LEXIS 2979 (W.D. Okla. Feb. 19, 1997).

29. See Transcript of Oral Arguments on Motion for Summary Judgment, at 31 (copy on file at *University of Miami Law Review*). Section 1038 of the Oklahoma Corporations Code simply permits the board to “create and issue . . . rights or options entitling the holders thereof to purchase from the corporation any shares of its capital stock . . .” OKLA. STAT. ANN. tit. 18 § 1038 (1997). The typical shareholder rights plan (or poison pill) involves the creation and issuance of a specifically designed option to dilute the holdings of a hostile bidder. Effectively then, the court held that the express delegation of this power to the board did not defeat the use of a bylaw amendment by the shareholders to constrain it.

30. See *Board Decides to Terminate Company's Poison Pill Plan*, WALL ST. J., Mar. 19, 1997 at B-4.

an encroachment would result, notwithstanding the after-the-fact nature of the shareholder review.

II. WHEN DOES A BYLAW AMENDMENT INVADE THE BOARD'S AUTHORITY IMPERMISSIBLY?

Proponents of shareholder authority to adopt a bylaw amendment that requires redemption of a poison pill can advance some non-frivolous arguments for their position: (1) such bylaw amendments do not require the expenditure of corporate funds nor typically mandate the taking of any affirmative step (and may in fact economize on costly defensive tactics); (2) they also do not interfere with "ordinary business decisions", as that phrase is usually understood, because a poison pill represents a fundamental financial decision, and one having no impact on "ordinary" day-to-day operations; (3) such bylaw amendments serve to protect shareholder interests in an area where they have a vital interest—namely, the marketability of their shares—because poison pills and shareholder rights plans do necessarily restrict the field of eligible buyers and thus affect share marketability.

On the other hand, Delaware decisions have regularly stated the proposition that:

Delaware law confers the management of the corporate enterprise to the stockholders' duly elected board representatives. The fiduciary duty to manage a corporate enterprise includes the selection of a time frame for achievement of corporate goals. That duty may not be delegated to the stockholders.³¹

On this basis, attempts to restrict defensive tactics arguably interfere with the board's choice of the optimal "time frame for achievement of corporate goals."³² Economists (and others) may find this argument incomplete and even incoherent because it apparently confuses the principal's preferences with those of the agent. From their perspective, discretionary authority in the board is a means to an end: namely, shareholder wealth maximization. Nonetheless, in the jurisprudence of Delaware, the protection of board authority does sometimes seem to be accepted as an end in itself.

In this light, what is the most sensible "bright line" standard that can be drawn to separate permissible bylaw amendments from impermissible ones that invade the board's authority? Several lines seem possible:

1. *Ordinary versus "Fundamental"*. American corporate law

31. *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1154 (Del. 1989) (citation omitted).

32. See *supra* note 31 and accompanying text.

gives shareholders no right to approve or veto (at least directly) ordinary business decisions, but it does require shareholder ratification of "fundamental" corporate changes (e.g., mergers, sales of substantially all the corporation's assets, liquidations, charter amendments, etc.). Defensive tactics relate more to this latter side of the spectrum than to the former, and hence are arguably more subject to regulation through the bylaws.

2. *Affirmative Orders versus Negative Constraints.* The case law seems clearest in holding that a shareholder directive that the board take specified affirmative action is ineffective. Conversely, bylaw amendments requiring a shareholder vote to specified corporate action seem almost never to have been struck down. Thus, one possible line is that between (1) a prospective requirement that restricts future board or managerial action without shareholder approval and (2) a mandatory instruction to the board to take affirmative specified action (or to undo prior action). The former type of bylaw amendment (i.e., negative limitations) seems permissible, while the latter type (i.e., affirmative instructions) seems generally impermissible.

3. *Procedure versus Substance.* Bylaws necessarily codify and express the corporation's "housekeeping" and procedural rules, but rarely address specific substantive decisions. Thus, while a bylaw instructing the board to hire Mr. X as President seems of doubtful validity,³³ one requiring that specified steps be taken and specified notices be given before a contract over a specified amount be approved seems clearly valid. To this extent that restrictions on defensive tactics impose procedural restrictions (rather than absolute bars), they presumably stand on somewhat higher ground.

4. *Corporate Governance vs. Business Decisions.* Perhaps the safest and soundest distinction is between bylaws that affect the allocation of power between shareholders and directors prospectively (particularly with regard to a broad and generically defined class of cases) versus bylaws that address only a single business decision. As just noted, the status of a bylaw instructing the board to hire Mr. Jones as President seems very doubtful. But, few would doubt that a bylaw requirement that defined self-dealing transactions over a specified threshold (say, \$10,000,000) must be ratified by shareholders before becoming effective would be valid. Indeed nothing is stated more expressly in Section 109(b) of the Delaware General Corporation Law than that the bylaws can restrict the "rights or powers of its stockholders, directors, officers or employees."³⁴ Thus, requiring shareholder ratification of a future poison pill seems well within Section 109's scope, particularly to the

33. See, e.g., *Auer v. Dressel*, 118 N.E.2d 590 (N.Y. 1954).

34. See *supra* note 7 and accompanying text.

extent that Delaware decisions have also recognized that there is an element of self-dealing in defensive tactics.³⁵

To be sure, the *Fleming* court did not offer any of these distinctions in support of its ruling in its very brief opinion. Nor did it distinguish between the proposed bylaw's requirement that future pills be adopted only with shareholder approval (which seems permissible) and the bylaw's additional instruction that the existing pill be redeemed (which seems impermissible under the foregoing analysis). The latter instruction overrules a prior board decision, rather, than setting up a governance process for future decisions; in contrast, the former ratification requirement is prospective, procedural, and governance-oriented and thus seems consistent with the statutory role given bylaws under Delaware Gen. Corp. Law §109.

Under these interpretations, it should be possible for institutional investors to conduct proxy solicitations seeking to (1) to require that the effectiveness of any future poison pill be conditioned on shareholder approval within a specified period after the board's action, and (2) preclude any amendment, repeal, or waiver of an existing pill without such a vote. The latter provision restricting amendments or waivers could have special utility for institutional investors in several distinct settings. First, existing pills often have triggering levels at 20% of the outstanding stock, and a target board, once faced with the prospect of an actual bidder, may wish to lower that level to, say, 10%. A bylaw amendment restricting such a modification without a shareholder vote should be upheld under the foregoing analysis. Second, where there is both a friendly and a hostile suitor for the company, the board may wish to waive the pill for the first bidder, but not the second. This exact situation happened in the recent takeover battle for Conrail, as the Conrail board waived the pill vis-a-viz CSX, but not Norfolk Southern. Possibly, any such waiver could be conditioned on a shareholder vote. Or, more realistically, the bylaw amendment might be written to require that should the board waive the pill for one bidder (i.e., the "friendly" bidder), it must also waive the pill for all bidders (at least if they made a qualifying offer, as defined in the bylaw amendment). Effectively, this prohibition on selective waivers might ensure that shareholders would obtain a fair auction, undistorted by the board, once the pill was initially waived.

Of course, Delaware courts may see the law differently than the district court in *Fleming*. The poison pill is well understood in Delaware

35. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954-55 (Del. 1985) ("omnipresent specter" of an inherent conflict of interest overhangs defensive actions by management and the board).

to permit unilateral board action without a shareholder vote, and any attempt to use bylaw amendments to change this fundamental allocation of power between shareholders and directors touches on a sensitive nerve in Delaware, whereas shareholder advisory committees, being far less significant, do not. Bylaw amendments affecting the re-adoption or modification of a poison pill and requiring a shareholder vote for such a change to be effective thus face Delaware courts with a politically charged issue—precisely because their significance dwarfs other possible bylaw amendments. Nonetheless, the basic structure of Delaware law suggests that shareholders do have the right to restrict the board for the future (but not to require the repeal or modification of an existing pill).

III. CAN THE BOARD REPEAL A SHAREHOLDER ADOPTED BYLAW AMENDMENT?

If we assume that the corporation's certificate of incorporation delegated to the board the power to amend the bylaws, the board could seemingly respond to any shareholder adopted bylaw amendment with its own amendment purporting to repeal or amend the shareholder-passed bylaw. In most contexts, this tactic would invite shareholder outrage and would be unthinkable, but in the context of contested takeover battles, it is not only thinkable, but predictable. Faced with ouster, management has little to lose.

At first glance, the board has a strong argument in favor of its authority to repeal or modify a shareholder passed bylaw: the board's authority to amend comes from the certificate of incorporation and therefore arguably cannot be superseded by any bylaw (whether passed by the board of the shareholders), because a bylaw cannot conflict with the certificate of incorporation.³⁶ That is, although the shareholders can take action by a bylaw amendment, they cannot, by a bylaw amendment, cancel or limit their earlier delegation of power to the board in the certificate to amend the bylaws.

At least in Delaware, the other side of this debate begins with the express language of Section 109(a) that: "The fact that such power [to amend bylaws] has been so conferred upon the directors . . . shall not divest the shareholders . . . [of] the power, nor limit their power to adopt, amend or repeal bylaws."³⁷

36. See *Burr v. Burr Corp.*, 291 A.2d 409 (Del. Ch. 1972); *Centaur Partners, IV v. National Intergroup, Inc.*, 582 A.2d 923 (Del. 1990).

37. DEL. CODE ANN. tit. 8 § 109(a) (1991). This provision, adopted in 1974, appears to have been intended to refute the suggestion of one federal district court that the board could reject a shareholder proposed bylaw amendment and thereby disqualify it even from consideration at the

Arguably, shareholder power to amend the bylaws is frustrated if the directors can cancel such an amendment the next day. But does this quoted sentence express some implicit theory of inherent shareholder power over the bylaws that authorizes shareholders to adopt a bylaw that is beyond board repeal? One Delaware Chancery Court decision may hint at such a theory. In *American Int'l Rent-A-Car, Inc. v. Cross*,³⁸ the Chancery Court was faced with a fact pattern in which it appeared that shareholders at the annual stockholder meeting were about to reject an attempt to repeal a critical bylaw, when the chairman of the meeting temporarily adjourned the meeting. During the interval, the board met and itself repealed the bylaw. Although the Chancery Court refused to enjoin this conduct, it noted that, if the shareholders were dissatisfied, they could reinstate the bylaw and add a provision denying the board power to amend it.³⁹ Thus, the actual outcome of the case permitted the board to frustrate shareholder action, but in dicta the court concluded that shareholders had an effective remedy. Nonetheless, does this suggested remedy—namely, a shareholder prohibition on board modification of its bylaw—really work? A subsequent treatise has doubted it.⁴⁰ Other Delaware decisions have also permitted the board to frustrate shareholder action.⁴¹

Outside of Delaware, the power of shareholders to adopt a bylaw enforcement that the board may not modify or repeal is better established. Revised Model Business Corporation Act §10.20 expressly recognizes such a power to place a shareholder passed bylaw beyond board repeal.⁴² Some twenty-two states have provisions of similar effect in their corporate codes.⁴³ Thus, outside of Delaware, a bylaw amendment seems an effective technique for restricting the future use of the poison pill.

Even in Delaware, the uncertainty about whether the board may repeal a shareholder passed bylaw may have less significance than first appears. This is because, the board's power to repeal presents only an

shareholders' meeting. See *SEC v. Transamerica Corp.*, 67 F. Supp. 326 (D. Del. 1946), *modified*, 163 F.2d 511 (3d Cir. 1947), *cert. denied*, 332 U.S. 847 (1948); see also, DAVID A. DREXLER ET AL., *DELAWARE CORPORATION LAW AND PRACTICE*, § 9.02, at 9-3 (1996).

38. 1984 WL 8204 (Berger, V.C.).

39. *Id.* at *3 ("Alternatively, [the shareholders] could cause a special meeting of the stockholders to be held for the purpose of amending the bylaws and, as part of the amendment, they could remove from the Board the power to further amend the provision in question.").

40. See DAVID A. DREXLER ET AL., *DELAWARE CORPORATION LAW AND PRACTICE*, § 9.02, at 9-4 (1996) ("[T]his somewhat casually offered suggestion cannot fairly be read as a definitive holding that such stockholder's action would be more binding than the directors' subsequent repeal of the repeal.").

41. See *USACAFES v. Office*, 1985 WL 44685 (Del. Ch. 1985).

42. See REVISED MODEL BUS. CORP. ACT § 10.20(a)(2).

43. See *id.* § 10.20 cmt. at 283-84.

academic issue to the extent that shareholders can limit the practical exercise of that power with procedural limitations. That is, if shareholders can protect their bylaw amendment from board repeal or modification by specifying in the same bylaw how the board can amend it, the shareholders can gain the tactical upper hand. For example, shareholders could provide that such a bylaw amendment could only be accomplished on specified advance notice to the shareholders (say, 90 days) or on a single specified date (such as the date of the annual shareholders' meeting). Then, if a repeal were voted by the board, it could be quickly canceled on the same date at the shareholders' meeting. An early Delaware decision seems to uphold this procedure of limiting when the board can act.

More importantly, exactly this technique has been employed in the pending Rexene proxy solicitation that, as noted above, Mr. Wyser-Pratte and Spear, Leeds & Kellogg have undertaken. Their solicitation consists of two general proposals: (1) a "Director Removal Resolution", which would remove nine of the ten directors and fill four of the vacancies with their nominees, but which would permit the incumbent CEO to remain as a fifth and final director on a five person board, and (2) a "Bylaw Proposal," which would, among other things, preclude certain defensive actions, unless approved by shareholders. Specifically, the Bylaw Proposal would apply if Rexene received a fully financed, cash offer for 100% of its stock at a premium of at least 25% over its average market price during the preceding month. In the event that Rexene board received such a "fair" offer, then the board would be required to terminate all defensive measures against the offer "unless a favorable shareholder vote was obtained approving a board policy of resistance within ninety days after the offer was made."⁴⁴ As contemplated, this bylaw would require the board to redeem its poison pill if such a favorable shareholder vote were not obtained within ninety days after the offer was received. To prevent the repeal of this critical bylaw, an additional shareholder-passed bylaw would permit the board to amend these bylaws only under the following conditions: (i) the board-passed bylaw was adopted at a meeting of the board held in conjunction with the annual shareholder meeting, and (ii) the proposed board bylaw was not disapproved by the shareholders at the annual meeting.⁴⁵

Ingenuous as this approach is, does it work? Based on the analysis earlier advanced, it remains highly questionable whether the shareholders can mandate the redemption of the poison pill under Delaware law—

44. See Preliminary Solicitation Statement of Mr. Guy P. Wyser-Pratte and Spear Leeds & Kellogg, dated as of December 27, 1997, at p. 17.

45. *Id.* at 18.

even if they can in Oklahoma. However, they probably can prohibit the adoption of new defensive tactics if they are carefully defined, and they likely can delay or limit the board's ability to repeal their shareholder-passed bylaw to the circumstances specified in their bylaw.

IV. THE UNIONS' ROLE

It would be the equivalent of reviewing Hamlet without noting who played the Prince of Denmark to discuss the new proliferation of shareholder-proposed bylaw amendments without focusing on the pivotal role of labor unions in these contests. Not only did the Teamsters bring the *Fleming* case, but several other unions—among the Hotel Employees & Restaurant Employees International Union ("HERE") and the United Food and Commercial Workers Union ("UFCW")—have this year proposed a variety of bylaw amendments at other companies, which seek to redeem the poison pill, eliminate staggered boards, or establish confidential voting policies.⁴⁶

Some of these proposals have been advanced by unions, such as the Teamsters, that are substantial equity holders and have no discernable conflict of interest, but others have been proposed by unions (such as the UFCW) that hold only a token number of shares and view their activism as an extension of the collective-bargaining process.⁴⁷ Understandably, managements tend to regard at least the latter form of activism as simple harassment; in effect, the union is attacking the poison pill not to profit as a shareholder, but to create a nuisance value that will enable it to negotiate higher worker benefits or salaries. For example, HERE has proposed a mandatory bylaw amendment that would require Harrah's Entertainment Inc. to not adopt or maintain any poison pill.⁴⁸

A preferred tactic appears to be to rely not on Rule 14a-8, but instead to file an actual proxy solicitation covering the proposed bylaw

46. See Paul Sweeney, *Clash by Proxy: Organized Labor and Shareholder Activism*, ACROSS THE BOARD, May 1996, Vol. 33, No. 5, p.21; Vineeta Anand, *Funds Flexing Muscles Early in Proxy Battles*, PENSIONS & INVESTMENTS, Mar. 17, 1997, at p.20 (also discussing initiatives by the United Brotherhood of Carpenters and Joiners of America and the Union of Operating Engineers); Bernstein, *Sweeney's Blitz*, BUS. WK., Feb. 17, 1997, at p.56.

47. See Paul Sweeney, *supra*, note 46.

48. In late April 1997, HERE and Harrah's Entertainment issued conflicting reports as to whether this proposed bylaw had been approved by a majority of the outstanding shares at Harrah's annual shareholder meeting. Harrah's claimed that, to become effective, the bylaw had to be approved by holders of 75% of its outstanding shares and that the proposal had not even received the vote of a majority of the outstanding shares. See *Harrah's <Het. N> Says Union-Backed Proposed Fails*, REUTERS FIN. SERV., Apr. 25, 1997, available on LEXIS, News Library, Cumwvs File. Nonetheless, given that the proposal seems to have received a majority of the votes actually cast (if not of the outstanding shares), this is a remarkable showing for a low-cost proxy solicitation by a proponent with little equity ownership and low credibility to other shareholders. It suggests that better financed efforts by a significant shareholder might prevail.

amendment and then only solicit a limited number of shareholders in order to avoid unnecessary expense. One impact of this tactic may be to deny management the ability to exercise the discretionary voting authority conferred on it by earlier obtained proxies with regard to this issue, because it now knows there will be a contested vote at the annual meeting. Rule 14a-4(c)(1) generally denies management the ability to use the discretionary voting authority granted it by the standard proxy with respect to shareholder proposals as to which it has received adequate notice a reasonable time before the shareholders meeting.⁴⁹

Incensed by this approach, managements have been able to convince the SEC to read Rule 14a-4 narrowly, at least when the insurgent is not conducting an extensive proxy solicitation. A 1996 no-action letter, issued to the Idaho Power Company,⁵⁰ is read by some practitioners to authorize the issuer to utilize the discretionary voting authority granted it by the standard proxy, notwithstanding Rule 14a-4, so long as the insurgent's solicitation is limited and management publicly states how it intends to vote on the issue.

This seems, however, very much the wrong approach for the SEC to take. Essentially, it ignores the rights of the neutral shareholder caught between the two contending sides. Let us assume the proposed bylaw amendment will bar a future poison pill. The shareholder may wish to vote for this proposal, even if the soliciting union's purpose is to harass management, and it is little solace to this shareholder that management has publicly announced its opposition and intention to vote proxies given to it against the proposal (pursuant to the discretionary voting authority given it by the standard proxy card). If (as is likely) the insurgent union does not solicit public shareholders (but contents itself with a largely symbolic solicitation of institutional holders), the public shareholder faces Hobson's Choice: the shareholder can either grant a proxy to management (knowing that management will vote against this proposal) or refrain from voting. Clearly, attendance at the shareholder meeting in person in order to vote is too costly an alternative.

What should the SEC do? A broad exemption under Rule 14a-4, based simply on the rationale that the insurgent is not conducting an extensive proxy solicitation, may violate the intent underlying Rule 14a-4 and in any event ignores the vulnerable position of the public shareholder. The better course may be to create an exemption under Rule 14a-4 for proxy solicitations by a holder or holders who have only a *de*

49. See 17 C.F.R. § 240.14a-4(c)(1); *see also* *United Mine Workers of America v. The Pittston Company*, [1990] Fed. Sec. L. Rep. (CCH) ¶ 94, 946 (D.D.C. Nov. 24, 1989); *Larkin v. Baltimore Bancorp.*, 769 F. Supp. 919 (D. Md. 1991).

50. *See* *Idaho Power Company*, 1996 SEC No-Act LEXIS 352 (Mar. 13, 1996).

minimis share ownership (say, collectively, under 1%). This would preclude a union which owns only a few shares from harassing management with a bad faith solicitation. It would, however, allow a more substantial shareholder to conduct a low-cost targeted solicitation without permitting management to vote the shares of unwitting or unwilling shareholders against the proposal.

CONCLUSION

If one conclusion is safe, it is that this is an unstable and dynamic moment in corporate governance. In all likelihood, the current structure of the proxy rules (and in particular Rules 14a-4 and 14a-8) need to be rethought.⁵¹ The great danger, however, is that the appearance of a few harassing proxy solicitations by unions engaged in labor bargaining will provide the pretext for business groups to demand the dismantling of those proxy rules that protect the shareholder's right to franchise. The appearance of labor unions on the corporate governance playing fields is not by any means an ominous event, but it is a destabilizing one.

51. Under the National Securities Markets Improvement Act of 1995, the Commission must undertake a study of the shareholder proposal process, and in the interim the Commission appears to be deferring any short-term changes in policy. See "Commission Refuses to Consider Shareholder Proposal," *Insights*, Vol 11, Nov. 4, p.25 (April, 1997).