

## **Delaware Supreme Court Addresses the Validity of Stockholder Adopted Bylaws**

In *CA, Inc. v. AFSCME Employees Pension Plan*, No. 329, 2008 (Del. July 17, 2008) (en banc), the Delaware Supreme Court held that a stockholder bylaw requiring the corporation to reimburse the proxy expenses of a successful short-slate proxy contest violated Delaware law. The proposed bylaw would have required the corporation to reimburse the reasonable expenses of a stockholder group in running a short slate of director nominees for election, provided that at least one nominee on the short slate was elected to the board of directors. The SEC certified two questions to the Delaware Supreme Court: (1) Is the proposed bylaw a proper subject for action by shareholders as a matter of Delaware law? and (2) Would the proposed bylaw, if adopted, cause the corporation to violate any Delaware law to which it is subject?

The Court answered both questions in the affirmative, thus invalidating the proposed bylaw. The Court addressed the long-simmering debate about the permissible scope of shareholder adopted bylaws and the doctrinal tension in the statutory framework between DGCL Sections 141(a) and 109(b). Section 141(a) commands that the business and affairs of the corporation be managed by or under the direction of the board, except as otherwise provided in the DGCL or in its charter. Section 109 empowers the stockholders to amend the bylaws. The board may amend the bylaws only if empowered to do so by the charter.

Taking a measured, case-specific approach, the Court concluded that it was unable "to articulate with doctrinal exactitude a bright line that divides those bylaws that shareholders may unilaterally adopt under Section 109(b) from those which they may not under Section 141(a)."

Addressing the first certified question, the Court held the proposed bylaw is a proper subject for action by stockholders as a matter of Delaware law. In determining the validity of the proposed bylaw under the statutory framework, the Court focused on whether the proposed bylaw regulated a board process or was substantive in that it "mandates the decision itself." The Court determined that the proposed bylaw regulated a board process, despite requiring the

expenditure of corporate funds. Therefore, the Court concluded the proposed bylaw did not run afoul of the DGCL.

Despite its validity on statutory grounds, the proposed bylaw did not withstand scrutiny under the second certified question. The Court held that the proposed bylaw, as written, would violate common law because it impermissibly infringed on the board's fiduciary duties. Relying on precedents such as *Paramount Communications, Inc. v. QVC Network, Inc.*, 63 A.2d 34 (Del. 1994), and *Quickturn Design Systems, Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998), the Court reaffirmed that contractual provisions that limited a board's future exercise of fiduciary duty were invalid. That the provision here involved a stockholder adopted bylaw rather than a contract that the board had imposed upon itself did not change the result. Therefore, the bylaw failed because it did not "reserve to [the corporation's] directors their full power to exercise their fiduciary duty to decide whether or not it would be appropriate, in a specific case, to award reimbursement at all." The Court noted, however, that the proponents of the proposed bylaw, as written, could either seek to amend the CA certificate of incorporation to include the substance of the bylaw or seek recourse from the Delaware General Assembly.

The debate is already underway among practitioners as to who "won" -- directors or stockholders -- and what the decision might portend for the future. On the one hand, the decision reaffirms the primacy of the board in managing the business and affairs of the corporation and the importance of the directors' overarching fiduciary duties in weighing the validity of a statutorily authorized bylaw. From the standpoint of activist stockholders, they now know that bylaws addressing director elections are a proper subject for action. Although the proposed CA bylaw was rejected, look to creative counsel to begin to craft new proposals that will successfully navigate the fiduciary duty strictures analyzed in the opinion.

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