

Shareholder Authority At Issue In Hilton Bylaw Fight

By Neil O'Hara

Shareholders and board directors at Hilton Hotels are sparring over an age-old question these days: Who's the boss?

At issue are two corporate governance resolutions filed by shareholders in the last three years—an advisory resolution in 2004 calling for more independence on the board of directors, and a binding one from this past April requiring the board to adopt a bylaw for shareholder approval to enact a poison pill.

Both resolutions won majority support from shareholders. Hilton's board likes neither, ignoring the first and dragging its feet on the second—and that intransigence prodded shareholder activists to fight. Now the Hilton stand-off has emerged as a flashpoint for just how far shareholders can push boards to certain actions via binding resolutions, threats of litigation or other tactics.

"It was a pretty overwhelming vote," says Courtney Alexander, deputy director of research for the hotel workers' union (colorfully named UNITE HERE), which sponsored both resolutions. Shareholders supporting this spring's binding resolution on poison pills won 68 percent of votes cast. Alexander stops short of promising a court battle if necessary, but firmly says: "We are planning to pursue this."

Hilton, not surprisingly, is resisting. When UNITE submitted its proposal on poison pills, the \$3.8 billion hotel chain argued even before the shareholder meeting that the amendment would be illegal, because shareholders have no right to preempt the power vested in directors by statute to manage the company. (Anticipating that argument, UNITE's resolution defaulted to an advisory one, legally obligating Hilton to put it on the proxy anyway.) When the bylaw amendment passed, Hilton announced that its board would "meet in due course to consider the proposal and discuss appropriate courses of action."

The two sides cite different provisions of the Delaware General Corporation Law to defend their positions. On one hand is the Hilton board and Section 141(a) of the law: "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation."

UNITE, however, counters with

■ THE LAW SAYS

In the dispute between Hilton Hotels and a hotel workers' union, both sides cite different provisions of the Delaware General Corporation Law to defend their positions, with the company citing Section 141(a), and UNITE HERE citing Section 109. To read the full document, go to www.complianceweek.com and enter Print Reference Code: 080623.

SECTION 141(A)

Title 8: Corporations

CHAPTER 1. GENERAL CORPORATION LAW

Subchapter IV. Directors and Officers

§ 141. Board of directors; powers; number, qualifications, terms and quorum; committees; classes of directors; nonprofit corporations; reliance upon books; action without meeting; removal.

- (a) The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation...

SECTION 109

Title 8: Corporations

CHAPTER 1. GENERAL CORPORATION LAW

Subchapter I. Formation

§ 109. Bylaws.

- (a) The original or other bylaws of a corporation may be adopted, amended or repealed by the incorporators, by the initial directors if they were named in the certificate of incorporation, or, before a corporation has received any payment for any of its stock, by its board of directors. After a corporation has received any payment for any of its stock, the power to adopt, amend or repeal bylaws shall be in the stockholders entitled to vote, or, in the case of a nonstock corporation, in its members entitled to vote; provided, however, any corporation may, in its certificate of incorporation, confer the power to adopt, amend or repeal bylaws upon the directors or, in the case of a nonstock corporation, upon its governing body by whatever name designated. The fact that such power has been so conferred upon the directors or governing body, as the case may be, shall not divest the stockholders or members of the power, nor limit their power to adopt, amend or repeal bylaws.
- (b) The bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees. (8 Del. C. 1953, § 109; 56 Del. Laws, c. 50; 59 Del. Laws, c. 437, § 1.)

Source: Delaware General Corporation Law (As prepared by the Division of Research of Legislative Council of the General Assembly with the assistance of the Government Information Center).

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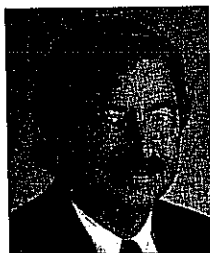
Hilton Bylaw Dispute Profiles Limits Of Shareholder Power

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Section 109: "The bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees." In essence, UNITE and Hilton disagree over whether that power supersedes the management authority granted to directors by Section 141(a).

Plaintiff Attorneys vs. Corporate Bar

UNITE's legal team, led by Richard McCracken of the firm Davis, Cowell & Bowe, are firm advocates of shareholder primacy. McCracken won a 1999 case in Oklahoma in which the state Supreme Court upheld a bylaw amendment on shareholder approval of poison pills as binding, and he expects Delaware courts to follow suit since Oklahoma's corporate law is modeled after Delaware's.



McCracken

Historically, he says, Delaware courts have read Section 109 literally and upheld bylaw amendments adopted by shareholders. He also cites *Unisuper v. News Corp.*, a December 2005 decision where the Delaware Chancery Court allowed shareholders to sue News Corp.'s board when it reneged on a promise to let shareholders vote on poison pills. "News argued that even if a contract existed it was unenforceable, because the power to adopt a poison pill rests exclusively with the board of directors," McCracken says. "The Chancery Court not only rejected but disparaged that claim as being an inversion of the whole statutory framework for the distribution of powers in a corporation."

In the *Unisuper* case, however, while the court allowed the shareholders' complaint to proceed, it also questioned their odds for success. In particular, the court noted that the *Unisuper* shareholders were sophisticated investors who negotiated binding contracts with News Corp.'s directors on some points, yet tolerated a "more transitory" board policy on the poison pill. The case was settled in April when News Corp. agreed to put its current pill to a vote as well as any other pills

it might adopt for the next 20 years.

Other experts in Delaware law disagree with McCracken's pro-shareholder view. Lawrence Hamermesh, a professor at Widener University School of Law, acknowledges that shareholders can adopt bylaws on matters spelled out in the statute—a required vote for the election of directors, for example. But even zealous shareholder rights proponents, he says, accept that a bylaw requiring shareholder approval before a company launched a new product would be invalid. Hamermesh believes a bylaw mandating shareholder approval for a poison pill is "at least arguably in the same league" as a new product bylaw. "It purports to regulate the conduct of the board on matters that fall within their managerial jurisdiction," he says.

Ellisa Habbart, a partner at The Delaware Counsel Group, notes that unlike directors, a shareholder has no fiduciary duty to the corporation or other shareholders. "There is no check on a shareholder," she says. "To have one instigate a change that restricts the power of the board and promotes its own self-interest may not be good for the company or the other shareholders." She believes that shareholders can enact bylaws that cover procedural matters, but not ones that prescribe how the board must act or that limit its discretion.

Habbart distinguishes the *Unisuper* case from Hilton's dispute because the News Corp. board chose to adopt the policy requiring a shareholder vote on its poison pill. "That is very different from having shareholders who do not have authority to manage a company impose a standard on the board," she says. The validity of a bylaw played no part in *Unisuper* either, she says; the suit went forward as a contract claim.

Gambit Fails In CA Case

The Delaware Chancery Court passed up an opportunity to clarify the law in June when it ruled that a complaint filed against CA (formerly Computer Associates) by Lucian Bebchuk, a professor at Harvard School of Law and shareholder activist, was not ripe to be heard. Bebchuk sued the computer services giant after CA refused to include in its proxy a proposed bylaw amendment that would require a unanimous vote of directors to

extend a poison pill and set a maximum one-year term on any pill adopted. In effect, the board would have to vote unanimously every year to maintain a poison pill in place.

Bebchuk's law firm, Grant & Eisenhofer, had hoped to tease a decision out of the court before CA's proxy was published, according to partner Stuart Grant. The judge in the case acknowledged that "the legal issue in this case is fraught with tension," but ultimately ruled that Bebchuk had not yet exhausted other options, such as approaching the Securities and Exchange Commission or seeking remedy in federal court, if CA did not include his resolution in its proxy.



Grant

The SEC declined CA's earlier request to take no action on the exclusion because the Delaware court was already involved. Neither the SEC nor a federal court will want to pre-empt a question of state law, Habbart says—so if CA did exclude Bebchuk's resolution from its proxy, the case would wind up back in Delaware. That confusing twist of events won't happen, however; CA has agreed to include Bebchuk's resolution in its proxy after all.

If shareholders ultimately vote Bebchuk's bylaw amendment down (a date for the 2006 annual meeting has not been publicly set, but CA told the court it planned to mail its proxy in July) the whole question ends there. If shareholders approve the bylaw, CA's board may defer to their wishes rather than incur additional legal expenses fighting in court. "The corporate bar has been smart," Grant says. "They have fought these things. When they have been unable to keep them off the ballot, most of the time they have been able to defeat them. When they haven't, they have caved."

Will Hilton cave, too? Time will tell—but don't bet on Delaware law being cleared up soon. The CA ruling may encourage activists to propose more binding resolutions, but Hamermesh notes that "these issues have been notoriously hard to tee up in court."

For additional resources, including court documents related to the Bebchuk and *News Corp.* cases, please go to www.complianceweek.com and enter Print Reference Code: 080623. ■