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DEFENDING AGAINST SHAREHOLDER PROXY ACCESS: DELAWARE'S FUTURE REVIEWING COMPANY DEFENSES IN THE ERA OF DODD-FRANK

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**DEFENDING AGAINST SHAREHOLDER PROXY ACCESS:
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*By: J.W. Verret**

ABSTRACT

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 has ensured that a shareholder's ability to place nominees to the board onto the corporate ballot, an objective long advocated by the institutional investor community, will soon be implemented by the Securities and Exchange Commission. Advocates of proxy access urge that it will help hold boards of directors accountable to their owners. Critics argue that it will give conflicted shareholders, like unions and state pensions, power they will use to facilitate their political objectives at the expense of ordinary shareholders. The shareholder primacy and director primacy theories of corporate law have framed an extensive debate in the literature. Regardless of which theory holds force, we can expect boards to implement defensive strategies in the wake of proxy access to limit shareholder power, in the same way that boards implemented defensive tactics in response to the hostile takeovers of the mid-1980s. Delaware's review of board proxy access defenses will shape its role in the foreseeable future in much the same way review of board takeover defenses shaped its role over the last 20 years.

This article in part considers what strategies may be useful for boards defending against proxy access and designs novel methods boards might consider. It also examines how Delaware judges are likely to review those defenses under a vast body of jurisprudence protecting the shareholder franchise, also known as the Blasius line of cases. Though the Blasius cases protect the shareholder franchise, they do not necessarily prohibit board policies, bylaws, or charter amendments with an incidental effect on the shareholder's federal nomination right. Finally, this article considers whether the defenses considered are likely to be struck down as pre-empted by federal law or prohibited by the federal securities laws or stock exchange listing requirements. The article offers a roadmap for how boards are likely to respond to proxy access and how Delaware's role as arbiter of the shareholder/manager relationship is likely to evolve in the new environment.

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I. INTRODUCTION

In light of the increasing incidence of takeover bids in recent years, counsel to publicly held corporations should carefully weigh the degree of takeover protection which may be afforded by defensive charter and bylaw provisions.

- Stephen A. Hochman & Oscar D. Folger, *The Business Lawyer*, 1978¹

One of the oldest debates in corporate law concerns the role that shareholders play in relation to managers of the companies in which they own shares. Advocates of increasing shareholder power have long urged that shareholders suffer from a collective action problem, limiting the effectiveness of their oversight. Berle and Means, whose work forms the foundation of much corporate law scholarship today, argued in the Roosevelt era that the “separation of ownership from control” in the modern large corporation justified extending the reach of federal regulation of companies.²

The latest iteration of that debate has been whether to let shareholders nominate candidates onto the management proxy card, also known as “proxy access.” The Securities and Exchange Commission (“SEC” or “the Commission”) considered rules to grant shareholders access to the corporate proxy in 2003 and 2006, but ultimately voted not to implement either proposal. The SEC also considered a third rule in 2009, but delayed a final vote on the rule out of concern that the Commission may not have the legal authority to implement such a change. The question was finally resolved in the summer of 2010, when the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act” or “the Act”) specifically recognized the SEC’s authority to require publicly traded companies to include shareholder nominees on the corporate proxy.

¹ Stephen A. Hochman and Oscar D. Folger, *Deflecting Takeovers: Charter and Bylaw Techniques*, 34 *BUS. LAW.* 537 (1978-79).

² ADOLF BERLE & GARDINER MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

Proponents of shareholder empowerment argue that proxy access will make it easier for shareholders to take an active role in monitoring managers and the incumbent board by the threat of replacement. They urge that the relative dearth of contested elections in publicly traded firms proves that the current system is broken. They also argue that the proper source of rules in this area is the federal government, and that pre-emption of state corporate law in this area is justified.

Critics of proxy access argue that the current system is optimal, and that shareholders remain free to sell their shares if they are dissatisfied with management performance. Critics further warn that the shareholders most likely to make use of proxy access are institutional investors, like unions and state pension funds, who will use their power toward political goals that conflict with maximizing long-term shareholder wealth. They also highlight the relative lack of empirical evidence showing that corporate governance reforms like this one result in any share value appreciation, and indeed they show some studies indicating just the opposite.

With this new development of shareholder access to the company proxy, we can expect boards of directors to develop new defensive tactics to shareholder challenges. If the hostile takeover period of the mid-1980s is any indication, corporate lawyers will innovate to meet a demand for defensive measures. As a result, Delaware corporation law will need to innovate as well to review the new defensive measures. The object of this article will be to consider, and in part to design, novel methods that boards might utilize to defend against a proxy nomination by an insurgent shareholder. It will also consider how those defenses are likely to be reviewed in the Delaware courts, and whether and to what extent expected defenses might be struck down by federal courts, the exchanges, or the SEC.

II. THE DEBATE OVER SHAREHOLDER ACCESS TO THE CORPORATE PROXY

This section will examine the academic debate over whether shareholders should be permitted to place nominees onto the proxy card financed by the corporation, also known as “proxy access.” In doing so, it will consider the debate over empowering shareholders more generally, both from the perspective of economic theory and through an analysis of the empirical evidence of whether shareholder empowerment adds value to publicly traded firms. It will also consider the proxy access regime that the SEC is expected to implement, based on its most recently circulated rules proposal.

A. *A History of the Theoretical Debate over Shareholder Empowerment*

The leading critique of the current voting system comes from Lucian Bebchuk, who argues that the current system, in which incumbents are financed by the company and insurgents are not, results in higher agency costs and challenges the legitimacy of the deferential approach of the business judgment rule.³ In support of his thesis that annual elections are a largely empty exercise, Bebchuk notes that during the period from 1996-2005 there were only 8 contested elections with rival slates among companies with a market capitalization of over \$200 million.⁴ Bebchuk argues that part of the reason for this odd result is the required cost of filing proxy statements, risk of legal liability, and solicitation costs.⁵ Further, he argues that shareholders

³ See Lucian Arye Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 676 (2007) [hereinafter *Bebchuk Myth*]. In support of his thesis that annual elections are a largely empty exercise, Bebchuk notes that during the period from 1996-2005 there were only 8 contested elections with rival slates among companies with a market capitalization of over 200 million. *Id.* at 687.

⁴ *Bebchuk Myth* at 687.

⁵ *Bebchuk Myth*, *supra* note 3, at 689.

suffer from a free rider problem, or that challengers may not fully internalize the benefits of a successful fight sufficient to justify the costs involved. Finally, he notes that incumbents get their costs paid by the company, but insurgents will only be reimbursed if they win.⁶ He also explains that staggered boards prevent a challenger from taking a majority of seats without waiting until two successful elections have passed.⁷

Stephen Bainbridge offers what has become the leading criticism of Bebchuk's view. Bainbridge considers the board of directors to be a guardian for the nexus of contracts that make up the corporation. In effect, his theory accepts shareholder wealth maximization as the ultimate driving goal, but his theory justifies placing the responsibility for managerial oversight with the managers of the company.⁸ He builds on literature explaining the existence and function of firms to show that the command and control function of firms is a vital solution to collective action constraints facing shareholders.⁹

He argues that a combination of fiduciary duty law and equity-based compensation is sufficient to link the interests of board members to shareholder wealth without a need to give shareholders additional powers to control directors.¹⁰ He contends that Alcian and Demsetz's view, that placing monitoring authority in the hands of shareholders is justified as they are the residual claimants of the firm, breaks down because of shareholder collective action problems.¹¹

In part Bainbridge offers his argument as justification for the status quo, and in part he observes

⁶ *Id.* at 690. He also notes that staggered boards prevent a challenger from taking a majority of seats without waiting until two successful elections have passed. *Id.* at 694.

⁷ Bebchuk Myth at 694.

⁸ See Stephen Bainbridge, *Director Primacy, the Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 551 (Winter 2003) [hereinafter Bainbridge Director Primacy]. He builds on literature explaining the existence and function of firms to show that the command and control function of firms is a vital solution to collective action constraints facing shareholders. *Id.* at 558.

⁹ Bainbridge Director Primacy at 558.

¹⁰ Bainbridge Director Primacy, *supra* note 8, at 563, 568-74.

¹¹ Bainbridge Director Primacy at 568.

that his theory more appropriately explains the current system of corporate governance.¹²

Bainbridge also supports the idea that most of the parties to contracts with the firm, including shareholders, can withhold their capital as a mechanism for protecting their interest.¹³ Bainbridge's critique is both about the system that is most efficient and a legalistic argument that shareholders do not actually own the corporation.¹⁴ He points out that in other countries in which employee representatives share governance responsibilities with managers, those employee groups have a difficult time maintaining the confidentiality of corporate proprietary information.¹⁵ He also notes that employee representative groups may have an incentive to allow managers to shirk as part of a mutual bargain.¹⁶

Lipton and Rosenblum question whether institutional investors have the resources or expertise to monitor managerial decisions.¹⁷ Lipton and Rosenblum also note that they may have conflicted interests that do not comport with the need to maximize firm value, such as the political interests of state pension funds managed by elected officials or the interests of union pension funds in maximizing employment for their current or future union members.¹⁸ They further argue that the presence of an insurgent director could hinder the cohesiveness and mutual trust of a board of directors, a result they argue will harm the board's ability to serve as advisors

¹² Bainbridge Director Primacy at 570-574.

¹³ Bainbridge Director Primacy, *supra* note 8, at 591.

¹⁴ Stephen Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 604 (Feb. 2006) [hereinafter Bainbridge *The Case for Limited*].

¹⁵ Bainbridge *The Case for Limited*, *supra* note 14, at 609. He also notes that employee representative groups may have an incentive to allow managers to shirk as part of a mutual bargain. *Id.* at 611.

¹⁶ Bainbridge *The Case for Limited* at 611.

¹⁷ See Martin Lipton and Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67, 78 (2003) [hereinafter Lipton and Rosenblum]. Lipton and Rosenblum also note that they may have conflicted interests that do not comport with the need to maximize firm value, such as the political interests of state pension funds managed by elected officials or the interests of Union Pension Funds in maximizing employment for their current or future union members. *Id.*

¹⁸ Lipton and Rosenblum at 78.

to firm management.¹⁹ Macey notes that one of the difficulties with a proxy access regime will be the difficulty in recruiting competent candidates.²⁰

Anabtawi focuses her critique of increasing shareholder power on the conflicts between shareholders.²¹ She catalogues the costs that would result from empowering a group of shareholders seeking to advance their own private interests at the expense of the shareholder collective, including the distortionary effects on managerial decision-making and the costs of influencing managers.²² Romano also lists some of the conflicts facing state and union pensions, including the pressure to maximize in-state employment and push for “socially responsible policies.”²³

One of the costs to proxy access that Grundfest identifies is something he terms “megaphone externalities,” which he uses to refer to a union or public pension funds ability to use the corporate election as a way to raise the profile of an issue even though the shareholder knows it will not be successful. Grundfest cites as an example a confrontation between CalPERS and Safeway CEO Steve Burd as an example of shareholders using the corporate ballot as a vehicle for political objectives unrelated to the value of the company at issue.²⁴ This could be of

¹⁹ Lipton and Rosenblum, *supra* note 18, at 80. See also Jonathan Macey, *Too Many Notes and Not Enough Votes*, 93 VA. L. REV. 759, 766 (2007). Macey notes that one of the difficulties with a proxy access regime will be the difficulty in recruiting competent candidates.

²⁰ Jonathan Macey, *Too Many Notes and Not Enough Votes*, 93 VA. L. REV. 759, 766 (.2007)

²¹ Iman Anabtawi, *Some Skepticism about Increasing Shareholder Power*, 53 UCLA L. REV. 561, 564 (Feb. 2006) [hereinafter Anabtawi].

²² *Id.* Anabtawi at 575. Anabtawi catalogues five central conflicts of interest between shareholders. One conflict she identifies is between shareholders with short term and those with long-term horizons.²² A second conflict is between highly diversified institutional shareholders with high risk preferences and concern for external effects of firm decisions vs. less diversified shareholders with a greater concern about risk but less concern about externalities.²² A third conflict she notes is between economic shareholders and those consisting of pension funds of unions and state governments. See *id.* at 585-89. See also, Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 796 (1993) [hereinafter Roberta Romano] (listing some of the conflicts facing state and union pensions, including the pressure to maximize in-state employment and push for “socially responsible policies.”).

²³ Roberta Romano, *Pension Fund Activism in Corporate Governance Reconsidered* 93 COLUM. L. REV. 795, 796 (.1993)

²⁴ See Joseph A. Grundfest, *The SEC’s Proposed Proxy Access Rules: Politics, Economics, And the Law*, 65 BUS. LAW. 361, 382 (2010) [hereinafter Grundfest]; see also Gina Chon, *Calpers Aims Director List at Increasing Board*

particular concern in light of the fact that CalPERS, the nation's most active state pension fund, is reported to have built a database of board candidates from which it can quickly draw in anticipation of its new powers under proxy access.²⁵

Vice Chancellor Strine of Delaware has also argued that the principal-agency problems between beneficiaries of managed capital (e.g., pension funds) and the managers of those institutions are significantly underdeveloped in the corporate law literature.²⁶ He terms this problem the “separation of ownership from ownership.”²⁷ This is part of his reason for advocating in favor of allowing shareholders to adopt bylaws which provide for proxy access, but in a flexible way that allows each company and each group of shareholders to design their own methods. The notion of using shareholder adopted bylaws to facilitate shareholder access to the corporate ballot in a flexible approach that took into account the particular needs of individual companies was the result of comments from Vice Chancellors Strine and Lamb at various corporate law symposia.²⁸ The SEC ultimately decided to abandon that approach in its latest rulemaking, but if the options considered in this article are permitted to stand, and if those defenses are effective, it might mean that shareholders and boards could still have the motive and opportunity to use bylaws to arrive at alternative means for shareholder access to the proxy outside of the federally mandated approach.²⁹

Thomas notes that institutional shareholders seem to largely rely on intermediaries like

Sway, Wall St. J., June 18, 2010, available at <http://online.wsj.com/article/SB10001424052748703513604575310944269110772.html> (indicating that this could be of particular concern in light of the fact that Calpers, the nation's most active state pension fund, is reported to have built a database of board candidates from which it can quickly draw in anticipation of its new powers under proxy access).

²⁵ Gina Chon, Calpers Aims Director List at Increasing Board Sway, WSJ, June 18, 2010, available at <http://online.wsj.com/article/SB10001424052748703513604575310944269110772.html>

²⁶ See Leo E. Strine Jr., *Breaking the Corporate Governance Logjam In Washington: Some Constructive Thoughts on A Responsible Path Forward*, 63 BUS. LAW. 1079, 1082 (2008).

²⁷ *Id.*

²⁸ Strine, *Logjam* at 1087.

²⁹ Facilitating Shareholder Director Nominations, Exchange Act Release No. 34-60089, 74 Fed. Reg. 29024 (proposed June 18, 2009) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249 & 274).

Riskmetrics to develop their voting policies, and that since Riskmetrics will be judged based on returns to the institutional clients we could expect that the policies would comport with maximizing the value of the shares.³⁰ And yet the conflicts may remain, since Riskmetrics fees are not performance sensitive and Riskmetrics and intermediary proxy advisors like it could be expected to fulfill the incentives facing the managers of their institutional clients. Schwab and Thomas argue that union pension funds will be unable to form coalitions with non-union shareholders to obtain majority support for privately motivated shareholder activity.³¹ Anabtawi counters that coalitions can in fact form through logrolling, and she also notes that private arrangements between managers and shareholders can obviate the need for a majority vote.³²

When we view these conflicts through the lens of Mark Roe's theory for the development of the financial regulatory state, we may consider the potential for conflicted institutional shareholders and entrenched managers to actually collude at the expense of more diversified retail shareholders as a result of new powers for conflicted institutional investors in accessing the corporate proxy.³³ This could be used to justify pre-commitment strategies whereby the board ties its own hands to limit the reach of future action it may not want to take. In this case, however, through limiting the ability or desire for conflicted shareholders to access the corporate ballot as reviewed in this article.³⁴

Bebchuk, on the other hand, replies to this special interest argument by reminding us that

³⁰ Randall Thomas, *Public Pension Funds as Shareholder Activists: A Comment on Choi and Fisch*, 61 VAND. L. REV. EN BANC 1, 4 (2008) (responding to Stephen J. Choi & Jill E. Fisch, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance*, 61 VAND. L. REV. 315 (2008)).

³¹ Schwab and Thomas argue that union pension funds will be unable to form coalitions with non-union shareholders to obtain majority support for privately motivated shareholder activity. See Stewart J. Schwab and Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism By Labor Unions*, 96 MICH. L. REV. 1018, 1082 (1998); but see. Anabtawi, *supra* note 21, at 594 (noting that coalitions can in fact form through logrolling, and she also notes that private arrangements between managers and shareholders can obviate the need for a majority vote).

³² Anabtawi at 594.

³³ See MARK ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE (2003).

³⁴ For more on pre-commitment strategies in other contexts, see Stephen Bainbridge, *Dead Hand and No Hand Pills: Precommitment Strategies in Corporate Law*, 29 J. CORP. L. 1, 2 (Fall 2003).

nominated candidates will still need to obtain a majority vote, and many shareholders do not vote out of rational apathy. Even further, the collusion that board access may generate could be unverifiable at the time shareholders vote. For example, special interests may gain the ability to present an alternative slate for seemingly legitimate reasons but also agree to withdraw the challenge in exchange for a side payment.

Stout and Anabtawi argue that one response to the conflicts of powerful shareholders would be to expand the application of fiduciary duties to shareholders.³⁵ This would also require expanding the notion of control, which is the hook onto which corporate law could place fiduciary duties for shareholders.³⁶ Their approach would require an outcome determinative test for control, requiring the court to look into whether a particular shareholder was the “but for” cause of the corporations action.³⁷ But the realities of board process, in which members can negotiate off the record and board members elected under proxy access will not represent a majority of board members, will make realistic application of fiduciary duties in this specific context entirely unworkable. Where the board and managers privately negotiate an issue that alters a decision falling squarely within the business judgment rule, a shareholder challenge would be nearly impossible.

B. *The Dodd-Frank Act, a Victory for Proxy Access Proponents*

Giving shareholders the ability to place nominees onto the corporate ballot, or proxy access, has been the subject of numerous rules proposals from the SEC, but until now the

³⁵ Iman Anabtawi and Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255 (2008).

³⁶ *Id.* at 1296. Their approach would require an outcome determinative test for control, requiring the court to look into whether a particular shareholder was the “but for” cause of the corporations action. *Id.* at 1295.

³⁷ Anabtawi and Stout at 1295.

Commission was not able to pass a rule.³⁸ This delay was in part because the Commission's authority to issue rules permitting shareholders to access the corporate proxy was uncertain.³⁹

With passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the debate over whether the SEC has the authority to issue rules permitting access to the corporate proxy is over. The Dodd-Frank Act gives the SEC the express authority to issue rules requiring boards to give shareholders access to the corporate proxy. The SEC's latest rule proposal would permit shareholders to nominate candidates to the corporate ballot in certain circumstances and subject to certain limitations.⁴⁰

This new turn is a bit ironic, as Manne has argued that one of the consequences of limiting the influence of intermediary brokers and making the vote simulate a real meeting under the Securities Exchange Act of 1934 was to make voting more expensive and actually limit notions of shareholder democracy.⁴¹

A new line of argument in the debate has focused on whether proxy access should be adopted as a default rule from which shareholders are able to opt-out.⁴² The Dodd-Frank Act does not specifically address the question of whether shareholders can pass bylaws opting-out of the federal proxy access regime, and the SEC's proxy access proposal prior to passage of the Act does not include an option for firms or their shareholders to opt-out of proxy access. Even

³⁸ Some of the more detailed features of existing SEC regulation over the proxy process include extensive disclosure requirements, allowing shareholders to mix candidates together to make voting a minority slate easier, and requiring a separate proxy vote on each matter considered. Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 614 (2003) (citing 17 C.F.R. §240.14a-4(b)(2)) [hereinafter Mark Roe Competition].

³⁹ The delay was in part because the Commission's authority to issue rules permitting shareholders to access the corporate proxy was uncertain. See Jodie A. Kirshner, *What Rough Beast . . . Slouches Towards Bethlehem: Business Roundtable v. SEC and the SEC's Delegated Rulemaking Authority*, 25 ANN. REV. BANKING & FIN. L. 497.

⁴⁰ Facilitating Shareholder Director Nominations, Exchange Act Release No. 34-60089, 74 Fed. Reg. 29024 (proposed June 18, 2009) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249 & 274). This new turn is a bit ironic, as Manne has argued that one of the consequences of the 34 Act's approach to voting reform limiting the influence of intermediary brokers and making the vote simulate a real meeting was to make voting more expensive. See Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 115 (1965).

⁴¹ Manne at 115.

⁴² Lucian Bebchuk and Scott Hirst, *Private Ordering and the Proxy Access Debate*, 65 BUS. LAW. 329, 332 (2010).

Bebchuk, the leading proponent of proxy access, argues in favor of allowing shareholders to opt-out of a proxy access regime.⁴³

Grundfest also argues that, even if proxy access is a good idea, it should be structured in a way that permits shareholders to opt-in to a proxy access regime fashioned in a way that takes into account the particular circumstances of the company at issue.⁴⁴ Despite the fact that the SEC's rule does not expressly permit firms to opt-out, nor is it structured as an opt-in rule, the existence of other avenues through which Boards might frustrate shareholders seeking to nominate candidates, or make that process more costly, as this article will present and analyze could still at least allow boards and shareholders to effectively opt-out.⁴⁵

It may seem that, once the SEC has crafted its rule on this topic, the debates over whether shareholders should have proxy access and how that rule should be adopted would be completed. This article will show that such an early celebration for advocates of proxy access would be misguided, and that the variety of defenses available to boards may permit them to indirectly opt-out of proxy access regardless of any direct authority under an SEC rule to do so.

C. *The Costs and Benefits of Proxy Access*

Going beyond the theoretical evidence about shareholders and boards within the theory of the firm literature, the empirical evidence in this area is both scarce and mixed. Much of it considers incidences of self-financed proxy fights for corporate control, with very little considering whether access to the corporate proxy to nominate a minority slate will have much effect. Some evidence points in favor of benefits to successful contested solicitations in the

⁴³ Bebchuk Myth, *supra* note 3, at 710.

⁴⁴ Grundfest, *supra* note 27, at 362.

⁴⁵ *Id.* at 379.

broad sense.⁴⁶ Indeed, much of Bebchuk's justification for proxy access focuses on the cost of entrenchment from anti-takeover provisions,⁴⁷ but if minority slate elections actually encourage collusion between large institutional shareholders and managers, then proxy access may actually have the effect of increasing entrenchment costs.

In addition to the actual costs at particular companies, Hutchison and Alley describe a second order cost in that as the entire system of America corporate governance transitions to a less board-centric approach, that transition will itself require an unraveling of other related corporate governance systems resulting in added cost.⁴⁸

Grundfest recently undertook the task of determining whether proxy access will directly result in appreciation of shareholder value. He cites two studies on this topic. One by Larcker, Ormazabal, and Taylor noted evidence that markets reacted negatively to announcements about proxy access regulation, and that in particular firms with institutional investors holding more than 1% of outstanding shares displayed larger than average negative price returns.⁴⁹ He also cites another stock price event study finding that key event dates in proxy access regulatory process also correlated with negative stock price effects.⁵⁰

A report from Buckberg and Macey also argues that the proxy access reforms are not

⁴⁶ See Bebchuk Myth, *supra* note 3, at n. 68 (citing Lisa F. Borstadt & Thomas J. Zwirlein, *The Efficient Monitoring Role of Proxy Contests: An Empirical Analysis of Post-Contest Control Changes and Firm Performance*, 21 FIN. MGMT. 22 (1992); Harry DeAngelo & Linda DeAngelo, *Proxy Contests and the Governance of Publicly Held Corporations*, 23 J. FIN. ECON. 29, 30 (1989); Peter Dodd & Jerold B. Warner, *On Corporate Governance: A Study of Proxy Contests*, 11 J. FIN. ECON. 401, 402 (1983); David Ikenberry & Josef Lakonishok, *Corporate Governance through the Proxy Contest: Evidence and Implications*, 66 J. BUS. 405, 432-33 (1993); J. Harold Mulherin & Annette B. Poulsen, *Proxy Contests and Corporate Change: Implications for Shareholder Wealth*, 47 J. FIN. ECON. 279, 280 (1998)).

⁴⁷ See Bebchuk Myth, *supra* note 3, at 713.

⁴⁸ Harry G. Hutchison and R. Sean Alley, *The High Costs of Shareholder Participation*, 11 U. PA. J. BUS. L. 941, 959 (Summer 2009).

⁴⁹ See Joseph A. Grundfest, *Measurement Issues in the Proxy Access Debate 2*, n.11 (Stanford Rock Center for Corporate Governance Working Paper) available at, <http://ssrn.com/abstract=1538630> (citations omitted) [hereinafter Grundfest, *Measurement Issues*].

⁵⁰ See *id.* at 3, n.17 (citing Ali C. Akyol, Wei Fen Lim and Patrick Verwijmeren, *Shareholders in the Boardroom: Wealth Effects of the SEC's Rule to Facilitate Director Nominations* (Department of Finance, University of Melbourne, Dec. 14, 2009), available at <http://ssrn.com/abstract=1526081>).

only unnecessary but also prohibitively costly.⁵¹ Among the arguments against proxy access they make are that (i) empirical evidence supports the notion that financial markets already sufficiently impose costs on underperforming managers, (ii) boards oust managers convicted of wrongdoing almost without exception, (iii) the low frequency of contested elections suggests that they are not actually valued, (iv) shareholders can afford to do their own contested solicitations, with the media cost currently being around \$150,000, (v) hedge funds are already running alternative slates, (vi) it will undermine the competitiveness of American capital markets, and (vii) the proposal will inhibit a company's ability to access capital.⁵² In measuring the costs of contested solicitations, they cite to event studies demonstrating negative abnormal returns up to two years after the election of a dissident director.⁵³

This section has considered a very old and far reaching debate over the benefits and costs to proxy access. This paper does not purport to offer a definitive answer to whether shareholder access to the corporate ballot is beneficial for corporate value. The analysis will, however, link with the next two sections to help us understand the types of "compelling interests" that Delaware will be willing to accept as legitimizing the board defenses explored in this article. It will also offer insight to how Delaware is likely to respond and how debates over corporate federalism will experience dynamic shifts.

III. PROXY FIGHT DEFENSES

⁵¹ NERA Economic Consulting, Report on Effects of Proposed SEC Rule 14a-11 on Efficiency, Competitiveness and Capital Formation (Aug. 17, 2009), *available at* http://www.nera.com/upload/Buckberg_Macey_Report_FINAL.pdf.

⁵² *Id.* at 1-7, 21-22. Buckberg and Macey also cite to evidence indicating that the AFL-CIO, for instance, consistently votes in favor of incumbents at firms in which it does not represent workers more often than at firms in which it does not. *Id.* at 12. They also report that at the large-cap firms for which nominating shareholders will need a mere 1% interest to nominate, the median company had 10 1% shareholders who would be able to take advantage of proxy access. *Id.* at 13.

⁵³ *Id.* at 10.

This section will unveil and examine a number of methods that boards of directors might employ to defend against contested solicitations, particularly those in which a shareholder places nominees onto the company proxy pursuant to their new authority arising from the Dodd-Frank Act.⁵⁴ With the exception of proxy puts, all of these methods are novel, at least in the context of being used to defend against shareholder proxy access.⁵⁵ As such, there remains some level risk, depending on the defense, in whether they would be upheld. While legality will be discussed in later sections, the analysis here will focus on the strategic value of these mechanisms to a board seeking to subvert a minority slate nominated onto the corporate proxy. Although boards may consider additional methods for defending against proxy-accessed solicitations, the defense mechanisms presented here will at the very least spark debate and provide a framework for analyzing how Delaware courts, federal courts, the SEC, and the exchanges will respond to defensive tactics taken by boards.⁵⁶

⁵⁴ Even before this new development in shareholder voting power, boards of directors employed a variety of defensive tactics to limit or hinder shareholder challenges to board incumbents through consent solicitations. These included, for example, strategic maneuvers in (i) setting the record date for stockholders entitled to act by written consent, (ii) establishing a deadline for delivery of those consents, (iii) soliciting revocations of those consents, (iv) investing corporate resources in campaigning for contested solicitation, and (v) appointing an inspector of the election. Eric S. Robinson, *Defensive Tactics in Consent Solicitations*, 51 BUS. LAW. 677, 678 (1996). Boards would also put in place structural defenses, such as staggering the terms of directors or requiring advance notification of a contested solicitation. Robert B. Thompson, *Corporate Voting*, 62 VAND. L. REV. 129, 139 (2009). In many ways, the poison pill also serves a dual function as a defense to contested solicitations, in addition to its function of preventing hostile tender offers, because it discourages challengers from amassing a sufficient stake to make a contested solicitation worth the investment of time and resources unless the shareholder envisions a follow-on tender offer.

⁵⁵ With the exception of proxy puts, designed by Arlen and Talley, all other defenses introduced in this article were developed by the author. See Jennifer Arlen and Eric Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, 152 U. PA. L. REV. 577, 583 (2003) [hereinafter Arlen and Talley].

⁵⁶ Some of the defenses considered in this section will involve implementation through changes to a corporation's bylaws. Much of the scholarship regarding bylaws has considered the extent to which shareholders can adopt bylaws to limit the authority of the board. See Lawrence A. Hamermesh, *Corporate Democracy and Stockholder Adopted Bylaws*, 73 TUL. L. REV. 409 (1998); see also John C. Coates and Bradley Faris, *Second-Generation Shareholder Bylaws: Post-Quickturn Alternatives*, 56 BUS. LAW. 1323 (2001) [hereinafter Coates and Faris]; and Brett H. McDonnell, *Shareholder Bylaws, Shareholder Nominations, and Poison Pills*, 3 BERKELEY BUS. L.J. 205, 205 (Dec. 2005).

A. *Defenses Related to the Characteristics of the Board*

1. Director Qualification Bylaws

The Delaware General Corporation Law (“DGCL”) gives the board of directors the authority to adopt bylaws specifying the qualifications required to serve on the board. Boards often include as one qualification that board members must own stock in the corporation. This is intended to align the interests of board members with the other shareholders in the company. We might expect then that other qualifications designed to ensure that board members’ interests are aligned with the other shareholders would survive challenge.

Director qualification bylaws requiring directors to take specific action would likely not survive scrutiny.⁵⁷ However, qualification requirements that would seem to be permitted by the Delaware courts include variables like length of experience, type of experience by industry, type of experience by institution, type of experience by level of authority, professional degrees or certifications, educational background, and conflict limitations. For instance, it could require an MBA, a CFA, and 20 years of experience at the senior executive level of a comparable

Little has been said, however, about the ability of the board to adopt bylaws limiting the authority of shareholders, or in particular the ability of shareholders to adopt bylaws or charter amendments limiting the authority of other shareholders. Some of the analysis, particularly with respect to defenses implemented in ways that shareholders could subsequently change by adopting bylaws of their own, will depend in part on whether the company allows shareholders to act by written consent. Coates and Faris report that roughly a quarter of Delaware corporations still permit action by written consent.⁵⁶ Coates and Faris, *supra* note 69, at 1336.

This article will set aside concerns particular to action by written consent, except for the general observation that action by written consent can have dynamic effects when used in conjunction with shareholder access to the corporate proxy, and as such boards may be expected to try and limit shareholder’s ability to act by written consent as a result of proxy access. For example, shareholders who can act by written consent could adopt bylaws requiring unanimous board approval to implement poison pills. As such, if shareholders can place a minority of directors on the board through using the corporation’s proxy, that minority of directors could then obtain significant power as their vote would be necessary for the board to implement a poison pill.

⁵⁷ Lawrence A. Hamermesh, *Corporate Democracy and Stockholder Adopted Bylaws*, 73 TUL. L. REV. 409, 483 (1998).

institution. One way to write such a qualification restriction would be to give the board discretion to interpret the qualifications. The board would maintain the authority to resolve, on a case-by-case basis, any ambiguity in the qualifications. As we will see through an examination of the relevant case law, as long as the board is able to establish that the principal motivation for the qualification provision is not to impede exercise of the franchise then it will only need to establish a rational basis for the qualifications.

2. Director Resignation Policies

In order to facilitate majority voting, the Delaware corporate code was amended to permit directors to submit advance resignations contingent on future events. DGCL 141(b) reads that “A resignation is effective when the resignation is delivered unless the resignation specifies a later effective date or an effective date determined upon the happening of an event or events.” DGCL 141(b) further notes that “A resignation which is conditioned upon the director failing to receive a specified vote for reelection as a director may provide that it is irrevocable.”

One way to implement a defensive measure would be for the incumbent directors to submit to the corporation non-rescindable resignations contingent on the election of a nominee who was not approved by the nominating committee of the board of directors. In order to meet the express authorizing language of DGCL 141(b), the irrevocable resignation could be contingent on a director who failed to receive a unanimous vote in any election in which any director not approved by the nominating committee of the board also won election. This would protect the irrevocable resignation within the express authorizing language of the DGCL provision.

This would be a particular strong provision to be sure; a failure to maintain a working quorum of the board could result in failure to meet debt default provisions, stock exchange listing requirements, ability to certify required SEC filings, and a variety of other disastrous consequences. And it is precisely the prospect of such dire results that gives this scorched-earth defensive tactic its strategic relevance. Because it would mean that the contested solicitation could literally destroy the corporation, it would quell the shareholder electorate's appetite for such a result. Further, it would be one of the more difficult provisions to challenge, as even a court of equity would not be able to compel the board of directors to rescind their resignations.

3. Permanently Appointed Directors

Another, more theoretical, possibility to defend against proxy nominations involves a minority of permanently appointed directors who did not run for annual election, but were instead voted in by the other members of the board of directors. This defensive mechanism would likely require significant amendment to the DGCL. Their seats wouldn't be subject to nomination, because they are instead appointed by majority vote of the other voted directors. But the elected positions on the board would then become smaller in number, such that the SEC's current proxy access rule restriction on only nominating a certain percentage of seats up for election would hinder the actual number of nominations. The DGCL permits the board to appoint directors to replace voted directors, so it wouldn't be such a stretch to have permanently appointed directors.⁵⁸

Though this defense is not obviously illegal, recent case law explored in the next section indicates that it may be viewed with hostility by Delaware courts. It could be supported by the

⁵⁸ This option would likely governed by DGCL 223.

policy argument that the policy behind independence requirements under Delaware law could be subverted by conflicted shareholders.

4. Delegation to Board Committees

Another defense might include making greater use of subcommittees to take various board actions. This measure would be less on the order of a defense, and more of a way to minimize the impact of the insurgent directors. Delaware law permits the full board of directors to delegate decisions to subcommittees of the board.⁵⁹ The company bylaws will typically outline the powers granted to particular subcommittees of the board, and subcommittees can be given broad powers to act on behalf of the full board.⁶⁰ If a board felt that the presence of an insurgent director at an annual meeting presented a risk to the cohesiveness of the board, it could adopt a bylaw empowering a subcommittee of the board to decide contentious issues. The insurgent could be shut out of the deliberations of that subcommittee. Indeed, the board's bylaws could include a broadly empowered subcommittee of the board including all members but the insurgents. That subcommittee could offer an opportunity for frank discussion among the members and either a decision or a referral of the matter back to the full board with summary minutes of the meeting prepared by the corporate secretary. This would permit the board to exclude the insurgent member from sensitive discussions about matters pertaining to conflicts posed by the constituent institutional investor who nominated the insurgent director to the board.

5. Withholding Indemnification, Advancement, Directors and Officers Insurance

⁵⁹ 8 Del. Code §141(c).

⁶⁰ *Perlegos v. Atmel Corp*, 2007 WL 475453 at 15 (Del.Ch. 2007).

Coverage, and 102(b)(7) Protection from Insurgent Directors

One strategically useful defense for boards might be to adopt a policy that the board will indemnify, advance legal expenses, and purchase directors and officers insurance coverage only for members of the board who were approved by the nominating committee of the board in advance of the contested election. Another powerful defensive measure would be withholding DGCL 102(b)(7) charter provision coverage from insurgent directors. DGCL 102(b)(7) provides an express corporate liability exemption which allows the corporation to limit or eliminate a director's personal liability for good faith violations of the duty of care. However, such a defense might be more difficult to implement for publicly traded companies because it requires a charter amendment approved by the shareholders.

Delaware law permits indemnification of officers, directors, or employees for actions in which such party "acted in good faith and in a manner reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no cause to believe his conduct was unlawful."⁶¹ Delaware law also permits corporations to purchase insurance for officers and directors even for circumstances for which indemnification is not allowed.⁶² This provision is a vital source of protection for directors who may otherwise face the prospect of multi-billion dollar liability for their actions.⁶³ Withholding that protection from insurgent directors may give boards a powerful strategic advantage in discouraging insurgent nominees in contested elections. In effect, if institutional investors aren't able to recruit candidates, then access to the corporate proxy becomes meaningless.

⁶¹ 8 Del. Code §145.

⁶² 8 Del. Code §145 (g).

⁶³ See Bernard S. Black, Brian R. Cheffins, and Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055 (2006).

A board's ability to withhold advancement and indemnification is fairly unclear. On the one hand, the statute emphasizes that "A corporation shall have the power to indemnify any person who was or is a party" ⁶⁴ On the other hand, it states that "To the extent that a present or former director has been successful on the merits or otherwise in defense of any action . . . such person shall be indemnified against expenses (including attorney's fees)" ⁶⁵ The latter would seem to indicate a mandatory indemnification requirement, while the former reads more like merely an optional authorizing legislation. To make matters more complicated, the statute places a majority of the board of directors that are not a party to the issue as the primary arbiter of whether indemnification is appropriate. ⁶⁶ At the same time the statute denotes the Court of Chancery as having exclusive jurisdiction to determine the propriety of advancement or indemnification. ⁶⁷ Further, the statute provides that "the indemnification and advancement of expenses provided by the DGCL shall not be deemed exclusive of any other indemnification or advancement rights provided in the bylaws, an agreement, or a vote of the shareholders." ⁶⁸ The court in *Frantz Manufacturing v. EAC Industries* upheld a bylaw requiring shareholder approval before the indemnification of directors, so at least that restriction on indemnification is permissible. ⁶⁹

Though there is some uncertainty involved, it would seem there is at least some room for boards to withhold, or at the very least threaten to withhold indemnification and advancement from insurgent directors. There is nothing to suggest that boards cannot withhold insurance coverage for directors and officers. Alternatively, a board could also move to amend its charter

⁶⁴ 8 Del. Code §145(a).

⁶⁵ 8 Del. Code §145(c).

⁶⁶ 8 Del. Code §145(d).

⁶⁷ 8 Del. Code § 145(k).

⁶⁸ 8 Del. Code §145(f).

⁶⁹ *Frantz Mfg. Co. v. EAC Indus.*, 501 A. 2d 401 (Del. 1985).

provision under 102(b)(7) to opt-out of the fiduciary duty of care only for those directors approved by the nominating committee of the board.

B. *Defenses to Effectively Increase an Insurgent's Costs*

1. Contingent Dividends

One defensive method boards could implement would be to make dividends, or perhaps even just a single dividend, to shareholders contingent on the election of only those nominees who are approved by the nominating committee of the board. Depending on the size of the dividend, such a move would not necessarily interfere with the shareholder franchise. If shareholders are fully informed, and they decide to accept a dividend rather than vote for an alternative slate, that decision would be the pure product of shareholder choice. It also would not involve discriminating between shareholders because even the nominating shareholders would obtain the benefit of the dividend.

The strategic benefits would be three-fold. First, institutional investors subject to ERISA face a loose requirement to fulfill the prudent investor standard. As a result, they may feel that giving up certain dividends in exchange for uncertain benefits from a new slate could risk violating that duty. Second, the decision facing retail and otherwise uninterested shareholders changes completely. If it is true that shareholders suffer from an acute collective action problem, then they are as apathetic about spearheading their own activity as they are about voting against the management slate on the management proxy. But where that vote presents a clear cost to action, the retail or low ownership institutional shareholder faces an entirely different calculus.

Finally, the proxy nomination becomes more costly for the nominating shareholder as well, as they would also lose the value of the dividends and may similarly face fiduciary duty constraints.

The strategic value of such a move will of course depend on how much the dividend has value to the board and, comparatively, to the shareholders. A company that feels it needs regular dividends to maintain its capital base may be concerned about the prospect that the dividend will be vitiated by the contested election.⁷⁰ But, if the shareholders are equally concerned about the prospect about a lost dividend, and that information is verifiable, then the provision would never actually need to be exercised. In other words, if all parties believe that it has sufficient deterrent effect, then the dividend contingency would never actually be exercised and boards would not need to be concerned about embedding such a defense in their dividend schedules.

2. Contested Election Triggers: Golden Parachutes and Tin Parachutes

Golden parachutes are executive payments automatically triggered by an unapproved change in control. They are designed in part to compensate executives for the risk of losing their position unexpectedly and in part to limit the prospect of a hostile takeover. Tin parachutes perform a similar function, but accrue to lower level employees. The Delaware courts have tended to allow golden parachute payments triggered upon the change of control of a company, particularly where it is alleged that the new controllers may be harmful to the company's best interest.⁷¹ The question remains whether a board of directors could include as a triggering event a change in a minority of board seats, or whether the courts would be willing to accept a more

⁷⁰ The Mogliadino Miller hypothesis about the irrelevancy of dividend policy notwithstanding, many executives do feel dividend policy is important, whether due to cognitive bias or due to the existence of the enumerated exceptions to the MMH.

⁷¹ Hills Stores Company v. Bozic, 769 A.2d 88 (Del.Ch. 2000).

incremental definition of control for these purposes.

As part of its defense against a proxy fight from Carl Icahn, Yahoo Inc. put into place a tin parachute which could not be altered by the board of directors “once a person has publicly announced a plan” for a “change in control” of current management, such as an unapproved tender offer or an announced proxy fight.⁷² Using proxy fights as a trigger for a golden parachute was a fairly unique provision for a parachute payment, and it never ultimately came under review since the board and the shareholders settled the contest in that case.

In order to survive scrutiny these defensive parachutes would need at the very least to be preapproved long prior to any contested election. The courts have generally accepted golden parachutes triggered upon changes in corporate control, but triggers of minority slate elections may be a different matter. In the event this strategy is utilized it would help to limit the trigger to events where a nominee is placed on the corporate ballot without being approved by a majority of independent directors.

There is some support for the notion of tin parachutes being triggered upon the incident of changes in control. Tin parachutes function similarly to golden parachutes, but rather than only accruing to executives, the payments involve pension payments to blue collar employees that may even be sufficient to make the company illiquid. Tin parachutes as a protective device have the added strategic virtue of accruing to the benefit of union pension employees, the very group that union pension fund administrators purport to represent in their shareholder activism.

Another strategic difference between the defenses of the golden and tin parachute variety may be the application of shareholder approval of golden parachute payments recently included as part of the Dodd-Frank Act. Depending on how those rules are implemented by the SEC, it

⁷² Jeffrey Cane, Does Yahoo Have a "Dead Hand Poison Pill?" (June 10, 2008), *available at* <http://www.portfolio.com/views/blogs/daily-brief/2008/06/10/does-yahoo-have-a-dead-hand-poison-pill#ixzz0uTq6F6W7>.

may be the case that tin parachutes would not be subject to an advisory vote by shareholders.

3. Poison Pills and Proxy Puts Triggered by Proxy Contests

As this article describes in far more depth in the following section, the “poison pill” is a powerful defense to hostile tender offers that triggers automatic discounted share issuances to all but the hostile bidding shareholder. The share issuances are sufficient to make the hostile bid a losing proposition. However, the poison pill also has significant consequences for proxy fights.

The poison pill can serve as a significant deterrent to proxy access nominations, particularly when the pill treats shareholders communicating with each other in advance of a proxy contest as sufficient to count their collective interest as a triggering event. Further, as developed in more detail in the next section, in the event that the thresholds of shareholder ownership triggering the poison pill happen to be set lower than the shareholder ownership thresholds adopted by the SEC as necessary prerequisites for shareholders to access the corporate proxy, the poison pill can offer an even more powerful defense to shareholder proxy access.

But the poison pill is certainly not the only defense to hostile takeovers that can be similarly maneuvered to protect against proxy fights.⁷³ Talley and Arlen refer to “unregulable defenses” when they describe pre-bid transactions in which parties embed into contracts, entered into for business reasons entirely unrelated to proxy fights and tender offers, contractual

⁷³ This article considers some of the defenses already being used in the realm of changes in control and analyzes whether they may also be useful in the realm of changes of a minority of the board. If the courts take the view that defenses are only legitimate in the change of control context, then this would require the court to take a more nuanced definition of control, in which a minority of seats on the board could at times constitute the key swing vote. For example, a minority slate nominated under the SEC’s nomination procedures could become part of a controlling coalition in the event that another shareholder self-financed a proxy fight outside of the SEC’s nomination process.

provisions which would make proxy fights and tender offers prohibitive.⁷⁴ Proxy puts and tin parachutes are examples of this practice.

Talley and Arlen argue that courts have a difficult time regulating these defenses because they are often adopted with a dual business purpose in addition to the secondary entrenchment effect they provide.⁷⁵ They identify as examples provisions in third party contracts like IP licenses, leases, joint ventures, debt and equity financing, union contracts, and employee stock options that trigger upon a change in control.⁷⁶ For example, a third party licensing intellectual property could have a legitimate concern that the presence of a new minority insurgent director on the board, with access to the information, could put the security of their intellectual property in jeopardy. As such, they may seek a provision terminating the IP license upon the victory of a slate of nominees who have not been approved by the nominating committee of the board of directors. If the company's intent behind the proxy put provision is to satisfy that outside party's concern, then the decision would obtain deferential business judgment review and survive challenge.

Such third party contracts can either have termination provisions or milder penalty provisions triggered upon a change in control.⁷⁷ In this case, they might also be triggered upon a shareholder nomination of an insurgent slate. One advantage to the board is that it could use the cost of that penalty in its materials arguing against the alternative slate by identifying that if shareholders vote for the challenger it will cost the firm a specified amount in penalty expenses.

⁷⁴ Jennifer Arlen and Eric Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, 152 U. PA. L. REV. 577, 583 (2003) [hereinafter Arlen and Talley].

⁷⁵ *Id.* at 600.

⁷⁶ *Id.* at 615.

⁷⁷ *Id.* at 624.

4. Targeted Share Issuances⁷⁸

The current discussion among the SEC Commissioners suggests that they will impose a 3% ownership requirement on shareholders before they will be able to place nominees onto the company's proxy. If that were the case, it would not necessarily take a significant share issuance to water down the nominating shareholders' interest such that they will lose the ability to qualify for proxy access nominations. There is some Delaware precedent for much larger share issuances that have the ultimate effect of inhibiting proxy contests.⁷⁹ In this instance, it would aid a board's defense if the share issuance was only designed to reduce the shareholder's interest below the threshold, as the board could argue that it did not intend to impede the shareholder's ability to conduct a successful proxy contest, but merely intended to thwart a shareholder's ability to do so on the corporate proxy.

5. Election Expense Bonds

Boards could require the nominating shareholder to post a bond to pay for the expenses of the contest in the event that their candidate loses. Though the board would not be able to prevent shareholders who qualify under the SEC's rules from placing their nominees onto the ballot, the board could require the posting of such a bond as a prerequisite for lifting some of the other defenses described in this section. In that case, even if the defenses listed above are of questionable legitimacy under existing law, the uncertainty about that fact could still offer some

⁷⁸ Targeted share issuances are distinguished from poison pills, as targeted share issuances could be purchased by the hostile party on an equal footing with other shareholders.

⁷⁹ See, e.g., *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 278 (Del. Ch. 1989). See also *Glazer v. Zapata Corp.*, 658 A.2d 176 (Del. Ch. 1993)

negotiating leverage to incumbent management. One of the beneficial strategic effects of such an offer, particularly if it was expressly written into one of the defenses discussed in this article, is that the presence of an election expense bond exemption may in fact alter the legal analysis under which a court will review the defense.⁸⁰

C. *Defenses Associated with Structuring Shareholder Voting*

1. Chinese Menu Ballots

Preferential voting with an ordinal ballot, as well as instantaneous runoffs, may be used to dig more deeply into the preferences of shareholders in contested elections.⁸¹ Such a system would allow shareholders to rank the candidates they prefer, in the order in which they prefer them. This method would limit the ability of special interests to take over the corporate ballot, as it would in some circumstances eliminate candidates for which a majority of shareholders have a strong preference against. One of the reasons that special interests have a chance to influence corporate elections is that the realities of the election process do not permit runoffs. However, with an ordinally ranked ballot, an election inspector could count a shareholder as voting for their successively ranked preferences in a hypothetical runoff. This would have the benefit of requiring that nominees receive a broad base of preferential support among the entire group of shareholders.

⁸⁰ For example, if the court reviews the defenses explored above under the *Blasius* or the *Unocal* line of cases reviewed in the following section, and if the court accepts the premise that defenses targeted at nominations to the corporate proxy are equivalent to defenses targeted at the shareholder franchise itself, then the presence of an exemption for shareholders posting such a bond may reduce the likelihood that the court will consider the particular defense to be an inequitable measure when viewed in conjunction with an election expense bond exemption that would still allow an avenue for shareholder challenge to the board.

⁸¹ See J.W. Verret, *Pandora's Ballot Box, Or A Proxy With Moxie? Majority Voting, Corporate Ballot Access, and the Legend of Martin Lipton Re-Examined*, 63 BUS. LAW. 1007 (2007)

The strategic value of such a configuration would depend in part on the number of nominees, with its value increasing as the number of filed nominees increases. It would be particularly useful in cases in which one shareholder nominates through the federal proxy access process and a different shareholder also simultaneously funds their own contested slates. This method would also significantly complicate the voting process itself, which would mean that a greater percentage of shareholder ballots would likely go uncounted as being invalidly filled out. In the event that voided ballots tended to favor insurgents, it may offer an added defensive benefit. The SEC proxy rules leave significant room open for redesigning the proxy ballot form, since their rules weren't designed with contested elections in mind, and this method would be permissible under the SEC's existing rules.

2. Amending the Charter to Limit the Voting of Conflicted Shareholders

Another defensive method would be to limit the counting of votes by "conflicted shareholders" as defined in pre-approved charter amendments. For example, they could be defined to include shareholders that are "entities who are either sponsored by a governmental body of a state in which the company does business, or an entity sponsored by an organization any of whose members are employed by the company that is not administered by the company, or an entity sponsored by an organization any of whose members have regulatory or government contract oversight responsibility over the company."

One potential qualifier on such a charter amendment would be to require a majority vote of the non-conflicted shareholders to allow the votes of the conflicted shareholders to count. Every corporate election would have a line item which would ask the non-conflicted

shareholders whether they want the union and government pension fund votes to count in that election. Limiting voting rights because of conflicts is not without precedent—the DGCL requires majority-of-the-minority votes to approve conflicted transactions.

A ruling in *I.P. Phillips v. Insituform of North America, Inc.* indicates that any fundamental shift in power between classes of shareholders must take place in the charter, rather than in the bylaws.⁸² Delaware law generally recognized that stockholders have a general right to vote their shares out of their own selfish interest, limited only by the fiduciary duties that a controlling shareholder may have.⁸³ This does not mean, however, that the board or the other shareholders may not limit those voting rights. In this instance, though the conflicted shareholders do not happen to be controlling shareholders individually, as a coordinated group they may be able to obtain control. As we will see in the next section, this type of mechanism would likely be one of the most critically reviewed in the Delaware courts, and as such would likely require implementation by way of a charter amendment. Such an amendment may be difficult for a company that is already publicly traded, but it may be easier to include this provision in new, pre-IPO companies that are likely to face significant pressure from conflicted institutional investors.

3. Client-Directed Voting

The SEC is currently considering a proposal to make it easier for proxy solicitors to communicate directly with beneficial shareholders and to encourage beneficial shareholders to give voting instructions to the brokers who hold shares on their behalf. In the event that the SEC

⁸² *Phillips v. Insituform of North America, Inc.*, 1987 WL 16285 (Del. Ch. Aug. 27, 1987).

⁸³ *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840, 845 (Del.1987).

approves those rules, it would give boards another defensive weapon to use in advance of proxy fights. Given the pendency of rulemaking on this point, which has yet to achieve a recognizable character given its very recent introduction July 14, 2010, this article will table analysis of this defensive measure while briefly highlighting its pendency.

D. *Additional Defenses*

1. Whitemail

A defensive option boards have often used historically in the takeover context is greenmail, or selectively buying out a challenging shareholder's interest. The Court of Chancery's current view of greenmail is that it is generally permitted.⁸⁴ In considering how to adopt that defensive measure used in the takeover context into the context of proxy nominations, there would likely be some price at which long-term investors would also be willing to give up their nomination at a particular company in cases where the shareholder pursuing the contest is actually concerned with the value of their investment in the company.⁸⁵

The IRS imposes a 50% excise tax on greenmail, which has largely discouraged the practice, but that restriction only operates in the event that the greenmailer was threatening a hostile tender for control of a company.⁸⁶ Thus, the threat of nominating an insurgent minority slate of candidates, as required by the SEC's proxy access rule, onto the corporate proxy would

⁸⁴ See, e.g., *Cheff v. Mathes*, 199 A.2d 548 (Del. Ch. 1964).

⁸⁵ Though a powerful exception for pension funds would be if the shareholder cares more about the incentives that particular contest creates for boards of other firms, or if the pension fund is usually the contest to push political interests or the further collective bargaining objectives. But otherwise, there may be a price at which insurgents can be satiated, and thus proxy access may require a second look at the laws governing greenmail.

⁸⁶ IRS, Form 8725, *Excise Tax on Greenmail*, available at <http://www.irs.gov/pub/irs-pdf/f8725.pdf> (last visited July 18, 2010).

not be covered by that excise tax. It would be a different form of side payment, one negotiated in exchange for dropping a contested nomination to the corporate proxy rather than one negotiated in exchange for dropping a takeover attempt. Since the corporate proxy card is typically a white card,⁸⁷ a useful name for such a side payment, to distinguish it from the historical greenmail, would be whitemail.

2. State Anti-Takeover Statutes

In the early 1990s, Stephen Bainbridge raised the possibility of using state anti-takeover statutes designed to prevent hostile takeovers to also defend against proxy contests. Evidencing a fairly unique prescience for academics writing about the evolution of corporation law, Bainbridge considered whether anti-takeover statutes, which limit a bidder's ability to takeover a company without the approval of the board, might be applied to proxy contests.⁸⁸ He noted that, if one were to tinker with the definition of share ownership to include "control of shares," as the definition in the Pennsylvania statute requires, and also if one were to define control to include obtaining the right to vote proxies, as one federal district court does, then the anti-takeover laws could be used as a defense against proxy solicitations to nominate new members to the board.⁸⁹ He offered a number of arguments about federal pre-emption and whether such a broad anti-takeover law could be struck down as preempted by the federal proxy rules.

At the time of the article, 1992, it was unclear whether Congress intended to completely pre-empt state laws to govern the exercise of shareholder voting or to govern only the solicitation

⁸⁷ <http://www.globenewswire.com/newsroom/news.html?d=193725>

⁸⁸ Stephen Bainbridge, *Redirecting State Takeover Laws at Proxy Contests*, 1992 WIS. L. REV. 1071, 1099 (1992) [hereinafter Bainbridge, *Redirecting*].

⁸⁹ *Id.* at 1099.

of proxies, and so Bainbridge's analysis left open room for the possibility of using anti-takeover laws for this purpose.⁹⁰ In light of the fact that the express purpose of the proxy nomination provisions of the Dodd-Frank Act were intended to specifically give shareholders the right to nominate and vote in alternative directors, it would seem that a such a change in state law would face harsh scrutiny in the federal courts and would not, in the post-Dodd-Frank era, represent a strategically viable solution. The Bainbridge insight on using state anti-takeover statutes for a new purpose remains, however, a groundbreaking one that has significantly informed and inspired an analogous mode of thought underlying the other defenses presented by the author in this article.

This section has offered a number of strategically useful defenses that boards might use to defend against proxy access nominations. The next section will consider their legality under Delaware corporate law, and the section after that will consider legality under federal rules. But even as to defenses of questionable legality, a significant advantage remains—these defenses can still give managers considerable deterrent power. This power is especially significant where no one individual shareholder has an incentive to bring a test case and where justiciability doctrine questions, like those presented in *Bebchuk v. CA*,⁹¹ prevent testing until the actual results of a contested election occur. While the Dodd-Frank Act has paved the way for greater proxy access for shareholders, boards still have the incentive and ability to defend against unwanted intrusions.

IV. THE LEGITIMACY OF PROXY ACCESS DEFENSES UNDER DELAWARE LAW

⁹⁰ *Id.* at 1145.

⁹¹ 902 A.2d 737 (Del. Ch. 2006).

This section presents an extensive analysis of Delaware law governing the shareholder franchise. It will offer a look at both statutory provisions governing the shareholder franchise, as well as case law interpreting those provisions. It will consider in depth the *Blasius*⁹² line of cases through which the Delaware judges have strenuously urged caution against board policies which have as their principal goal interference with the shareholder's right to vote.

It will also consider the *Unocal*⁹³ line of cases that governs board defenses to changes in control, a line of jurisprudence which has been grafted together with the *Blasius* cases in many circumstances because of the frequent pairing of proxy fights and tender offers. This section will consider how *Blasius* review will be required to evolve in light of the new shareholder proxy access regime and take on new life separate and apart from *Unocal*.

Finally, and most importantly, this section will look at each of the board defenses to proxy access presented in this article and consider whether they are permitted under the DGCL and whether the Delaware courts will be likely to strike them down as an inequitable constraint on the shareholder franchise. In so doing, this section will begin with a broad view of the Delaware cases concerning the shareholder franchise and work toward those cases which touch on issues particularly relevant to the individual defenses considered in this article.

A. *Shareholder Voting and the DGCL*

The right to vote shares in Delaware is an incident of legal ownership.⁹⁴ However, the DGCL gives the board of directors the right to govern aspects of the election process. For instance, the board has the authority to extend the time period required to call a special meeting

⁹² *Blasius Indus., Inc. v. Atlas Corp.* 564 A.2d 651 (Del.Ch. 1988).

⁹³ *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

⁹⁴ *Norton v. Digital Applications, Inc.*, 305 A.2d 656 (Del. Ch. 1973).

or delay the annual meeting in response to a takeover threat, which in certain circumstances the Delaware courts, including the Delaware Court of Chancery and the Delaware Supreme Court, have ruled a reasonable exercise of board authority.⁹⁵ The corporate charter may also, under certain circumstances, contain restrictions on shareholder voting.⁹⁶ The board has the authority to use and design proxies, but not to make the use of proxies so prohibitively difficult as to prevent their use.⁹⁷

Delaware does clearly note that the importance of the shareholder franchise does not mean that the voting process cannot be restricted for valid reasons by procedural rules as long as those rules are reasonable.⁹⁸ For example, in the related area of shareholder action by consent, the Delaware Supreme Court invalidated a bylaw that would delay the effective date of shareholder action by written consent. The court ruled that the result would have violated the underlying purpose of action by written consent, which included that it take effect immediately.⁹⁹

Stockholders can be held to a fiduciary duty to other shareholders in the event they are determined to be controlling shareholders.¹⁰⁰ Stockholders have the right to vote out of whatever motive they choose, as long as that motive is not to the detriment of other shareholders in the event that a fiduciary duty applies.¹⁰¹ However, identifying the actual shareholder can be difficult in the current system in which various layers of intermediaries stand between the

⁹⁵ Kidsco v. Dinsmore, Del. Ch., 674 A.2d 483 (1995); *see also* Stahl v. Apple Bancorp, 579 A.2d 1115 (Del. Ch. 1990); *see also* Speiser v. Baker, 525 A.2d 1001 (Del. Ch. 1987).

⁹⁶ Providence & Worcester Co. v. Baker, 378 A.2d 121 (Del. Supr. 1977).

⁹⁷ Atterbury v. Consolidated Coppermines Corp., 26 Del. Ch. 1, 20 A.2d 743 (1941).

⁹⁸ *Hubbard*, 17 DEL. J. CORP. L. at 258.

⁹⁹ Datapoint Corp. v. Plaza Securities Co., 496 A.2d 1031, 1036 (Del. 1985). In part that holding rested in an understanding of the underlying intent of the bylaw, which was to permit management sufficient time to defeat the shareholder action.

¹⁰⁰ Allied Chem. & Dye Corp. v. Steel & Tube Co. of Am., 14 Del. Ch. 1, 120 A.486, 491 (1923).

¹⁰¹ Heil v. Standard Gas and Electric Company, 17 Del. Ch. 214 (1930); Ringling Brothers v. Ringling, 29 Del. Ch. 610 (1947); DuPont v. DuPont, 251 F. 937 (D. Del. 1918).

company and the ultimate shareholder.¹⁰² Delaware has recently innovated its approach to determining beneficial shareholders.¹⁰³

Proxy access may also result in an increased reliance on standstill agreements, also referred to as long-term “peace treaties.”¹⁰⁴ One frequent and legitimate practice in proxy fights involves standstill agreements negotiated in advance of the actual proxy fight and resolving the points of contention between the parties. One likely result of the renewal of proxy fights is that agreements between shareholders and managers will become more frequent and will take on renewed importance. Such an agreement could relate, in advance of a settlement, to factors like the procedural rules of the election, selection of inspectors, and methodology for the proxy count.¹⁰⁵ It could also result in an agreement by the company to place insurgent nominees on the board or by the shareholder to vote for incumbents in future elections. In the absence of an agreement, management will generally control the procedural rules, thus management will need to obtain some benefit from the agreement to commit to particular rules of election procedure.

But pre-fight agreements might in some cases offer both sides an opportunity to define the parameters of the fight to prevent escalation deemed costly by both sides. It may also offer a tool for management to limit the number or the nature of insurgent nominees. This would, however, require further interpretation of any SEC rule like the current SEC proposal which limits the ability of management and insurgents, and expressly limits the ability of insurgent shareholders to nominate while they have entered into an agreement with the company.

¹⁰² See Marcel Kahan & Edward B. Rock, *The Hanging Chads of Corporate Voting*, 96 GEO. L.J. 1227 (2008).

¹⁰³ *Kurz v. Holbrook*, 989 A.2d 140 (Del. Ch. 2010).

¹⁰⁴ See Bagley, *supra* note 13, at A-55 (citing Joseph W. Bartlett and Christopher B. Andrews, *The Standstill Agreement-A New Form of Corporate Peace Treaty*, 62 BU L. REV. 143 (1982)). These “peace treaties” will typically indicate a willingness to forgo a current proxy contest and possibly future proxy contests.

¹⁰⁵ It could, for example, govern deadlines for filing proxies, opening and closing of the polls, forms of the ballot, schedule for the formal count, methods of sharing meeting expenses, and methods for resolving disputes. See Constance Bagley and David J. Berger, *Proxy Contests and Corporate Control: Strategic Considerations*, *Corporate Practice Series*, at A-55 (2nd ed. 2001) [hereinafter Bagley].

If courts determine that shareholder nominations can present a legitimate threat to the corporation, it may consider adopting a hard line in reviewing them to limit manager's flexibility, or at least require "fiduciary outs" in those agreements to give the board flexibility to ignore provisions it has agreed to with institutional investors if the board believes in good faith that compliance with such an agreement might represent a violation of its fiduciary duty to other shareholders in the corporation.

For example, when one major shareholder, hoping to purchase more shares for a proxy contest than was currently allowed under the governing standstill agreement, challenged that agreement for violating the board's fiduciary duties to the corporation, a Pennsylvania court ruled that the board had valid business reasons for entering into that agreement.¹⁰⁶ It would seem that, were a similar challenge made in Delaware, the court could hold that a similar business purposes exists. And yet, under the ruling of *AFSCME v. CA* the court would also likely require a fiduciary out clause accruing to the benefit of the board.¹⁰⁷ This would not help, however, with implicit agreements between shareholders and the board. In that instance, fiduciary outs would do little to limit the transfer of bargaining power from the board to shareholders because the implicit agreements do not have courts as a governing mechanism but instead rely on a combination of trust, threats, and personal relationships. To limit the transfer of leverage, a different form of defense is required in which the board would pre-commit to defending against the insurgent.

B. *Blasius and Schnell: The Need for Compelling Justification*

¹⁰⁶ See Bagley, *supra* note 13, at A-55 (citing *Enterra Corp. v. SGS Association*, 600 F. Supp. 678 (E.D. Pa. 1985)).

¹⁰⁷ *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227, 232 (Del. Supr. 2008).

The case of *Blasius v. Atlas* is the foundation of Delaware’s recent jurisprudence protecting the shareholder franchise.¹⁰⁸ *Blasius* was based on an earlier ruling in *Schnell v. Chris-Craft*, which is frequently cited as a corollary to cases analyzing *Blasius*.¹⁰⁹ The court in *Schnell* held that “inequitable action does not become permissible simply because it is legally possible.”¹¹⁰ Vice Chancellor Strine has written on the nature of Delaware’s court of equity and the role it plays in governing the wide discretion given to directors by the DGCL, using the *Schnell* case as a keystone for his argument. One implicit corollary to the rule in *Schnell* that Vice Chancellor Strine urges must be true is that if a provision in the DGCL authorizes boards to take a certain action there must in fact be a set of circumstances under which such action is equitable.¹¹¹

Thus, the primary motivations of director action become an important element of the test, particularly where the court chooses to use a *Blasius* test rather than the *Unocal* standard.¹¹² In *Blasius*, the court considered board action that was technically permitted under the DGCL and the company’s charter—the authority to expand the size of the board and appoint the new members. Despite being technically permitted, the court ultimately invalidated the action on the grounds that the motivation for using that legal authority was inequitable. The court held in *Blasius* that the principal motivation behind the board’s defensive maneuver was to prevent the insurgent shareholders from potentially placing a new majority on the board.¹¹³ The court noted

¹⁰⁸ That case had origins in an earlier ruling, *Schnell v. Chris-Craft*, determining that simply because the managers of a company have the authority under the DGCL to take certain actions does not mean that they may use that authority inequitably, and particularly with the purpose of perpetuating themselves in office. *See Schnell v. Chris-Craft Industries, Inc.*, 285 A.2d 437, 439 (Del. 1971).

¹⁰⁹ *MM Companies, Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118, 1132 (Del. Supr. 2003)

¹¹⁰ 285 A.2d at 439.

¹¹¹ Leo Strine, *If Corporate Action is Lawful, Presumably There Are Circumstances In Which It Is Equitable To Take That Action: The Implicit Corollary To The Rule of Schnell v. Chris-Craft*, 60 BUS. LAW 877, 883 (2005) [hereinafter *If Corporate Action is Lawful*].

¹¹² *Mercier v. Inter-Tel, Inc.*, 929 A.2d 786, 807 (Del.Ch. 2007).

¹¹³ *Blasius Indus., Inc. v. Atlas Corp.* 564 A.2d 651, 655 (Del.Ch. 1988)

that the motivation behind the board's defensive action was key to its analysis, and that if the board expansion had been taken independently of the consent solicitation in a way that merely had an incidental impact on shareholder action,¹¹⁴ the court's ruling would have been different.¹¹⁵

Blasius recognizes that “[t]he shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.”¹¹⁶ *Blasius* expresses misgivings about actions taken with the principal objective of subverting the will of a majority of shareholders because it “does not involve the exercise of *the corporation's power* over its property, or with respect to *its* rights or obligations; rather, it involves allocation, between shareholders as a class and the board, of effective power with respect to governance of the corporation.”¹¹⁷

In *Blasius*, the court was careful, however, not to adopt a per se rule of invalidity for all board action designed principally to thwart a shareholder vote. The court stated that

In [its] view, our inability to foresee now all of the future settings in which a board might, in good faith, paternalistically seek to thwart a shareholder vote, counsels against the adoption of a *per se* rule invalidating, in equity, every board action taken for the sole or primary purpose of thwarting a shareholder vote, even though I recognize the transcending significance of the franchise to the claims to legitimacy of our scheme of corporate governance. It may be that some set of facts would justify such extreme action.¹¹⁸

The court in *Blasius* emphasized that the type of shareholder action it was concerned about impeding was that provided for in the corporation law as well as the company's certificate of incorporation.¹¹⁹ If, for example, a company has a proxy access bylaw pursuant to Delaware law, then actions taken by a board to subvert an attempt by shareholders to make use of that right

¹¹⁴ *Id.* [Blasius]

¹¹⁵ By contrast, when an issue under consideration does not touch on matters of directorial control and does not thwart the will of a majority of shareholders, courts will apply the business judgment rule to review the director's decision thereunder. *See In re MONY Group Inc. S'holder Litig.*, 853 A.2d 661, 675 (Del. Ch. 2004).

¹¹⁶ *Blasius Indus.*, 564 A.2d at 659.

¹¹⁷ *Id.* at 660. [Blasius]

¹¹⁸ *Id.* at 662. [Blasius]

¹¹⁹ *Id.* at 663. [Blasius] Notably, the court makes no mention of tactics designed to impede the exercise of federally granted rights.

would clearly fall under the *Blasius* standard. If the company does not have such a bylaw, however, it seems clear that *Blasius* should not apply to defensive tactics triggered only by a contested election in which a shareholder attempts to nominate onto the corporate proxy. In other words, one must remain careful to distinguish authorized board action taken with the intent to impede a shareholders ability to nominate candidates to the corporate proxy from authorized board action taken with the intent to impede a shareholders ability to run an opposing slate on their own. The former is not necessarily protected by *Blasius*.

The court synthesized the existing law to rule that actions taken for the primary purpose of impeding the exercise of shareholder voting power require the board to bear a heavy burden of demonstrating a compelling justification for such action.¹²⁰ Thus, the “compelling justification” necessary to overcome the heightened standard of scrutiny of *Blasius* has been described as “quite onerous” and has therefore been a test applied rarely.¹²¹ The court has noted that the compelling justification test of *Blasius* is most likely to be found in circumstances where the board is defending against a shareholder using its power to threaten or exploit other shareholders.¹²²

In applying *Blasius*, the court has not restricted itself to those bylaws which have the actual effect of limiting the shareholder franchise, instead noting that “defensive actions by a board need not actually prevent the shareholders from attaining any success in seating one or more nominees in a contested election for directors and the election contest need not involve a

¹²⁰ *Id.* at 661. [*Blasius*]

¹²¹ *Williams v. Geier*, 671 A.2d 1368, 1376 (Del. 1996); *see also* David C. McBride and Danielle Gibbs, *Interference with Voting Rights: The Metaphysics of Blasius Industries v. Atlas Corp.*, 26 Del. J. Corp. L. 927, 929 (2001) [hereinafter McBride] (noting that, as of 2001, no Delaware court has ever found a compelling justification for an action taken for the primary purpose of interfering with a shareholder vote).

¹²² *Mendel v. Carroll*, 651 A.2d 297, 306 (Del. Ch. 1994).

challenge for outright control of the board of directors.”¹²³ Though the court in *Blasius* expressed misgivings with the holding, a prior ruling in *American Rent-A-Car* took a more liberal view of tactics designed to thwart the will of a shareholder majority.¹²⁴ If the Delaware courts decided to alter the evolution of the *Blasius* line of cases in the post-proxy access world, *American Rent-A-Car* would offer a foundation for such a shift.

One of the results of the courts articulation in *Blasius* that actions are reviewed based upon their “primary purpose” is simply that boards and their advisors will seek to articulate a business purpose for their actions separate and apart from that of impeding elections.¹²⁵ McBride notes that subsequent cases have altered the notion of “primary purpose” to a test that instead focuses on whether action has the principal effect of impeding effective shareholder action. For example, McBride argues that *Blasius* is not implicated where the board recommends to the shareholders a bylaw or charter amendment that limits their ability to vote on matters going forward and the shareholders actually approve such a provision.¹²⁶

McBride also argues that where the board’s decision is not actually a business decision, but instead purely a tactical maneuver, that action is more likely to face *Blasius* scrutiny.¹²⁷ Changes to voting rules, meeting adjournments, or poison pills designed principally to effect the shareholder franchise would fall into this category.¹²⁸ But where the action is principally a business decision with an incidental effect on voting, it may escape *Blasius* review. Thus, proxy

¹²³ *MM Companies, Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118, 1132 (Del. Supr. 2003) (citing *IBS Fin. Corp. v. Seidman and Assocs., L.L.C.*, 136 F.3d 940, 951 (3d Cir.1998)).

¹²⁴ Subsequent holdings have emphasized the *Blasius* view and largely ignored the view of *American Rent-A-Car*, though the latter has never been expressly overruled, but that does indicate that a less rigorous approach to *Blasius* review would not be without precedent. See *American Rent-A-Car, Inc. v. Cross*, C.A. No. 7583, 1984 WL 8204 (Del. Ch. May 9, 1984).

¹²⁵ McBride, *supra* note 30, at 929.

¹²⁶ *Id.* at 934. [McBride]

¹²⁷ *Id.* at 936-38. [McBride]

¹²⁸ *Id.* [McBride]

put provisions and other “non-regulable defenses,” if negotiated at arms-length and insisted on by the creditors, may survive *Blasius* review under McBride’s analysis.

However, McBride also notes that the matter becomes more complicated where a business transaction is entered for dual purposes, one of which is to thwart a shareholder vote.¹²⁹ He offers the example of share issuances undertaken both for the purpose of raising capital and for the purpose of diluting the voting position of challengers.¹³⁰ In many of those circumstances, the court has permitted the defensive tactics under a lesser *Unocal* standard.¹³¹ McBride also argues that *Blasius* has an important role to play in non-control election contests.¹³²

1. The Progeny of *Blasius*

Now that this article has considered *Blasius* from a broad view, a brief look at some of the cases interpreting *Blasius* will provide further insight. In *MM Companies v. Liquid Audio*, the court considered a board’s tactic in expanding the size of the board from 5 members to 7 and appointing the additional two directors, all in response to an impending proxy contest.¹³³ The court held that the board’s primary purpose was to diminish the influence of the insurgent directors, and therefore the primary purpose was to disenfranchise shareholders despite the fact that the maneuver did not directly affect the shareholders’ ability to vote or nominate

¹²⁹ *Id.* at 939. [McBride]

¹³⁰ *Id.*

¹³¹ McBride, *supra* note 30, at 939 n.59.

¹³² *Id.* at 944. [McBride] McBride offers a prediction for how a renewed *Blasius* standard has developed and could be expected to continue to grow: “a balancing of the imminence of the shareholder action at issue, the severity of the impediment created by the board action and the credibility or persuasiveness of the other purposes proffered for the action taken.”

¹³³ *MM Cos. v. Liquid Audio, Inc.*, 813 A.2d 1118 (Del. 2003).

directors.¹³⁴ The timing of the board’s decision, on the eve of the contested election, was also critical to the court’s holding.¹³⁵

In *Openwave Systems Inc. v. Harbinger Capital Partners Master Fund I, Ltd.*,¹³⁶ the court heard a challenge to an advance notification bylaw. It noted a general view that where advance notice bylaws “unduly restrict the shareholder franchise or are applied inequitably, they will be struck down.”¹³⁷ In *Stahl v. Apple Bancorp, Inc.*, the Court of Chancery reviewed the delay of an annual meeting, designed to prevent a hostile takeover through proxy fight, under the *Unocal* standard.¹³⁸ The court found that the delay was reasonable on the grounds that it would give the board time to collect information necessary to fully inform the shareholder vote. Thus, we might consider that board actions which were contingent on additional disclosure by the insurgent shareholder, going beyond the disclosures they are required to make, might come closer to passing the intermediate test of *Unocal*. If a proxy defense were contingent on the insurgent providing additional details to the shareholders about its discussions with other institutional shareholders, and how the institutions may or may not coordinate their activity across institutions or with the employee bargaining arms of pension funds, the board defense may come closer to passing muster under *Unocal*, or possibly even *Blasius*.

In *Hubbard v. Hollywood* the Court of Chancery also held that “the shareholders’ right to vote includes the right to nominate a contesting slate,” and that a nomination process which unduly restricts a shareholder’s ability to nominate an alternative slate ultimately renders the

¹³⁴ *MM Cos.*, 813 A.2d at 1132.

¹³⁵ *MM Cos.*, 813 A.2d at 1132.

¹³⁶ *Openwave Sys. v. Harbinger Capital*, 924 A.2d 228, 239 (Del. Ch. 2007).

¹³⁷ *Openwave Sys.*, 924 A.2d at 239; *see also In re MONY Group Inc. S’holder Litig.*, 853 A.2d at 673; and *MM Cos.*, 813 A.2d at 1127 (These holdings have emphasized that the Court of Chancery is “vigilant in policing fiduciary misconduct that has the effect of impeding or interfering with the effectiveness of a stockholder vote” and that “This is particularly the case in matters relating to the election of directors.”).

¹³⁸ *Stahl v. Apple Bancorp, Inc.*, 16 Del. J. Corp. L. 1573 (Del. Ch. 1990).

election process a meaningless process.¹³⁹ The court has, however, permitted limitation on the shareholder's right to nominate through a bylaw that discriminated among shareholders based on the amount of time they have held their shares. In *Jana Master Fund*, the court interpreted a bylaw restricting shareholder nominations to those shareholders holding stock for at least a year.¹⁴⁰ Although the court did rule that the bylaw only applied to nominations on the corporate proxy, it did not find that the bylaw violated *Blasius* or the DGCL.¹⁴¹ Thus, there may be some space for further restrictions that go beyond the one year holding restriction to longer time periods or other additional procedural restrictions, particularly where they condition the operation of policies which complicate shareholder nominations under the federal rules. Even more importantly, the right to nominate a contesting slate recognized in *Hubbard* does not necessarily include the right to nominate that slate onto the corporate proxy under a federal access rule.

C. *Takeover Defenses and the Unocal Standard*

In the 1980s, a growing market for high yield bonds supported a wave of hostile tender offers. As a result, boards started making use of a variety of methods to prevent hostile tender offers from succeeding. One of the most useful strategies was the shareholder rights plan, also known as the poison pill. The poison pill was triggered upon a shareholder obtaining ownership of more than a specified percentage of shares without prior board approval, and when triggered, it would automatically give all shareholders except the bidder the right to buy shares at a

¹³⁹ See *Hubbard v. Hollywood Park Realty Enters., Inc.*, 17 DEL. J. CORP. L. 238, 250 (1991). For example, Delaware has invalidated a bylaw requiring 70 days advance notice which was adopted 63 days prior to the annual meeting. See *Lerman v. Diagnostic Data, Inc.*, 421 A.2d 906 (Del. Ch. 1980).

¹⁴⁰ *Jana Master Fund, Ltd. v. CNET Networks, Inc.*, 954 A.2d 335, 342 (Del. Ch. 2008)

¹⁴¹ *Id.*

discount such that the bidder would never be able to purchase a majority of the outstanding shares.

In reviewing the legitimacy of the poison pill in *Moran v. Household International*, the court considered an argument that since the poison pill in that case prohibited acquisition of more than 20% of the shares of the company, it limited the shareholders' ability to conduct a proxy contest.¹⁴² The court conceded that "while the Rights Plan does deter the formation of proxy efforts of a certain magnitude, it does not limit the voting power of additional shares."¹⁴³ The court based this holding on a finding that "many proxy contests are won with an insurgent ownership of less than 20%" and "that the key variable in proxy contest success is the merit of an insurgent's issues, not the size of its holdings."¹⁴⁴ This powerful dicta provides a foundation for a company to use a poison pill as a defense to hostile proxy fights in addition to their more traditional use as tender offer defenses.

Poison pills did not develop solely for the purposes of defeating a hostile tender offer, but also served the secondary purpose of defending against a proxy fight designed to obtain a majority of board seats.¹⁴⁵ In *Moran*, the court found that the poison pill was a permissible device because the board's decision of whether to redeem said pill was still subject to fiduciary duty review and because an acquirer could still communicate with a group of shareholders of less than the prohibited percentage and engage in a proxy contest.¹⁴⁶ And yet strangely, the court has

¹⁴² *Moran v. Household Intern., Inc.*, 500 A.2d 1346, 1355 (Del. 1985).

¹⁴³ *Id.* at 1355. [*Moran*]

¹⁴⁴ *Id.* [*Moran*] One of the benefits to shareholders the court has recognized is that the poison pill generally results in bidding contests that have generally resulted in higher offers for the company than the initial higher offer. *See Carmody v. Toll Bros., Inc.*, 723 A.2d 1180, 1186 (Del. Ch. 1998).

¹⁴⁵ Commentators have argued that one purpose of the poison pill is to limit not only the acquisition of a controlling interest in a company, but also limit the ability of any individual shareholder to acquire enough shares to make a proxy contest worthwhile. *See* Randall S. Thomas, *Judicial Review of Defensive Tactics in Proxy Contests*, 46 VAND. L. REV. 503, 510, 512 (1993) [hereinafter Thomas]. *See also* Lucian A. Bebchuk, John C. Coates, and Guhan Subramanian, *The Powerful Anti-Takeover Effect of Staggered Boards*, 54 STAN. L. REV. 887 (2001).

¹⁴⁶ *Moran*, 500 A.2d at 1354.

subsequently also recognized that one of the intended effects of a poison pill is to inhibit proxy fights by making them less attractive to those seeking to finance a contested solicitation and by preventing groups of shareholders from acting together.¹⁴⁷ Nevertheless, the Delaware courts still permit their use.

The court has also held that in assessing the validity of poison pills, it will focus on the reasonably foreseeable effect that a pill will have on a proxy fight at the time it was adopted, rather than a focus on the actual effect it has on proxy fights.¹⁴⁸ In reviewing a pill trigger that considered coordinated shareholder activity as sufficient to create a group which would, together, suffice to trigger the pill, the court held that such a provision was a reasonable exercise of the board's power.¹⁴⁹ This gave the board a powerful deterrent to prevent shareholders from coordinating with each other in the lead up to a proxy fight.

With the poison pill jurisprudence taking on a focus of whether the board is required to rescind the pill or not under *Revlon*¹⁵⁰ and *Unocal*, the courts have had few occasions to consider the limit to which a poison pill trigger can reach coordinated activity between shareholders. The renewed vigor of shareholder contests in the age of proxy access and the need of nominating shareholders to coordinate with other shareholders to advance their nominees will likely bring that question to the fore of litigated matters. As it stands now, poison pill trigger provisions based on shareholder coordination to reach the pill minimum remains at least a theoretical possibility for boards defending from proxy contests.¹⁵¹

¹⁴⁷ Henley Group, Inc. v. Santa Fe Southern Pacific Corp., 13 Del. J. Corp. L. 1152, 1163 (Del. Ch. 1988).

¹⁴⁸ Stahl v. Apple Bancorp, Inc., 16 Del. J. Corp. L. 1573, 1585 (Del. Ch. 1990).

¹⁴⁹ *Id.* at 1586.

¹⁵⁰ Revlon, Inc. v. Macandrews & Forbes Holdings, 506 A.2d 173 (Del. 1986).

¹⁵¹ Limiting this point, Abrams notes that many Boards in the early nineties entered in agreements to modify the reach of these group activity pill triggers. Warren and Abrams, *Evolving Standards of Judicial Review of Procedural Defenses in Proxy Contests*, 47 BUS. LAW. 647, 670 n. 98 (1992)(citing Centaur Partners, IV v. National Intergroup, Inc., 582 A.2d 923, 928 (Del. 1990); Henley Group, Inc., 13 Del. J. Corp. L. at 1163).

This is not to say that the poison pill is an absolute defense against proxy fights in the same way that it is an absolute defense against tender offers. Depending on how the pill is interpreted, and whether it lumps communicating shareholders together for purposes of their ownership percentage sufficient to trigger the pill, it may serve as a powerful deterrent to proxy fights. But a shareholder willing to lead a proxy fight independently and regardless of only owning a small percentage of shares can still wage a successful proxy contest despite the presence of the poison pill in the charter or bylaws. The presence of the pill just makes the enterprise that much more costly and risky.

The poison pill will be a more powerful deterrent in the proxy access sphere because the types of shareholders likely to use proxy access—large institutions uninterested and unable to acquire control of the company through the contest—will be precisely the types of shareholders most likely to be deterred by a poison pill. The intersection of *Blasius* and the takeover jurisprudence in this area is not yet developed enough to make broad predictions about how Delaware courts are likely to react to such a use for the pill, but many opportunities for defensive posturing remain open to companies with strong poison pills.

Once the legitimacy of defensive tactics was secured as a general matter, the court began to consider how to review a board's decision whether or not to redeem the defensive measure. Under *Unocal*, defensive tactics presenting the possibility that the board is acting out of a desire to perpetuate itself in office are reviewed under a balancing test where the board must demonstrate that it had reasonable grounds to believe a threat to the corporation existed and that the defensive measure is reasonable in relation to the threat posed.¹⁵² Once that test is passed, the board's decision to adopt or maintain the defense at issue will be reviewed under the business judgment rule. One threat that the Delaware courts have accepted as legitimately justifying a

¹⁵² *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).

takeover defense is the prospect that a takeover bid would hurt the long-term strategic plan of a corporation, including threats to its corporate culture and the editorial integrity of its media properties.¹⁵³

In the subsequent *Revlon* case, the court considered how *Unocal* duties should be reviewed when a company is up for sale and subsequent bidders emerge seeking to obtain control of the company.¹⁵⁴ *Paramount v. QVC*¹⁵⁵ tailored the application of *Unocal* and *Revlon* to consider changes in control as the primary motivation for defensive tactics. In part, *Paramount v. QVC* considered whether minority shareholders in a company without a majority shareholder enjoy a more advantageous position to minority shareholders in a company with a majority shareholder.¹⁵⁶ The court focused on how the receipt of a control premium is what compensates shareholders for this, and that defensive measures are justified by their ability to help directors secure that control premium for the shareholders.¹⁵⁷ Though the election of a minority of insurgent directors would involve incremental increases in control for the minority slate, a nominating shareholder would not be permitted under the federal proxy access rule to use federal proxy nominations to facilitate acquisition of a majority of the board. Therefore proxy defenses of the type considered here would likely not implicate *Revlon* duties.

In *Mentor Graphics v. Quickturn*¹⁵⁸ and *Carmody v. Toll*,¹⁵⁹ the court considered application of a set of unique twists on the poison pill idea. *Carmody* considered a “dead hand” pill which would prevent any director except those in office as of the plan’s adoption from

¹⁵³ *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1155 (Del. 1989).

¹⁵⁴ *Revlon, Inc. v. Macandrews & Forbes Holdings*, 506 A.2d 173 (Del. 1986).

¹⁵⁵ *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34, 43 (Del. 1994).

¹⁵⁶ *Id.*

¹⁵⁷ *Id.*

¹⁵⁸ 728 A.2d 25 (Del. Ch. 1998).

¹⁵⁹ 723 A.2d 1180 (Del. Ch. 1998).

redeeming the pill prior to its expiration.¹⁶⁰ The court invalidated that provision in part on the grounds that disparate voting rights for directors must be placed into the charter, requiring shareholder approval, and that limiting director power in this way would impermissibly interfere with the board's authority to manage the business and affairs of the company.¹⁶¹ The court went even further, however, to consider plaintiff's claim that the dead hand pill constituted a fiduciary duty violation. The court held that both claims were cognizable under Delaware law. In that case the court held that the dead hand pill purposefully disenfranchised shareholders because

even in an election contest fought over the issue of the hostile bid, the shareholders would be powerless to elect a board that is both willing and able to accept the bid, and they "may be forced to vote for [incumbent] directors whose policies they reject because only those directors have the power to change them."¹⁶²

In the court's reasoning it noted that one of the justifications in *Moran* was that the poison pill at issue there would have a limited effect on a proxy contest.¹⁶³ The court also considered a second line of challenge under *Unocal/Unitrin* and noted a cognizable claim that the dead hand pill rendered a successful contest impossible, and could be found preclusive, under similar reasoning.¹⁶⁴

In *Quickturn*, the court considered a dead hand provision with a more limited continuing director provision that merely delayed redemption of the pill for a six month period. In spite of the possibility that the delay would cause a significant percentage of shareholders not to vote in favor of the hostile slate, the dead hand provision in that context was not preclusive but was, however, a disproportionate response as the board was unable to articulate why a delay of that

¹⁶⁰ Carmody v. Toll Bros., Inc., 723 A.2d 1180, 1184 (Del. Ch. 1998).

¹⁶¹ *Id.* at 1191. [Carmody]

¹⁶² *Id.* at 1193 (citing Jeffrey N. Gordon, "Just Say Never" *Poison Pills, Deadhand Pills and Shareholder Adopted By-Laws: An Essay for Warren Buffett*, 19 CARDOZO L. REV. 511, 540 (1997)). [Carmody]

¹⁶³ *Id.* [Carmody] By contrast, the court previously noted, without object, that poison pills did in fact have a significant dampening effect on proxy contests.

¹⁶⁴ *Id.* at 1195. [Carmody]

length was necessary.¹⁶⁵ Vice Chancellor Strine has offered criticism of the holding in *Quickturn*, noting that its broad reach to prohibit boards from binding the actions of future boards puts into jeopardy many long-term contracts that companies typically enter into during the ordinary course of business.¹⁶⁶ He also noted that perhaps the reach of that holding should be constrained to circumstances involving the poison pill.¹⁶⁷

In *Selectica, Inc. v. Versata Enterprises, Inc.*¹⁶⁸, the court considered challenge to a poison pill triggered upon unauthorized shareholder ownership of as little as 4.99% of the voting securities of the company. The court's holding was motivated in large part by the possibility that the acquisition of the block would, under various tax code provisions, hinder the value of the company's existing net operating losses ("NOLs").¹⁶⁹ Shareholders with greater than 5% of the voting securities were considered owners under the tax provisions, and the prospect of their acquiring additional shares put the status of the NOLs, a substantially valuable asset from the company's perspective, in jeopardy. Notably, in its adoption of the new pill the board grandfathered in existing 5% shareholders.

The numerical value of this pill is particularly interesting in light of the 5% trigger incorporated into the SEC's previous proxy access rule. At companies in the situation of *Selectica*, adoption of a poison pill with a 4.99% trigger would also have the side benefit of prohibiting new shareholders from acquiring sufficient voting securities to actually nominate candidates to the corporate proxy. If that were the case, proxy access could be avoided

¹⁶⁵ *Mentor Graphics Corp. v. Quickturn Design Systems, Inc.*, 728 A.2d 25, 51 (Del. Ch. 1998).

¹⁶⁶ If Corporate Action is Lawful, *supra* note 18, at 896.

¹⁶⁷ *Id.* Much of this analysis will turn on whether a board's decision to try and sidestep shareholder nominations under the federal process, or to make use of that process more difficult, will be considered to "touch upon issues of control" and whether it "purposefully disenfranchises shareholders" if shareholder maintain the right to nominate and vote for an alternative set of directors through an independently financed solicitation. *See Stroud v. Grace*, 606 A.2d 75, 92 n.3 (Del. Supr. 1992).

¹⁶⁸ *Selectica, Inc. v. Versata Enterprises, Inc.*, 2010 WL 703062 *1 (Del. Ch. 2010).

¹⁶⁹ *Id.*

altogether for new shareholders. Former 5% shareholders would, however, retain the ability to nominate.

It is unlikely that the Delaware courts would sanction a broad application of *Selectica* beyond its particular facts under existing law, since the pill was designed in relation to the threat of losing valuable assets rather than with the purpose of expressly limiting shareholder challenge. The threat of damage from an insurgent board member that managers could plead is likely not as strong or apparent as the threat of losing a NOL, which can be valued more directly, and thus boards would likely need something more to justify the low threshold.¹⁷⁰

And yet on the other hand, it also is not clear that the Delaware courts would reject such an approach outright using the *Blasius* standard. At the very least, the intersection of the 4.99% poison pill permitted in *Selectica* and the 5% holding limitation tacked onto the proxy access rule leave open room for strategic behavior by managers looking to use poison pills as a defense to proxy access.

Again, pill triggers designed to limit shareholder nomination rights do not necessarily implicate *Blasius*, since they do not necessarily interfere with the shareholder franchise but instead merely interfere with one avenue for shareholder nominations. One way to temper the courts' hostility to broad poison pills limiting the shareholder nomination rights could be that the low trigger pill adopted by the board could include an express provision permitting shareholders to exceed the low threshold, but not a higher threshold like 15%, and automatically obtain a waiver from the board if the shareholder signed a standstill agreement contracting not to nominate shareholders under the SEC's proxy access rule. That would eliminate much of the harm the court considered from the low trigger pill in *Selectica*.

¹⁷⁰ The court noted in *Selectica* that “the 5% trigger necessary for an NOL pill to serve its function imposes a far greater cost on shareholders than the pill thresholds traditionally employed and held as acceptable by our Courts in the anti-takeover context.” *Id.* at *15.

A defensive measure can be invalidated under *Unitrin* where it “precludes effective stockholder action.”¹⁷¹ But such a mechanism would still permit shareholder funded solicitations for a shareholder with greater than 5% ownership but less than 15%, and the pill would still be reviewable under existing jurisprudence for board reaction to shareholders attempting to exceed 15% ownership. The question would be whether sidestepping federal proxy access rules is something the court considers a measure that precludes effective action, which would concomitantly require the court to hold that independent shareholder solicitations are so inferior to nominations to the corporate proxy under the SEC’s system that an inability to use the SEC’s approach threatens the shareholder franchise and/or was preclusive and coercive.¹⁷²

Another important way to ensure the defensive use of poison pills is upheld would be for the board to adopt a bylaw establishing a shareholder’s right to nominate candidates to the corporate proxy in a manner separate and entirely different than the federal proxy access right, and further exempt from application defensive measures designed to hinder the nomination under the federal proxy access right.

A related issue is the use of proxy put provisions in debt covenants to accomplish the same principal objective of poison pills, but through the use of debt rather than equity and directed at proxy contests rather than share acquisition. In *San Antonio Fire and Police Pension Fund v. Amylin*, the court considered a “proxy put” provision in debt covenants which would permit debtholders to accelerate their debt and demand repayment in the event shareholders elected to the board a majority of directors who were not approved by the incumbent directors.¹⁷³ The court held that the provisions were permitted as a general matter, since the directors could

¹⁷¹ *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1388-89 (Del. 1995).

¹⁷² Such a holding would be fairly bold and unprecedented under a corporate code which until recently was unclear on whether shareholders had the right to adopt bylaws permitting shareholder access to the corporate proxy.

¹⁷³ *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc.*, 983 A.2d 304, 306 (Del. Ch. 2009).

have approved shareholder nominees under the proxy put provisions, and would be governed by standard fiduciary duties.¹⁷⁴ But the court also noted that if a similar indenture provision prohibited the board from stopping the acceleration clause, and ultimately operated to inhibit the shareholder franchise, then such a provision would raise concerns about “the exercise of the board’s fiduciary duties in agreeing to such a provision” and that “[t]he court would want, at a minimum, to see evidence that the Board believed in good faith that, in accepting such a provision, it was obtaining in return extraordinarily valuable economic benefits for the corporation that would not otherwise be available to it.”¹⁷⁵ Additionally, “the Court would have to closely consider the degree to which such a provision might be unenforceable as against public policy.”¹⁷⁶ This dicta suggests that a hard proxy put that did not leave room for board discretion in approving nominees from insurgents may be ruled invalid under existing law. With the likelihood that such contracts will only become more popular in the wake of federal proxy access, the Delaware courts will soon need to revisit the dicta in *Amylin* and consider a more precise delineation for the boundaries of permissible embedded defenses like proxy puts.

D. *Blurring the Line: the Blending of Unocal and Blasius*

The Delaware courts’ review of proxy defenses became entangled with its review of takeover defenses because, after the innovation of the poison pill, bidders began using proxy fights as an alternative method for instituting a hostile acquisition.¹⁷⁷ The court has summarized the interplay of *Unocal* and *Blasius* succinctly: “In reality, invocation of the *Blasius* standard of

¹⁷⁴ *Id.* at 307. [Amylin]

¹⁷⁵ *Id.* at 315. [Amylin]

¹⁷⁶ *Id.* at 315. [Amylin]

¹⁷⁷ *In re Gaylord Container Corp. Shareholders Litig.*, 753 A.2d 462, 482 (Del. Ch. 2000).

review usually signals that the court will invalidate the board action under examination. Failure to invoke *Blasius*, conversely, typically indicates that the board action survived (or will survive) review under *Unocal*.¹⁷⁸ Bebhuk similarly introduces the interaction between proxy fights and tender offers when he notes that *Unocal*, when it recognized the legitimacy of board power to block tender offers, relied in part on the fact that shareholders could replace the board if they did not like the board's defensive behavior.¹⁷⁹ The courts have typically recognized three legitimate threats in the takeover context: the risk of opportunity loss that a hostile offer may eliminate the possibility of alternative offers, the risk of structural coercion in a tender offer, and the risk that shareholders will fail to appreciate the managers' representations about underlying value.¹⁸⁰ One important question in considering how these cases apply to the analysis is whether the law governing takeover defenses would or should also apply to proxy fight defenses, particularly since most shareholders in this context will be running a short slate for minority representation on the board.

The courts have recognized the inherent congruence between the “compelling justification” enhanced standard of review under *Blasius* and the extension of that rationale within the *Unocal* enhanced standard of judicial review.¹⁸¹ The courts have also noted, however, that the two standards are not mutually exclusive and has frequently offered redundant recitation of the two standards with similar results in cases finding a failure to meet the standard.¹⁸² Thus, the justification required to meet the compelling justification standard of *Blasius* is the same regardless of whether the decision under challenge occurred within the context of a change of

¹⁷⁸ *Chesapeake Corp. v. Shore*, 771 A.2d 293, 323 (Del. Ch. 2000).

¹⁷⁹ Bebhuk Myth, *supra* note 3, at 680.

¹⁸⁰ *Mentor Graphics Corp.*, 728 A.2d at 45. Notably, one element of the *Unocal/Unitrin* review that is expressly not grafted into *Blasius* review is the legitimacy of the defense that shareholders may make a poorly advised choice in their selection of a director. See William T. Allen, Jack B. Jacobs & Leo E. Strine, *Function over Form: A Reassessment of Standards or Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1321 (2001).

¹⁸¹ *MM Cos., Inc.*, 813 A.2d at 1129.

¹⁸² *Id.* at 1130.

control or otherwise.¹⁸³ Since the opinions in the area have typically involved *Blasius* analysis in the context of a *Unocal/Unitrin* situation, it becomes difficult to separate the courts' analysis under the two standards as they are typically viewed together. Thus, it remains unclear the extent to which the courts might be expected to use precedent from these takeover situations in situations in which insurgents seek a minority of board seats.

The proxy access changes at the federal level promise to significantly alter this dynamic. Contested elections have traditionally been part and parcel of a tender offer. This may have been because only the prospect of a control acquisition would make a proxy contest financed by the challenger worthwhile. With access to the corporate proxy, however, more contested solicitations should be expected that do not dovetail with tender offers. As such, Delaware may be forced to further develop its *Blasius* jurisprudence independent of *Unocal* and *Unitrin*. In so doing, it will need to delve into the compelling justification test to consider the incidences of conflicted shareholders and whether it will accept the costs of shareholder activism described in Part II of this article as meeting the compelling justification test of *Blasius*. It will also, of course, need to consider whether to apply *Blasius* at all in the event defenses are surgically targeted solely at shareholder nominations via the federal regime.

In the one available articulation of behavior rising to the level of compelling justification under the *Blasius* standard, the court has considered defensive measures designed to impede the voting rights of a controlling shareholder who had threatened to use his power to facilitate breaches of his contractual and fiduciary duties.¹⁸⁴ Expanding that articulation to also include a threat perceived by the board for a conflict of interest faced by institutional shareholders could be a natural continuation of that analysis, but it would also require an expansion of the range of

¹⁸³ *Id.*

¹⁸⁴ *Hollinger Int'l, Inc. v. Black*, 844 A.2d 1022, 1089 (Del. Ch. 2004).

activities currently understood under the limited number of cases actually analyzing the “compelling justification” prong of the *Blasius* test. In one case, the Court of Chancery offered in dicta that “I do not believe that the use of a test of this kind should signal a tolerance of the concept of ‘substantive coercion’ in the director election process. The notion that directors know better than the stockholders about who should be on the board is no justification at all.”¹⁸⁵ In that case, Vice Chancellor Strine did note that his decision not to recognize the differing motivations of shareholders was premised on a lack of economic justification from the defendants for why that might be.¹⁸⁶

In defining the interplay of *Blasius* and *Unocal*, the court has noted that

the *Blasius* standard should be reformulated in a manner consistent with using it as a genuine standard of review that is useful for the determination of cases, rather than as an after-the-fact label placed on a result. Such a reformulation would be consistent with prior decisions recognizing the substantial overlap between and redundancy of the *Blasius* and *Unocal* standards, and would have the added benefit of creating a less prolix list of standards of review. Notably, however, the Delaware Supreme Court's recent decision in *Liquid Audio* continued to employ the ‘compelling justification’ language of *Blasius* within the context of an appropriate *Unocal* review of director conduct that affects a corporate election touching on corporate control.¹⁸⁷

The case of *Chesapeake v. Shore*¹⁸⁸ offers an example of this merged standard of review in action. In reviewing a supermajority voting bylaw, the court held under the *Unocal* standard that for such a bylaw to survive it must show that the challenging shareholder could reasonably attain the votes necessary to amend the bylaws, and that under a 90% turnout attaining the 60% supermajority would be mathematically impossible.¹⁸⁹ The court, however, rejected the same bylaw under the *Blasius* standard, since it required a supermajority vote of the disinterested

¹⁸⁵ *Mercier*, 929 A.2d at 811.

¹⁸⁶ *Id.* at 815. However, a similar defendant, justifying their defensive measure on grounds similar to this articles view of the how institutional economic literature presents significant costs from empowered but conflicted shareholders, may fare better.

¹⁸⁷ *MM Cos. v. Liquid Audio, Inc.*, 813 A.2d 1118, 1129-31 (Del. 2003).

¹⁸⁸ *Chesapeake Corp. v. Shore*, 771 A.2d 293, 334 (Del. Ch. 2000).

¹⁸⁹ *See id.* at 334. The court, however, declined to hold that supermajority voting bylaws were outright invalid, noting that the timing of the bylaw in response to a takeover threat and the lack of sufficient deliberation by the board played a primary role in the court's decision. *Id.* at 343.

shareholders. It also worked to minimize the voting power of the challenging shareholder. Instead, the court determined that the threat identified, that of an all-shares, all-cash tender offer, could not meet the compelling interest requirement of *Blasius*.¹⁹⁰ However, a different threat may offer a different result, such as an argument that the threat of a dissident board member could squash pending deals or present conflicts unclear at the time to the shareholders.¹⁹¹

Vice Chancellor Strine, Justice Jacobs, and former Chancellor Allen have all written that the fundamental problem with the *Blasius* standard is that it offers little additional guidance to judges going forward that is not already subsumed by the *Unocal* and *Revlon* standards. Instead, it is simply an outcome determinative test, and they argue for an elimination of the *Blasius* standard as a standalone test.¹⁹² Thus, the Delaware jurists behind many of the leading cases interpreting *Blasius*, as well as the author of the *Blasius* case itself, believe that *Blasius* review should be completely subsumed into the *Unocal/Unitrin* line of cases.¹⁹³ It is unclear whether they also considered the circumstances of a post-proxy access world, and whether they would encourage a renewed growth of the *Blasius* standard considered independently for this unique twist or would instead hold firm with their argument that the *Unocal/Unitrin* line of cases offers sufficient conceptual rigor to handle the battle that will ensue. This article will therefore give thought to both possibilities.

E. *Proxy Defenses Reconsidered*

¹⁹⁰ *Id.* at 345.

¹⁹¹ Importantly, though, supermajority voting restrictions are generally upheld, thus leading us to conclude that some restrictions on the shareholder franchise are permissible beyond merely procedural restrictions.

¹⁹² See William T. Allen, Jack B. Jacobs & Leo E. Strine, *Function over Form: A Reassessment of Standards or Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1314 (2001). Notably, this argument preceded the advent of proxy access, and the likely maneuvering of boards faced with the prospect of an electoral challenge facilitated by a federal proxy access right outside of the context of a change of control transaction.

¹⁹³ William T. Allen, Jack B. Jacobs & Leo E. Strine, *Function over Form: A Reassessment of Standards or Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1316 (2001).

In tension with the seemingly harsh review of *Blasius* is the fact that the Delaware courts have approved, under the right circumstances, an array of defenses that severely limit the shareholder franchise within the takeover context. Some of these limitations are specifically authorized under the DGCL and some are not, but all of them are constrained by equity, including poison pills,¹⁹⁴ limits on action by written consent, limits on the right to call a special meeting, supermajority vote requirements to amend the bylaws, advance notice requirements, stock repurchases, and staggered boards.¹⁹⁵

Two questions then will need to be answered in order to develop a useful and consistent jurisprudence in this area. First, outside of the context in which proxy fights accompany takeover fights, and are instead proxy fights for a minority position on the Board, just what threats will the Court of Chancery recognize as legitimate under *Unocal* in reference to fights for incremental changes in control? And what defenses would be considered proportional to those threats? Second, if the court applies *Blasius* rather than *Unocal* in those situations, will it begin to actually accept a level of threat as a compelling justification? Will it tailor the reach of *Blasius* so that it is no longer an outcome-determinative standard in which application results in an effective judgment against the defensive measure?

1. *Blasius* or *Unocal*: Which Will Control?

¹⁹⁴ One of the principal arguments raised against the poison pill was that it used a corporate power to discriminate against a single shareholder, but the court in *Moran* rejected that argument. 500 A.2d at 1359. And by discriminating against an individual shareholder, the clear and purposeful result is that the shareholder will be less likely to amass a sufficient stake, and therefore have a sufficient percentage of the company to give him the incentive to finance a proxy contest before even knowing whether shareholders will accept the tender offer. In fact, the court has even commented that this result is intentional. Despite the fact that the effect on the shareholder vote is indirect, it is nonetheless intentional and quite powerful. So we cannot say that board management of the voting system to thwart the will of a majority of shareholders is not without legal grounding in the right circumstances.

¹⁹⁵ *In re Gaylord Container Corp. Shareholders Litig.*, 753 A.2d at 481.

First, we should consider the set of circumstances that would justify defensive action against a minority insurgent slate running on the corporate proxy. The general issue concerns threats to board stability and the prospect of financing a candidate who is motivated by personal or conflicted concerns. Part II of this paper displayed a variety of both institutional economic and empirical arguments that could potentially serve as the basis for such a threat. Delaware courts have touched on a similar analysis before, as the case of *Grobow v. Perot* recognized the threat that a hostile director could pose to the effective functioning of a company and its board.¹⁹⁶ If the court reviewed non-takeover proxy defenses under a *Unocal/Unitrin* analysis it may still find such a threat insufficient to support the particular defense employed. However, it would seem more appropriate for the court to consider *Blasius* challenges independently.

The case of *AFSCME v. CA*¹⁹⁷ is particularly interesting in considering this question. In *AFSCME v. CA*, the court held that the stockholder's power to adopt bylaws under DGCL 109(a) may not limit the board's authority under Section 141(a) to manage the business and affairs of the company.¹⁹⁸ In determining which shareholder adopted bylaws are permissible, the court articulated 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."¹⁹⁹ The court expressly pointed to the procedural provisions included in Section 141. The director qualification statute expressly provides for director qualification bylaws as permissible under Section 141. Thus it seems clear that the shareholders will share authority with the board to amend the bylaws to provide for director qualification provisions.

¹⁹⁶ *Grobow v. Perot*, 539 A.2d 180, 184 (Del. 1988).

¹⁹⁷ *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227, 232 (Del. Supr. 2008).

¹⁹⁸ *Id.*

¹⁹⁹ *Id.* at 235.

The court in *AFSCME v. CA* considered a shareholder proposed bylaw mandating the reimbursement of expenses for victorious challenges. The court noted that such a bylaw was designed to facilitate the shareholder's interest in nominating alternative candidates, and that such an interest was an important part of the shareholder franchise as protected by *Blasius*. The court noted that shareholders have a legitimate interest in facilitating their voting rights by facilitating their participation in nominating alternative nominees.²⁰⁰ The fact that the court cited *Blasius* in considering whether the shareholder bylaw was legally permitted does not mean, however, that board maneuvering to limit the reach of shareholder nominations from federal regulations necessarily implicates *Blasius* review. The court expressly limited its holding to consideration of whether the shareholder proposed bylaw was "legally permitted under the DGCL."²⁰¹

Another core holding of *AFSCME* is that there are circumstances under which a board's fiduciary duty may prohibit it from reimbursing the election expenses of a shareholder challenging the board, even if that shareholder is victorious. The court's analysis centered on the possibility that the alternative slate was motivated solely by personal reasons, and that Delaware law may prohibit reimbursement of expenses for an election contest motivated solely by personal reasons.²⁰² In the hypothetical considered by the court in *AFSCME*, nominations directly to the corporate proxy could be even worse as it would not be limited only to victorious contests, but would require corporate expenditures in sending out proxy cards up front for contests in which the insurgent loses.

It would also therefore follow from *AFSCME* that there are a range of circumstances under which boards would not only be allowed, but their fiduciary duty would in fact require,

²⁰⁰ *Id.* at 237.

²⁰¹ *Id.* at 240.

²⁰² *Id.* (citing *Hibbert v. Hollywood Park, Inc.*, 457 A.2d 339, 345 (Del. 1983)).

taking reasonable and proportionate steps to impede a shareholder candidate financed on the corporate proxy. The court held that the fact that the limitation on the board's ability to exercise their fiduciary duties would in that case be approved by a majority of shareholders did not matter.²⁰³ This would give some credence to the use of election expense bonds in advance of shareholder nominations to the corporate proxy in particular, but this holding would also have significance for nearly all of the board defenses considered in this article.

One way to write proxy access defenses to limit the difficult scrutiny of *Blasius* may be to limit their application only to situations in which a covered shareholder is attempting to access the company's proxy. In effect, it would make clear that the primary purpose of the defensive provision was not to interfere with the shareholders right to vote, or the shareholders right to nominate an alternative slate, but merely to interfere with an attempt by a specific class of shareholders to nominate candidates on the company proxy. Note, for example, how in *Unitrin* the board's use of a share repurchase was upheld because the shareholders retained sufficient voting power to challenge the incumbent board and nominate their own candidates through a self-financed election.²⁰⁴ Also note that the DGCL permits, but does not require, bylaws facilitating shareholder access to the corporate proxy. Thus there is judicial as well as legislative recognition that nominations to the corporate proxy are not a necessary condition to full enjoyment of the shareholder franchise.

2. Determining the Legality of Proxy Access Defenses under Delaware Law

The proxy access defense considered in this paper that stands the greatest chance of being

²⁰³ *CA, Inc.*, 953 A.2d at 239.

²⁰⁴ *Unitrin*, 651 A.2d 1361.

upheld in Delaware would seem to be director qualification bylaws. Section 141(b) of the DGCL notes that “The Certificate of Incorporation or bylaws may prescribe other qualifications for directors.” In *Stroud v. Grace*, the court considered a director qualification provision requiring that a majority of directors have “substantial experience in line (as distinct from staff) positions in the management of substantial business enterprises or substantial private institutions, who are not officers, employees or stockholders, whether of record or beneficially, of the corporation or any of its subsidiaries.”²⁰⁵ In that case the burden of proving that the provision was inequitable fell on the plaintiffs, since the provision was approved by a majority of shareholders.²⁰⁶ The court has elsewhere held that qualification provisions that are reasonable will be held valid.²⁰⁷

As long as the director qualifications are applied on the front end, prior to a director being qualified, rather than on the back end in an attempt to unseat a previously qualified director, director qualification provisions have typically been upheld under Delaware law.²⁰⁸ Director qualification bylaws have most frequently been seen used by insurgents as a technique to acquire control rather than as a defensive mechanism for boards.²⁰⁹ Ultimately this issue may be the best test case for Vice Chancellor Strine’s insight about *Schnell v. Chris-Craft* that if the DGCL authorizes action, then presumably there must be some set of circumstances under which it is equitable for a board to take that action.

Another defensive maneuver that would seem to have a high likelihood of withstanding challenge would be the notion of making insurgent challenge less valuable in relation to alternatives. The court has noted that a board may take action to encourage shareholders to vote

²⁰⁵ *Stroud*, 606 A.2d at 93.

²⁰⁶ *Id.*

²⁰⁷ *Stroud*, 606 A.2d at 93.

²⁰⁸ *Kurz*, 989 A.2d at 157 (reversed in part on other grounds).

²⁰⁹ *See, e.g., Diceon Electronics, Inc. v. Calvary Partners*, 1990 WL 237089, 1 (Del. Ch. 1990).

in favor of, for example, merger agreements.²¹⁰ For instance, they may spend corporate funds on printing and distributing proxy statements and publication of their views in favor of a particular merger.²¹¹ They may not, however, coerce the shareholder vote by, for example, agreeing to restrictive provisions in the merger agreement that force shareholders to vote on a basis unrelated to the underlying merits of the transaction in question.²¹² This may have some constraining effect on shareholder dividends contingent on election of only those candidates approved by the nominating committee of the board would survive challenge.

There is some risk that such a maneuver could still be considered vote-buying under Delaware law, even if it otherwise survived *Blasius* review, but the matter remains as yet unsettled. Delaware's law on vote-buying jurisprudence does not go so far as to prohibit all exchanges of consideration in exchange for a stockholder's agreement to vote a certain way.²¹³ Indeed, voting trusts and voting agreements, in which the parties jointly exchange the consideration of voting for each other's candidates, are explicitly permitted by statute.²¹⁴ Vote-buying is subject to a two-part test, the first part being that if a challenging shareholder can show that the vote-buying was motivated by an "object or purpose to defraud or in some way disenfranchise the other stockholders" it will be expressly prohibited.²¹⁵ Then, even if properly motivated, a vote-buying transaction would still be a voidable transaction subject to a test for entire fairness.²¹⁶ Where the vote-buying accrues to all shareholders equally, it would seem able to pass this test. Indeed, rather than express vote-buying, it would actually be a case of a payment the board would otherwise make, though it is not required to make until approved, that

²¹⁰ *In re MONY Group Inc. S'holder Litig.*, 853 A.2d at 676.

²¹¹ *Id.* [MONY Group]

²¹² *Id.* [MONY Group]

²¹³ *Portnoy v. Cryo-Cell Intern., Inc.*, 940 A.2d 43, 67 (Del. Ch. 2008).

²¹⁴ *See* 8 Del. C. § 218.

²¹⁵ *Schreiber v. Carney*, 447 A.2d 17, 25-26 (Del. Ch. 1982).

²¹⁶ *Id.*

is withheld upon a certain event. So in effect, it is actually the converse of explicit vote-buying targeted to particular shareholders.

A number of the possibilities offered by this paper would likely be subjected to more rigorous review, but may still be feasible options.²¹⁷ In reviewing a proxy defense constructed as an employee pension plan heavily funding with corporate stock, which had the effect of diluting shareholder votes by 10% at the expense of employee shareholders, the court ruled that application of the *Blasius* standard was not appropriate, and that rather the balancing test of *Unocal* would be applied.²¹⁸ The court expressed doubt that, in that instance, the defensive measure would pass the second prong of *Unocal* and be sustained as reasonable in relation to the threat posed on the grounds that the board failed to even consider alternative measures. It did, however, recognize the legitimacy of the threat perceived by the board in their fear that the new bidder would cause significant employee unrest. If the court was willing to expand the reach of threats recognized as legitimate to include those related to the presence of a minority of insurgent board representation, this avenue may remain open. As such, it leaves open room for tactics like tin parachutes, targeted share issuances, and proxy puts.

The court has upheld severance packages that are triggered upon a change of control, and indeed golden parachutes are fairly widespread.²¹⁹ What remains to be seen is whether the court will also accept severance packages triggered upon a partial change in control. If the prospect of job loss for loyal employees fighting to protect the best interests of the organization is the primary motivator for those agreements, and the primary reason the court accepts executive severance agreements under *Unocal*, then one wonders whether proxy fights for partial control of the board will also represent legitimate justification as well. If, for example, independent

²¹⁷ Golden parachutes and tin parachutes would seem to fall under this category.

²¹⁸ *Aquila, Inc. v. Quanta Servs., Inc.*, 805 A.2d 196, 205 (Del. Ch. 2002).

²¹⁹ *Hills Stores Co. v. Bozic*, 769 A.2d 88, 108 (Del. Ch. 2000).

directors of the board are capable of being swayed into coalitions with the insurgent nominees, and the new members oppose the current managers, then some of the same risks which the court accepts in the full change-of-control context of takeovers would still be present for short slate nominations representing a more incremental change in control. The probability of the outcome may be less certain with a challenger who obtains less than a majority of shares, and they may even be required to certify a lack of control intent under the federal proxy access rule, but the magnitude of outcome could be just as significant for executives through the coalitions that form as a result.

The notion of permanently appointed board members may be the most difficult for Delaware courts to stomach. The Court of Chancery addressed the question of self-perpetuating boards in *Comac Partners v. Ghaznavi*, where in interpreting a classified board charter amendment it found that directors were not explicitly permitted to choose other directors for the initial terms of the classified board.²²⁰ That holding rested largely on the fact that the charter amendment did not explicitly provide for board appointment of directors, though it did note in dicta that

[i]t is odd to think that a sitting board of directors of an existing corporation can be empowered by a certificate provision to elect itself to new terms in the future, without further stockholder involvement. Our statutory scheme generally anticipates that the election of directors will be by the stockholders on an annual basis.²²¹

Though recognizing that the DGCL permits directors to appoint holdover directors on an interim basis, the court generally seems to indicate that annual elections for directors whose term is up during that year is a necessary foundation for the discretion directors are afforded.²²² The

²²⁰ *Comac Partners, L.P. v. Ghaznavi*, 793 A.2d 372, 380 (Del. Ch. 2001).

²²¹ *Id.* at 380.

²²² *See id.* at 381 (citing *Rohe v. Reliance Training Network, Inc.*, C.A. No. 17992, mem. op. at 26 (July 21, 2000) (“Under Delaware law, a certificate of incorporation cannot specify the directors of the corporation for more than an initial period. And except in the case of a properly classified board, all directors must face the electorate on an annual basis at the corporation's annual stockholder's meeting.”)).

notion of directors appointing other directors on a permanent basis goes against the court's understanding of the DGCL.²²³ Challenges to board appointment of directors have generally dealt with board self-perpetuation by appointing a majority of the board, so the court's hostility to self-perpetuating directors may be mollified somewhat if only a minority of directors are board appointed. Delaware has also upheld an agreement among all stockholders permitting a minority of shareholders appointment rights to a specified number of board seats.²²⁴ Thus, if a minority of shareholders can appoint a group of directors, why could not that same group grant directors the power to similarly appoint other directors on their behalf? Still, such a radical new change may require amendment to the DGCL to minimize the risk of uncertainty.

If indeed the takeover jurisprudence is grafted onto review of non-takeover proxy fights, there is some hope that selectively omitting the voting power of certain institutions may be permissible. The Delaware courts consider a defensive measure coercive when it operates to force management's preferred alternative upon stockholders.²²⁵ But as long as the percentage of management's voting stake is not dramatically increased by eliminating the conflicted votes, then the outcome remains out of management's hands and rests instead with the other non-conflicted shareholders. For this reason, a provision limiting the ability of conflicted shareholders to vote may have some hope of survival if it would bring the conflicted votes back into the tally where a majority of non-conflicted shareholders voted to permit the conflicted shareholders to vote in that particular election.

Delaware has noted that a contract will be unenforceable where it will require the board to refrain from action where the board's fiduciary duties require action.²²⁶ The court has

²²³ *Comac Partners*, 793 A.2d at 381.

²²⁴ *McIlquham v. Feste*, 2002 WL 244859, 7 (Del. Ch. 2002).

²²⁵ *In re Gaylord Container Corp. Shareholders Litig.*, 753 A.2d at 480.

²²⁶ *Unisuper Ltd. v. News Corp.*, 2005 WL 3529317, 7 (Del. Ch. 2005).

emphasized that the abiding principle behind such contracts is a concern that they take power out of the hands of shareholders.²²⁷ The court noted however that where a contract puts “the power to block or permit a transaction directly in the hands of shareholders” then the specter of entrenchment is no longer present.²²⁸ By that reasoning, a bylaw provision which put into the hands of non-conflicted shareholders the ability to throw out votes of conflicted shareholders would seem to escape some of the motivations underlying review of defenses.²²⁹ Such a provision could be narrowly tailored, for example, so that it would be triggered only for cases in which access nomination is used, and only for those shareholders meeting a specific definition which could be a function of their conflicts with the company as well as the size of their holdings.

The notion of discriminating between different groups of shareholders is not entirely alien to the court. The court has noted on prior occasions that boards are permitted to consider the divergent interests of different shareholders, and by implication discriminate among those interests in favor of long-term shareholders. The court in *Unitrin*, for example, notes that

distinctions among types of shareholders are neither inappropriate nor irrelevant for a board of directors to make, *e.g.*, distinctions between long-term shareholders and short-term profit-takers, such as arbitrageurs, and their stockholding objectives. In *Unocal* itself, we expressly acknowledged that ‘a board may reasonably consider the basic stockholder interests at stake, including those of short term speculators, whose actions may have fueled the coercive aspect of the offer at the expense of the long term investor.’²³⁰

In dicta, the court has suggested that a vote of a majority of a minority of shareholders not subject to a particular voting agreement can act to ratify the voting arrangements of a majority block.²³¹ This analysis might also be used to argue that restrictions on shareholder voting may

²²⁷ *Id.*

²²⁸ *Id.*

²²⁹ This doesn’t answer the question of whether such a provision would itself need to be ratified by shareholders, but I would offer some protection to challenge if the board adopted such a provision by bylaw.

²³⁰ *Unitrin Inc.*, 651 A.2d at 1386 (citations omitted).

²³¹ *Portnoy*, 940 A.2d at 69.

be permitted as long as they are approved by a majority of those shareholders who are not actually proposing the limitation. It may be analogous to think of such a voting limitation as similar to supermajority voting requirements for shareholder amendments to the bylaws. Delaware permits, for example, supermajority voting requirements to eliminate a classified board.²³² Though it's still something of an open question whether supermajority voting requirements could be put in place for the actual election of directors, *Centaur Partners*²³³ leans in that direction.

With respect to using the poison pill as a defensive mechanism against shareholder proxy access, there would be a few avenues available. First, there is the obvious possibility that board's will rewrite their pills to capture communication between a nominating shareholder and other shareholders, such that their collective activity requires their collective holdings be measured together, and thus their holdings would trigger the pill and water down the value of their holdings. This article has already looked at the possibility of proxy puts, with the result that the court's dim view of them in the *Amylin* case bodes poorly for their future. A third option remains. The *Selectica* case offers some potential for favorable review of a low trigger pill. In the event that the trigger was set low enough such that no shareholder was able to acquire enough shares to meet the minimum shareholder requirements of federal proxy access laws, then no shareholder would be able to nominate candidates to the corporate proxy without the approval of management. Review of such a defensive tactic in Delaware could be helped by a provision in the low trigger pill providing that the shareholder in question would be automatically exempted in the event they executed a standstill agreement contracting not to nominate directly to the corporate proxy.

²³² *Centaur Partners*, 582 A.2d at 928.

²³³ *Id.*

Flip-in pills are triggered when a shareholder obtains more than a specified percentage of shares in a company without approval of the board. When triggered, they give all shareholders other than the acquirer the opportunity to purchase additional shares at a discount.²³⁴ One way to implement a poison pill for this purpose would be to lower the trigger to 5%, in which case any shareholder who purchases a stake sizeable enough to meet the nominating provision would simultaneously suffer a significant decrease in their proportionate stake in the company. The lower threshold pill could then automatically allow that shareholder the option of receiving an exemption from application of the pill if they signed a standstill agreement in which they contract not to nominate candidates to the company's proxy. Triggers now are typically at the 10-20% shareholding level.²³⁵ Such a move would not limit shareholder voting rights, nor would it limit a shareholder's right to nominate an alternative slate, nor would it limit a shareholder's right to propose a bylaw provision commensurate with that permitted under *AFSCME v. CA* to reimburse successful insurgents for the cost of their expenses.²³⁶

3. Additional Considerations

It may also be the case that bylaws making nominations difficult for certain shareholders could not be challenged until the actual results of an election. Delaware has ruled, for example, that bylaws which presented the possibility of hypothetical risk of harm could not be challenged until the board actually used the bylaw to commit inequitable conduct.²³⁷ As such, even bylaws

²³⁴ See Bagley, *supra* note 13, at A-62.

²³⁵ *Id.*

²³⁶ The existing cases holding that the right to vote includes the right to nominate do not require that the right to nominate be without cost on the company's proxy. Indeed, the DGCL has taken an "opt-in" approach through the recent proxy access amendments, indicating that shareholders should also be permitted to tacitly opt-out.

²³⁷ *Stroud*, 606 A.2d at 96.

which could be subject to challenge upon their activation after an election, in which a dissident candidate won, could still serve as a deterrent to challengers and actually reduce their odds of victory or their interest in challenging the incumbent board in the first instance.²³⁸ As such, even defensive measures which seem to have low support in the existing case law, but which would not actually be justiciable in the Delaware courts until after the results of the election, would nonetheless have a powerful deterrent effect on the outcome for nominating shareholders and would also give the board significant negotiating leverage to obtain a compromise standstill agreement in advance of the election.

In cases in which the broad shareholder base may be willing to vote in favor of proxy defenses in advance of an actual contest or the heat of a specific corporate controversy, the board may consider putting proposed defenses to a shareholder vote for adoption in the charter rather than merely in the bylaws. One relevant question would then become whether the shareholder ratification doctrine would offer any benefit and remove the taint of a possible violation of the fiduciary duty of loyalty due to the director's entrenchment motive.²³⁹ *Gantler v. Stephens* offers the most recent iteration of the court's understanding of that doctrine, where the court found that the shareholder ratification doctrine applies only in cases where the shareholder vote approves director action for which the shareholder vote is not legally required.²⁴⁰ Taken literally, since a charter amendment requires a shareholder vote, it would not seem that the shareholder ratification doctrine would apply. However, if the same policy changes were instead placed into the bylaws by vote of the board, but the board sought a shareholder vote anyway, it would seem

²³⁸ This would, for example, accrue to the benefit of bylaws limiting the board's ability to indemnify, advance expenses, or obtain insurance coverage for successful candidates failing to obtain the endorsement of the board's nominating committee prior to the election.

²⁴⁰ *Gantler v. Stephens*, 965 A.2d 695, 713 (Del. Supr. 2009). Even then, shareholder ratification merely changes the standard of review to the business judgment rule. *Id.*

the shareholder ratification doctrine might be able to offer business judgment rule protection.

The timing of a board's decision to adopt these types of provisions will also be very important, and the rule is the earlier the better for purposes of surviving *Blasius* review. It would seem that the court will similarly view with heightened skepticism defenses against shareholder proxy access adopted in response to a specific perceived threat rather than adopted in advance of a specific contemplated challenge.²⁴¹ If not, then the court may impose the heightened standard of review used in the takeover defense context.²⁴² The court has subsequently determined that the *Blasius* decision was driven in large part due to the timing of the board's action.²⁴³ Delaware law actually encourages the adoption of defensive measures in advance of an actual contest rather than on the "eve of battle."²⁴⁴ Other cases have suggested that the fact that a board's decision regarding proxy procedures is taken before any knowledge of a contest or even a likely pending contested election is a helpful indication of appropriate board intent.²⁴⁵

Another vital element to any proxy access defense considered in this article or otherwise will be to ensure that they are very clearly drafted. Corporate bylaws and charter amendments are generally interpreted in the same way as other contracts, with one exception.²⁴⁶ When a corporate bylaw or charter amendment contains a restriction on the shareholder franchise, the

²⁴¹ See, e.g., *Openwave Sys.*, 924 A.2d at 243.

²⁴² See *Openwave Sys.*, 924 A.2d at 243-44 (citing *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del.1985); see also *Unitrin, Inc.*, 651 A.2d at 1378 ("This Court has been and remains assiduous in its concern about defensive actions designed to thwart the essence of corporate democracy by disenfranchising stockholders."); *Blasius Indus., Inc.*, 564 A.2d at 659, 669 ("There exists in Delaware a general policy against disenfranchisement." "The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests."); see also *Paramount Comm'ns, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 42 (Del.1994) ("Because of the overriding importance of voting rights, this Court and the Court of Chancery have consistently acted to protect shareholders from unwarranted interference with such rights."); *Wisconsin Inv. Bd. v. Peerless Systems Corp.*, 2000 WL 1805376, *7-8 (Del.Ch. Dec.4, 2000) (discussing *Blasius*); *IBS Fin. Corp. v. Seidman & Assoc's, L.L.C.*, 136 F.3d 940, 946 (3d Cir.1998) (relying on Delaware law to interpret New Jersey law finding improper manipulation of the number of board seats); *MM Cos.*, 813 A.2d at 1127).

²⁴³ *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 278, 286 (Del. Ch. 1989).

²⁴⁴ *In re Gaylord Container Corp. S'holders Litig.*, 753 A.2d 462, 478 (Del. Ch. 2000).

²⁴⁵ *Accipiter Life Sciences Fund, L.P. v. Helfer*, 905 A.2d 115, 127 (Del. Ch. 2006).

²⁴⁶ *Harrah's Entm't, Inc. v. JCC Holding Co.*, 802 A.2d 294, 309 (Del. Ch. 2002).

restriction must be clear and unambiguous in order to be sustained.²⁴⁷ For example, supermajority voting requirements which have the ultimate effect of disenfranchising a mere majority must be clear and unambiguous in order to take effect.²⁴⁸ If the court considers limitations on the shareholders right to nominate to also be a limitation on the franchise, then its strict interpretation of those types of provisions may also apply in this context.

Board proxy defenses adopted by bylaw amendment may be easier to implement, since they won't require a vote of the shareholders. Boards have had a particularly difficult time getting shareholders to approve anti-takeover defenses, so the prospect of shareholders adopting proxy access defenses may be equally unlikely.²⁴⁹ They would however be more open to challenge for inequitable conduct if they are not shareholder ratified. If the board has in place a provision requiring a supermajority vote for shareholders to amend the bylaws, as well as restrictions on the ability of shareholders to call special meetings, such a change may be nearly as concrete as a charter amendment as long as its withstands judicial review. In considering the adoption of proxy defenses, shareholder ratification may however be a more recommended option to limit the risk of a *Blasius* invalidation.²⁵⁰ The court has noted that *Blasius* will not be applied where a transaction limiting shareholder choice is approved by shareholders.²⁵¹

The question of the extent to which shareholders are permitted under Delaware law to self-restrict their own options, and tie themselves to the mast, is intimately linked with the dynamic nature of shareholding in liquid capital markets. The court has noted that “[t]he Board owes its fiduciary duties to the corporation and its stockholders, not merely a set of stockholders

²⁴⁷ *Harrah's Entm't, Inc.*, 802 A.2d at 310.

²⁴⁸ *Centaur Partners*, 582 A.2d at 927.

²⁴⁹ Michael Klausner, *Institutional Shareholders, Private Equity, and Antitakeover Protection at the IPO Stage*, 152 U. PA. L. REV. 755, 759-61 (2003)

²⁵⁰ The shareholder ratification doctrine holds that where the board acts in a manner in the best interest of the corporation, but beyond the authority of management, shareholder ratification can have the effect of actually curing the deficiency. See *In re Wheelabrator Technologies, Inc. S'holders Litig.*, 663 A.2d 1194, 1202 (Del. Ch. 1995).

²⁵¹ *Williams v. Geier*, 671 A.2d 1368, 1377 (Del. 1996).

as of a certain record date.”²⁵² A literal reading of this articulation would mean that just because a board follows the will of the majority of shareholders who originally proposed a proxy defense provision, the board may still be prohibited from following the shareholder approved bylaw out of its fiduciary duty to existing shareholders if such an action would frustrate the will of current shareholders. But such a literal application would necessarily thwart the will of shareholders who may approve such a restriction. In matters that do not involve the election of directors who will control the company, the court has stated that it will apply the *Blasius* standard only sparingly, and only in those situations in which the will of a shareholder majority appears to be thwarted.²⁵³ As such, it would seem that shareholder approval of a bylaw restricting shareholder choice could be argued as a situation not requiring *Blasius* review, since the action would not technically be thwarting the will of a “majority of shareholders” in the sense of the majority of shareholders at the time the limiting bylaw was considered.²⁵⁴

Stephen Bainbridge has explored the contractual utility of pre-commitment strategies in contracts in the area of *Revlon* review of M&A lockups. He offers the analogy of Odysseus binding himself to the mast so that he would not succumb to the sirens song, a recognition that ex-ante a party to a negotiation may see pre-commitment as a high value option.²⁵⁵ Bainbridge uses that analysis to critique the courts apparent hostility to M&A lockup arrangements.²⁵⁶ That argument would seem even more forceful here, where a majority of disinterested shareholders, though not necessarily a majority of existing shareholders, have approved the transaction and thus offer some element of shareholder ratification protection to the defensive measure. One

²⁵² *In re MONY Group Inc. S'holder Litig.*, 853 A.2d at 676.

²⁵³ *Id.* at 675. [MONY Group]

²⁵⁴ Though, of course, it could thwart the will of a majority of shareholders at the time of the vote actually under review.

²⁵⁵ Stephen Bainbridge, *Precommitment Strategies in Corporate Law: The Case of Dead Hand and No Hand Pills*, 29 J. CORP L. 1, (2003).

²⁵⁶ *Id.*

necessary requirement to shareholder adoption of new proxy defenses will likely be heightened SEC disclosure requirements and review during the comment period, as is the case for anti-takeover provisions.

As Jeff Gordon notes, the phrase “unless otherwise provided in the certificate of incorporation” is found throughout the DGCL.²⁵⁷ Yet, Gordon also reminds us that even Delaware has a striking number of mandatory provisions from which shareholders and the board cannot opt out.²⁵⁸ As a general matter, bylaws cannot restrict a board’s freedom to act such that it could cause a board to violate its fiduciary duties.²⁵⁹ The identity of the actor approving the bylaw, whether board or shareholder, is not likely to matter.²⁶⁰ Thus, this article will also need to examine the equitable constraints Delaware will place on modifications to the corporate charter, the bylaws, and corporate policies that boards might make in the wake of proxy access. Another relevant global observation about bylaws in this context is that one common provision to bylaws adopting staggered boards is that they require a 2/3 vote of the shareholders to amend the provision.²⁶¹

This article has thus far considered the strategic value of various board defenses in fending off proxy access and how those defenses fit into the existing academic debate over shareholder empowerment. It has offered a thorough review of the shareholder voting and takeover defenses jurisprudence in Delaware corporate law to provide a comprehensive picture of how those defenses will be reviewed by the Delaware courts. The final step in the analysis will be to examine whether the federal government will have the authority to block these

²⁵⁷ Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1553 (1989).

²⁵⁸ *Id.*

²⁵⁹ Coates and Faris, *supra* note 69, at 1330.

²⁶⁰ *Id.*

²⁶¹ Koppes, *Corporate Governance Out of Focus: The Debate Over Classified Boards*, 54 BUS. LAW. 1023, 1030 (1999).

defenses.

V. THE LEGITIMACY OF PROXY ACCESS DEFENSES UNDER FEDERAL LAW

Even if these defenses against shareholder proxy access survive scrutiny under Delaware law, questions remain as to whether Congress, the exchanges, or the federal courts will invalidate them. The Dodd-Frank Act raises concerns about the preemption of state corporate laws,²⁶² and this section will address those concerns as well as the possibility of judicial intervention by the federal courts in determining the legality of proxy access defenses.

A. *Congressional Preemption and the Role of Federalism*

Delaware's tremendous stake in its unique state corporate law²⁶³ has made strengthening its anti-takeover statutory provisions and other state-centered tools for board deterrence of proxy access a priority.²⁶⁴ Even further, American business as a whole has a stake in promoting a state-by-state diversity of incorporation law.²⁶⁵ Some scholars have argued however that both recent

²⁶² This memo will focus on federal preemption and will not analyze a possible commerce clause challenge against state regulation of corporate law. For a discussion of this potential constitutional challenge, see Bainbridge, Redirecting, *supra* note 126, at 1102, n.141.

²⁶³ See Guhan Subramanian, Steven Herscovici, & Brian Barbetta, *Is Delaware's Antitakeover Statute Unconstitutional? Evidence from 1988-2008*, 65 BUSINESS LAWYER 685 (2010) (available at <http://ssrn.com/abstract=1491071>) ("Delaware has a well-known interest in maximizing its share of the corporate charter marketplace."). See also Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2518 (2005) ("Delaware's primary interest groups – managers and investors – usually do not want corporate law to go federal."). However, for a contrasting take, Roe also argues, at 2518, that Delaware may not mind some federalization by Washington: "[a]fter all, if Congress federalizes a law, Delaware need not lose tax revenues; no one would flee Delaware, because no other state could do better for managers and investors. So Delaware may lose a little corporate law, but not its charters or taxes."

²⁶⁴ See Bainbridge, Redirecting, *supra* note 126, at 1102 ("...many target managers will ask their legislatures for defenses against proxy contests...[and]...many states will accommodate them.").

²⁶⁵ See Brett H. McDonnell, *Two Cheers For Corporate Federalism*, 30 J. CORP. L. 99 (Fall 2004) ("...federalism in establishing corporate law nonetheless remains both possible and desirable.").

federal legislation and techniques available to federal judges may undermine Delaware’s unique corporate legal regime through a creeping nationalization of corporate law²⁶⁶ which has some tremendously fearful that state corporate law cannot fight back when in conflict with federal policy priorities.²⁶⁷

In the early 1990s, Stephen Bainbridge argued that the “major constitutional hurdle faced by state proxy contest regulation is preemption by the federal securities laws.”²⁶⁸ The passage of the Dodd-Frank Act now raises numerous questions of preemption. Before analyzing the preemption issue, it is first necessary to evaluate what, exactly, the Dodd-Frank Act establishes as far as shareholder access to the proxy, and how it compares with current Delaware state powers. “[T]he Act amends Section 14 of the Securities Exchange Act of 1934 . . . to make it clear that the SEC has authority to adopt rules requiring public companies to include board nominees submitted by shareholders in the company’s proxy materials.”²⁶⁹ The decision to grant the SEC the power to craft such rules, and for Congress not to set out these rules themselves within the legislation, came after “. . . House members resisted the Senate’s efforts to impose minimum company share ownership thresholds and holding periods on shareholders seeking to

²⁶⁶ Wachtell, Lipton, Rosen and Katz LLP, Comments on the SEC’s Proxy Access Proposals, 7-8 (August 17, 2009) (“This structure [federalism] has allowed for comparison across jurisdictions, experimentation, and gradual evolution of business law in state legislatures and courts, some of which have developed substantial expertise with respect to specialized governance and business issues.”).

²⁶⁷ Robert B. Thompson, *Preemption and Federalism in Corporate Governance: Protecting Shareholder Rights to Vote, Sell, and Sue*, 62 LAW & CONTEMP. PROBS. 215, 242 (Summer 1999) (“The division between federal and state regulation now seems to turn on the substantive result that Congress desires rather than on any determination of which corporate functions are better performed by state governments in our federal system. . . .”) (available at <http://www.law.duke.edu/shell/cite.pl?62+Law+&+Contemp.+Probs.+215+%28Summer+1999%29#H2N7>).

²⁶⁸ Bainbridge, Redirecting, *supra* note 126, at 1102.

²⁶⁹ Covington & Burling LLP, Advisory: Dodd-Frank Act Executive Compensation and Corporate Governance 1, 3 (July 16, 2010) (available at <http://www.cov.com/files/Publication/97e096aa-7223-4609-af4d-d30b3d24cd90/Presentation/PublicationAttachment/5f3e97fd-71ab-4c1c-9e08-4d5073de13d2/Dodd-Frank%20Act%20-%20Enhanced%20Protection%20of%20Investors%20and%20Other%20Changes%20to%20Securities%20Regulation.pdf>).

nominate directors using the company's proxy materials."²⁷⁰ Congress clearly wanted to avoid the bruising fight that crafting the rules themselves would have entailed, and instead abdicated the responsibility to the SEC as a component of its rule-making function. Both the legislative history and outcome will likely have ramifications in any future preemption challenges.

The Congressional grant of proxy access rulemaking power to the SEC, unsurprisingly, comes at a time when the SEC has a specific rule proposal on shareholder access already on hand.²⁷¹ The currently proposed rule is that

a shareholder meeting specified ownership thresholds (1% for a large accelerated filer, 3% for an accelerated filer, 5% for all others) would be entitled to require the company to include its nominee(s) in the company's proxy materials, as long as the shareholder has the right to nominate directors under applicable state law and the company's governing documents. Such shareholders would be entitled to nominate the greater of one nominee or 25% of the number of board seats up for election.²⁷²

In April, 2009, the Delaware legislature passed and its governor signed into law amendments to the Delaware Code, two sections of which serve to grant shareholders further access to the corporate proxy. The amendments to Section 112 state that "if the corporation solicits proxies with respect to an election of directors, the corporation may be required to include in its proxy materials one or more nominees submitted by stockholders in addition to individuals nominated by the board of directors." The amendment to Section 113 grants that ". . . a bylaw may require the corporation to reimburse proxy solicitation expenses incurred by a

²⁷⁰ Latham & Watkins LLP, Corporate Governance Alert: Proxy Access, Say on Pay and Other Key Corporate Governance and Executive Compensation Provisions Under the Dodd-Frank Bill, 1-2 (July 2010) (available at http://www.lw.com/upload/pubContent/_pdf/pub3606_1.pdf).

²⁷¹ See www.sec.gov/rules/proposed/2009/33-9046.pdf.

²⁷² Covington & Burling LLP, Advisory: Dodd-Frank Act 1, 3-4 (July 16, 2010) (available at <http://www.cov.com/files/Publication/97e096aa-7223-4609-af4d-d30b3d24cd90/Presentation/PublicationAttachment/5f3e97fd-71ab-4c1c-9e08-4d5073de13d2/Dodd-Frank%20Act%20-%20Enhanced%20Protection%20of%20Investors%20and%20Other%20Changes%20to%20Securities%20Regulation.pdf>).

stockholder.”²⁷³ These amendments allow greater ease of access by shareholders to the proxy for Delaware corporations that choose to adopt their bylaws accordingly.

The real question for the purposes of this article is whether federal courts will be able to rule Delaware state laws facilitating the proxy defenses presented herein as preempted by the federal law. According to Bainbridge,²⁷⁴ there are three relevant preemption tests: the first is the field test, or whether the federal regulatory scheme is so comprehensive as to infer that Congress left no room for concurrent state regulation. The second test is the physical incompatibility test, which posits that should a federal and state regulation directly contradict such that compliance with one would require non-compliance or violation of the other, the federal regulation would win out.²⁷⁵ The third test is that of congressional purpose—a state statute must give way to federal law if it undermines the intent of Congress.

To determine whether the Dodd-Frank Act will preempt Delaware state corporate law under any of the above tests, it is first helpful to look back to earlier cases dealing with the preemption of state corporate law. Historically, only the Eighth Circuit, in 1982’s *National City* case, has held that the federal proxy rules of Exchange Act section 14(a) preempt a state statute limiting access to the proxy.²⁷⁶ Bainbridge, reviewing *National City*, found that the court considered two preemption theories: first, that the state proxy rules conflicted with federal law granting an insurgent the absolute right to a proxy contest, and second, that the state statute favored incumbent boards, in conflict with the congressional intent of section 14(a).²⁷⁷

Bainbridge posits that the Eighth Circuit’s analysis of congressional intent in enacting section

²⁷³ [http://legis.delaware.gov/LIS/lis145.nsf/vwLegislation/HB+19/\\$file/legis.html?open](http://legis.delaware.gov/LIS/lis145.nsf/vwLegislation/HB+19/$file/legis.html?open)

²⁷⁴ See generally, Bainbridge, Redirecting, *supra* note 126, at 1103-04.

²⁷⁵ See *Derdiger v. Tallman*, 75 F. Supp.2d 322, 324 (D. Del. 1999) (holding that federal securities legislation preempted certain types of class action securities lawsuits and removed them to federal court, illustrating a direct contradiction federal preemption).

²⁷⁶ *National City Lines, Inc. v. LLC Corp.*, 687 F.2d 1122 (8th Cir. 1982).

²⁷⁷ Bainbridge, Redirecting, *supra* note 126, at 1105.

14(a) mistakenly leads to the notion that any state interference into the proxy would be similarly preempted.²⁷⁸

However, Bainbridge argues that the D.C. Circuit in *Business Roundtable v. SEC*²⁷⁹ was actually closer in its interpretation of the congressional intent of section 14(a), which he argues should be more narrowly construed as a mechanical regulation of proxy procedure and not a broader theoretical statement about shareholder democracy.²⁸⁰ Bainbridge's review of the legislative history of the Exchange Act finds it to be “. . . conspicuously silent on substantive aspects of voting rights”²⁸¹ and the “legislative history [of section 14(a)] reflects a congressional desire to do nothing more than enable shareholders to make effective use of whatever voting rights they possess by virtue of state law.”²⁸²

The relevance of this history to the preemption question is that it illustrates the intent of section 14(a) of the Exchange Act and that the intent of Congress at the time was to defer to the states the substantive elements of proxy contest law. Therefore, broader determinations of shareholder voting rights would not be preempted by section 14(a) under any of the three tests cited above.²⁸³

These lessons of preemption can be applied to state anti-takeover law via the Supreme Court's holding in *CTS v. Dynamics Corp. of America*, which held that state anti-takeover statutes are not preempted by federal law.²⁸⁴ In *CTS*, Indiana state legislators exploited the “internal affairs doctrine,” which had been created thanks to a prior opinion by Justice White.²⁸⁵

²⁷⁸ See *id.* at 1106.

²⁷⁹ *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990).

Bainbridge, *Redirecting*, *supra* note 126, at 1106. See also *id.* at 1113 (“[the congressional hearings prior to the passage of section 14(a)]...do not support an absolute federal right for insurgents to wage proxy contests...”).

²⁸¹ *Id.* at 1115.

²⁸² *Id.* at 1118.

²⁸³ See *supra*, n.2745.

²⁸⁴ *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69 (1987).

²⁸⁵ *Edgar v. MITE Corp.*, 457 U.S. 624 (1982).

According to Bainbridge, the drafters of the Indiana anti-takeover law “. . . relied on the state’s traditional power to define corporate voting rights as a justification for regulating the bidder’s right to vote shares acquired in a control transaction.”²⁸⁶ Bainbridge goes on to find that the reason the Indiana statute was effective was due in part to its provision that required shareholder approval, which would “require the bidder to finance an expensive proxy campaign.”²⁸⁷ However, in his preemption analysis, Justice Powell found no conflict between this requirement and the federal Williams Act and that the Indiana act served to protect shareholders.²⁸⁸ Bainbridge finds that “*CTS* provides a basis for rejecting any federal right to wage proxy contests”²⁸⁹ and that a narrower interpretation is more likely.

Agreeing with Bainbridge’s interpretation of the Supreme Court’s corporate preemption cases, Larry Ribstein, in recent scholarship, has argued that the limits of preemption “inhere[] . . . in the nature of corporate governance law”²⁹⁰ and that “. . . it is difficult to isolate the functions and effects of a specific preempted provision.”²⁹¹ Such a determination shows that increasing nationalization of corporate law can produce a ripple effect far beyond a specific statute which is preempted. Because of the wide-ranging effects of a single preemption, the SEC’s new rules on proxy access may serve to invalidate a wider swath of Delaware corporate law than was previously anticipated, unless such law is tailored to conform to federal interests on the proxy issue.

In 1988, Delaware enacted its current anti-takeover statute, Delaware Code Section 203. Its constitutionality was challenged as preempted under the federal Williams Act, and was

²⁸⁶ Bainbridge, Redirecting, *supra* note 126, at 1122.

²⁸⁷ *Id.* at 1122.

²⁸⁸ *See CTS*, 481 U.S. at 83.

²⁸⁹ Bainbridge, Redirecting, *supra* note 126, at 1124.

²⁹⁰ Larry E. Ribstein, “Preemption as Micromanagement,” 65 *Business Lawyer* 789, 793 (May 2010).

²⁹¹ Larry E. Ribstein, “Preemption as Micromanagement,” 65 *Business Lawyer* 789, 793 (May 2010).

subsequently upheld in three federal district court decisions.²⁹² The basis for upholding the constitutionality of Section 203 was that it provided bidders with “a meaningful opportunity for success” and did not upset the intent of Congress for neutrality between bidders and targets. However, recent scholarship has called into question whether this predicate for upholding the statute’s constitutionality was actually true and that Section 203 is, in fact, preempted by the Williams Act for failure to grant bidders any success.²⁹³

Regardless, more recent responses to the Delaware proxy amendments and comparisons to the establishment of a federal proxy regime have considered all of this history, including that of the anti-takeover statutes. As one law firm advised its clients in anticipation of new SEC proxy access rules:

[t]he new federal law or proxy rules, which are very controversial and can be expected to be hotly debated over the next several months, could be similar to the Delaware law and merely be ‘enabling.’ They could supersede the Delaware law only in part by mandating certain aspects of proxy access that could not be made more company-friendly, while leaving other aspects up to state law and a company’s governing documents. Or, as both the proposed legislation and SEC proxy access Rule 14a-11 contemplate, they could establish an exclusive proxy access regime and oust, virtually in their entirety, state corporate laws and the ‘private ordering’ of proxy access by companies and their shareholders.²⁹⁴

When evaluating the preemption risks of the current Delaware proxy law, the same law firm noted in a briefing that “the Delaware General Assembly may have thought that by enacting a specific proxy access bylaw before a federal proxy access law or rule was enacted, the federal legislators and regulators would find it, legally and politically, more difficult to supersede the new Delaware law.”²⁹⁵ If this is true, it would be less likely that the SEC would establish rules that would either directly contradict the Delaware statute or would conflict in such a way as to entirely preempt Delaware’s proxy access scheme. This was confirmed, in fact, by the SEC’s

²⁹² Guhan Subramanian, Steven Herscovici, & Brian Barbetta, *Is Delaware’s Antitakeover Statute Unconstitutional? Evidence from 1988-2008*, 2 (2010) (available at <http://ssrn.com/abstract=1491071>).

²⁹³ *See id.* at 48.

²⁹⁴ Latham & Watkins, LLP, *Corporate Governance Commentary: Proxy Access Analysis No. 2 1, 2* (June 22, 2009).

²⁹⁵ *Id.*

most recent rulemaking proposal, which cited the new Delaware law positively in highlighting state statutory amendments to make it easier for shareholders to nominate directors.²⁹⁶

Preemption will likely occur if the SEC uses its rulemaking authority under the Dodd-Frank Act to directly contradict or usurp the existing Delaware framework.²⁹⁷ However, as Bainbridge has pointed out, direct contradiction is not the only way for the federal government to argue for preemption of Delaware proxy access. Rather, it need only show that the general intent of Congress in granting the SEC rulemaking authority is to prevent the type of proxy access regime that Delaware (or any other state) currently has in place. Despite the seeming ease of preemption, and a general policy shift toward federal control of shareholder access, the evidence from Delaware's 2009 passage of proxy access and the SEC's response²⁹⁸ tends to indicate that the SEC will likely sidestep preemption of Delaware law, so long as it continues to support increasing shareholder access.

The SEC has also approved a uniform rule for the stock exchanges with respect to disparate voting rights in stock that the stock exchanges actually administer.²⁹⁹ That standard prohibits companies trading on NYSE, AMEX, or NASDAQ from disparately reducing or restricting voting rights of existing shareholders.³⁰⁰ This rule was adopted to prohibit the issuance of supervoting stock, or stock with more pro rata votes than existing shares which would have the effect of watering down the voting rights of existing shareholders. That rule has been interpreted not to prohibit poison pills however, indicating a focus on defenses that run against a particular class of shares rather than a particular shareholder or type of shareholder.

²⁹⁶ See SEC Proposed Rules, 17 CFR 200, 232, 240, 249 and 274, 1, 20, n.70 (June 2009) (available at www.sec.gov/rules/proposed/2009/33-9046.pdf).

²⁹⁷ See Section II.B, *supra*.

²⁹⁸ See SEC Proposed Rules, 17 CFR 200, 232, 240, 249 and 274, 1, 20, n.70 (June 2009) (available at www.sec.gov/rules/proposed/2009/33-9046.pdf).

²⁹⁹ See *id.* at A-64 (citing Exchange Act Release No. 35,121 (Dec. 19, 1994), 59 Fed. Reg. 66,570 (1994)).

³⁰⁰ *Id.* at A-64.

Thus restrictions which focus on voting by particular shareholders which may be subject to a conflicted interest could be viewed as complying with that rule. The exchanges ultimately will be the interpreters of this rule on a case by case basis, and so any new defenses would need to be pre-cleared with them in order not to jeopardize a firm's listing.³⁰¹ As such, it remains unlikely that, as written, the stock exchange listing standards would present a significant hurdle as they are currently written to any of the defenses considered in this article. The notion of conflicted shareholder voting restrictions comes the closest to this rule, but still doesn't seem to technically violate it. The other defenses presented in this article do not seem to run into conflict with stock exchange listing standards.

So far, this section has considered only federal preemption as an invalidating mechanism for Delaware corporate law or other board defenses against expanded proxy access. Given the momentum from the Dodd-Frank Act for increased proxy access, it can be anticipated that such access will be granted, leaving boards in a position to utilize more unique defense tactics against proxy contests. While there may be significant momentum in favor of shareholder power over the proxy at the expense of boards, at this point, however, "...recent case law continues to demonstrate that the business judgment rule is as strong as ever, with courts continuing to defer to the informed, good faith decisions of boards..."³⁰² This is certainly true at the state level, where numerous proxy access defenses have been affirmed.³⁰³

B. *Judicial Intervention*

³⁰¹ Bagley, *supra* note 13, at A-65.

³⁰² David J. Berger; Kenneth M. Murray, *As the Market Turns: Corporate Governance Litigation in an Age of Stockholder Activism*, 5 N.Y.U. J. L. & Bus. 207 (Spring 2009).

³⁰³ *See, for example*, Apache Corp. v. New York City Employees' Retirement System, 621 F. Supp.2d 444, 453 (S.D. Tex. Apr. 22, 2008) (holding that a shareholder proposal was properly withheld from a proxy statement).

Notwithstanding current popular trends favoring greater shareholder power over boards, examining the various management defense strategies from *Corporate Acquisitions, Mergers and Divestitures*³⁰⁴ reveals minimal federal judicial intervention. One defensive tactic a board could make prior to a proxy contest is to insert provisions into the corporation's articles of incorporations implementing structural changes which can serve to deter proxy contests.³⁰⁵ One of these structural changes can be for a board to mandate notice-to-management requirements to deter shareholders from making last-minute nominations without giving the board an opportunity to respond. Such a policy is often allowed at the state law—and in particular in Delaware, where using notice provisions providing a range of 20-90 days of notice prior to a shareholder meeting has been approved by the courts,³⁰⁶ as has a 10 day period of notice.³⁰⁷ Delaware's only caveat is that “. . . when advance notice bylaws unduly restrict the stockholder franchise or are applied inequitably, they will be struck down.”³⁰⁸

The usage of a staggered board can also serve as a defense against proxy access, because it limits the amount of impact a single vote can have on the composition of the board.³⁰⁹ The opportunity for a Delaware corporation to use a staggered board is one of Delaware's key points of difference with other state corporate laws. The importance of a staggered board lies in its ability to prevent a counter-attack through proxy access against a poison pill: “A staggered board prevents a bidder from using [the poison pill] because it requires the bidder to elect an opposition

³⁰⁴ Aaron Rachelson, *Corporate Acquisitions, Mergers and Divestitures*, (West 2010).

³⁰⁵ See generally, Aaron Rachelson, *Corporate Acquisitions, Mergers and Divestitures*, CAMD § 1:159 (June 2010).

³⁰⁶ *Openwave Systems Inc. v. Harbinger Capital Partners Master Fund I, Ltd.*, 924 A.2d 228, 239 (Del. Ch. 2007).

³⁰⁷ *Accipiter Life Sciences Fund, L.P. v. Helfer*, 905 A.2d 115 (Del. Ch. 2006)

³⁰⁸ *Openwave Systems Inc. v. Harbinger Capital Partners Master Fund I, Ltd.*, 924 A.2d 228, 239 (Del. Ch. 2007).

³⁰⁹ Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence & Policy*, 54 STAN. L. REV. 887 (2002); Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants*, 55 STAN L. REV. 885 (2003).

slate at two annual meetings to change control of the board.”³¹⁰ The legality of the staggered board in this situation has been upheld in the courts, and it has been held that such directors can only be removed for cause.³¹¹ Federal courts, when applying Delaware’s unique federal law, have generally been deferential to these staggered boards and to the decisions of boards more broadly.³¹²

The federal response to notice requirements has been fairly muted, generally approving such actions.³¹³ Thus if the federal response has not been antithetical to these existing defenses to shareholder proxy fights, it may be expected that future review of the defenses to proxy nominations described in this article may be reviewed in the same way. Most key tactics which may be used by a board in defense against takeovers have survived preemption despite the existence of the Williams Act, and so we should similarly expect that board defenses to proxy access will survive the threat of preemption as well. This will be especially true if the Delaware courts, the Delaware legislature, and companies incorporated in Delaware are astute and strategic in their response to the proxy access reforms.

Though it is likely that the defenses presented in this article will not be preempted by the Dodd-Frank Act, there may be some appreciable level of risk that the federal courts will find that federal law preempts state law in this area. Even if that is the case, the majority of defenses presented in this article will survive. For defenses like state anti-takeover statutes as applied to proxy contests, it would be easy for the federal courts to preempt that statute because the relevant defenses are entirely dependent on the state statute. But where board defenses are not dependent

³¹⁰ Covington & Burling, LLC, Issue Alert: What Investment Managers Need to Know About Charters and Bylaws, 2, June 1999 (available at <http://www.cov.com/files/Publication/3dc30900-b4d8-4114-ad78-46fb71c96ded/Presentation/PublicationAttachment/67082535-17e8-48cd-b43d-4ba9c07e839e/oid6074.pdf>).

³¹¹ See, for example, <http://dealbook.blogs.nytimes.com/2008/06/27/anheusers-staggering-defense/> (“If the directors are considered staggered, then under Delaware law they can be removed only for cause.”).

³¹² Moore Corp. Ltd. v. Wallace Computer Services, Inc., 907 F. Supp. 1545 (D. Del. 1995).

³¹³ See David J. Berger; Kenneth M. Murray, *As the Market Turns: Corporate Governance Litigation in an Age of Stockholder Activism*, 5 N.Y.U. J. L. & BUS. 207, 208 (Spring 2009).

on a state statute, but merely incidental to the board's plenary authority, then the federal courts will not have a relevant state law to invalidate. Or, put another way, even if the federal courts found a state law to invalidate, it would not matter because the board would be able to maintain the defense anyway.

VI. CONCLUSION

The shareholder empowerment debate has been active in the corporate scholarship for some time. The academic literature on this question is informative and vast. The proposition that shareholder activity can in certain cases reduce agency costs is a defensible proposition, however, the institutional analysis highlights a wide variety of conflicts facing many large institutional investors that will significantly limit this potential. The existing empirical literature is incomplete, and is likely to remain so until a larger sample size of contested proxy access nominations become available and either the net costs or net benefits of proxy access are already experienced. At this time, the empirical evidence on shareholder empowerment generally is mixed and the emerging evidence on the current proxy access rule indicates that markets expect it will actually reduce shareholder value.

This article does not purport to resolve that debate. This article does, however, take issue with the proposition that the battle over the balance of power between shareholders and boards of directors is finished with the passage of the Dodd-Frank Act. For Delaware corporations, a wide variety of defensive strategies remain open to boards in defending against nominations to the corporate proxy under the new Dodd-Frank regime. Which of those defenses will remain legally available will depend on the analysis of Delaware state law and federal law presented in this

article, but nevertheless many if not most of them will remain viable defenses in most situations. This leaves open a wide space for boards and shareholders to settle into their own arrangements about whether and how shareholders should be able to access the corporate proxy and remedy the federal one-size-fits-all in favor of a more open, freedom-of-contract oriented approach.