

Ex-Ante Corporate Governance

George S. Geis*

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I. INTRODUCTION

Who should make decisions for a corporation? And how should decisions about who makes decisions be made? These fundamental governance questions motivate much of corporate law, as lawmakers seek to strike a sensible balance of power between managers, shareholders, creditors, suppliers, and other players in the corporate system. This tightrope is not easy to walk, however, and no one can design rules that will block faulty managers from abusing control over a firm's activities.¹ Likewise, laws cannot completely prevent a rogue investor from pursuing some actions that yield private spoils but impose greater collective harm on the corporation and other investors.² Corporate law can and should try to minimize these frictions, but they must be understood as the inevitable purchase price for other benefits that come with the coordination of economic activity through a firm.³

Between managers and shareholders, much of this struggle plays out in three key dimensions: the vote, the lawsuit, and the sale.⁴ Shareholders elect directors, who then appoint top managers, and most of the firm's decision making occurs through this delegated power. But shareholders who are upset with the corporation's leadership can expel the directors during the next election cycle. Alternatively, shareholders who are concerned with a specific action (or lack of action) can file a lawsuit alleging some harm, such as a breach of fiduciary duty or violation of securities law. And shareholders who do not want to bother with voting or suing might just sell their shares.⁵ The common feature of these strategies is that they involve an ex-post response to a perceived slight.

Increasingly, however, shareholders and managers are emphasizing tactics that move from ex-post response to ex-ante planning. Instead of removing individual directors, for example, a shareholder group might try to eliminate staggered boards—such that investors will find it easier to replace the entire board if warranted.⁶ Instead of fighting shareholder lawsuits in multiple jurisdictions, a board might adopt a forum selection provision that corrals future litigation into one preferred location.⁷ By shaping key aspects of corporate

1. These problems are documented in foundational literature on agency costs. See generally Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (outlining various distortions and costs that can arise through the separation of ownership and control); Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980) (same); Sanford J. Grossman & Oliver D. Hart, *An Analysis of the Principal-Agent Problem*, 51 ECONOMETRICA 7 (1983) (further analyzing the principal-agent problem).

2. These concerns perhaps present most acutely when a shareholder brings a class action lawsuit without merit. See, e.g., Roberta Romano, *The Shareholder Suit: Litigation without Foundation*, 7 J.L. ECON. & ORG. 55, 84–85 (1991) (discussing the turnover in top management of firms that are sued more often than others).

3. See R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 389 (1937) (explaining how firms are related to an outside network of prices and costs).

4. See Robert B. Thompson, *Preemption and Federalism in Corporate Governance: Protecting Shareholder Rights to Vote, Sell, and Sue*, 62 L. & CONTEMP. PROBS. 215, 216 (2000) (discussing these shareholder rights).

5. While individual transfers on secondary markets may not cause an abusive manager to lose sleep, a collective campaign to buy shares—triggering an outside market for corporate control—can serve as a powerful influencing force. See Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 114–17 (1965) (discussing mechanisms for gaining corporate control); see generally Frank H. Easterbrook & Daniel Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) (arguing defensive tactics in response to a tender offer can harm shareholders).

6. See *infra* notes 25–31 and accompanying text (describing the decline of staggered boards).

7. See generally Joseph A. Grundfest, *The History and Evolution of Intra Corporate Forum Selection Clauses: An Empirical Analysis*, 37 DEL. J. CORP. L. 333 (2012) (discussing the rise in forum selection clauses).

governance, before a specific incident arises, both directors and shareholders aim to establish structural rules that are favorable to their causes.

A primary (but not exclusive) instrument for ex-ante governance is the corporate bylaw. Long neglected, bylaws are gaining new attention as a vehicle for expanding, constraining, or channeling power in the corporate ecosystem.⁸ Directors are attracted to bylaws because, unlike charter amendments,⁹ they can be adopted without shareholder approval.¹⁰ Activist shareholders are likewise intrigued by bylaws because new rules may be approved over managerial objections. In short, bylaws are the rare unilateral tool in the workshop of corporate governance.

Not surprisingly, these ex-ante governance tactics are raising new legal problems. Judges are increasingly being asked to determine whether a given corporate bylaw is permissible. The current state of play is fluid, but the influential Delaware courts seem to be taking a more permissive attitude, based in part on the parallels between contract law and the corporate relationship.¹¹ By conceptualizing the corporation as a collection of negotiated agreements between the firm and individual shareholders, proponents of ex-ante governance defend unilateral bylaw initiatives as the permissible product of flexible private ordering. The full implications of shoehorning corporations into contract law are not entirely clear—indeed, it is not altogether obvious who the exact parties are to the “corporate contract”—even though lawmakers have been stating this as a self-evident truth for almost a century.¹² Nevertheless, the loose (though still controversial) embrace of

since *In re Revlon, Inc. S’holders Litig.*, 990 A.2d 940 (Del. Ch. 2010) was decided); Brian JM Quinn, *Shareholder Lawsuits, Status Quo Bias, and Adoption of the Exclusive Forum Provision*, 45 U.C. DAVIS L. REV. 137 (2011) (discussing a migration of shareholder lawsuits from Delaware).

8. See *infra* Sections II.A.2, II.B.2 (explaining how bylaws are being initiated by shareholders and boards in Delaware).

9. Changes to the corporate charter require an affirmative vote of directors and shareholders, which makes it more difficult to house governance provisions in this instrument. One conceivable exception may arise when a closely held firm adjusts its charter in anticipation of an initial public offering. The conventional wisdom suggests that some future public investors may not closely scrutinize otherwise controversial governance terms. See, e.g., Claudia H. Allen, *Bylaws Mandating Arbitration of Stockholder Disputes?*, 39 DEL. J. CORP. L. 751, 752 (2015) (examining the legal legitimacy of arbitration bylaws). Of course, it is also possible that these terms are priced into the public offering, such that sub-optimal governance features will result in a depressed issue price.

10. In Delaware, this is not technically true, as a matter of default rule, but large public firms routinely adjust the default to make it so. *Infra* notes 77–78 and accompanying text.

11. See, e.g., *Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934, 955–56 (Del. Ch. 2013) (“Stockholders are on notice that, as to those subjects that are subject of regulation by bylaw [under Delaware law], the board itself may act unilaterally to adopt bylaws addressing those subjects. Such a change by the board is not extra-contractual simply because the board acts unilaterally; rather it is the kind of change that the overarching statutory and contractual regime the stockholders buy into explicitly allow the board to make on its own.”).

12. Some lawmakers assert that the “corporate contract” runs between individual shareholders and the firm; others emphasize that the counterparties are the firm and the state—or even the individual shareholders themselves. See *Lawson v. Household Fin. Corp.*, 152 A. 723, 727 (Del. 1930) (“It has been generally recognized in this country that the charter of a corporation is a contract both between the corporation and the state and the corporation and its stockholders. It is not necessary to cite authorities to support this proposition.”); *Stolow v. Greg Manning Auctions Inc.*, 258 F. Supp. 2d 236, 249 (S.D.N.Y. 2003) (“The bylaws of a corporation constitute a contract between a corporation and its members.”); *Centaur Partners, IV v. Nat’l Intergroup Inc.*, 582 A.2d 923, 928 (Del. 1990) (“Corporate charters and by-laws are contracts among the shareholders of a corporation”); *STAAR Surgical Co. v. Waggoner*, 588 A.2d 1130, 1136 (Del. 1991) (“[A] corporate charter is both a contract between the State and the corporation, and the corporation and its shareholders The charter is also a contract among the shareholders themselves.”).

preauthorized one-sided modification in contract law¹³ provides some theoretical support for upholding unilateral corporate bylaws.

The problem, however, is that contract law may not be particularly well suited to preside over these types of ex-ante governance disputes.¹⁴ Indeed, invoking contract law to justify unilateral bylaws only implicates a different concern, sometimes described as the “latecomer term” problem.¹⁵ Key parties might be expected to possess proper incentives to mold sensible governance terms at the outset of a venture. But it is much less clear that these incentives will function effectively for downstream modifications by one party only.¹⁶ And if the mechanisms by which bylaw terms are priced into corporate relationships do not work seamlessly for latecomer adjustments, it is worth questioning whether contract theory should really offer much support for this trend.

This Article advances two primary claims. First, corporate law should not outsource the resolution of ex-ante governance problems to generalized principles of contract law. Contract law has not done a particularly good job of addressing the latecomer term problem, and the concerns presented are acute in the corporate context. (Moreover, tighter doctrinal coupling of these two legal fields raises a host of unanswered, and seemingly tangential, questions.) Second, if corporate law is to confront this problem directly, then its algorithms for delineating tolerable bylaws will require far greater clarification in the coming years as novel governance strategies proliferate. This Article does not attempt to establish precise standards for evaluating bylaws, but I will offer some thoughts on the topic.

The discussion is organized as follows. Part II sets the stage by exploring the rise of ax-ante corporate governance strategies—and especially those related to unilateral bylaw initiatives on the shareholder side and the director side of the firm. Part III considers the contractual foundations for this trend, arguing that contract doctrine is not a particularly helpful way to evaluate the proper scope of unilaterally adopted bylaws. This is true for reasons related to regulatory efficiency (i.e., avoiding duplicative legal claims) and for reasons related to contract law’s continuing struggle with unilateral modification (i.e., contract law has not really solved the latecomer term problem either). Moreover, contract law brings a host of additional “legal baggage” that seems tangential to the problem at hand. Part IV explores alternative institutions and approaches for adjudicating ex-ante governance problems, as a matter of Delaware corporate law, and posits that both legal and equitable frameworks will require significant growth to manage the task. A brief conclusion summarizes the Article.

II. THE RISE OF EX-ANTE GOVERNANCE

The hallmark of corporate governance is delegation. Shareholders may be the residual

13. See *infra* Section III.B (analyzing the latecomer term problem).

14. This is not to say that contract law is ill suited to govern all problems, or even all ex-ante problems, related to corporate governance. For example, a contract paradigm may be appropriate, under most conditions, for adjudicating governance rights of creditors, suppliers, and employees. This is true even though many bond covenants, for instance, also focus on ex-ante tactics (or at least seek conditions to trigger some form of ex-ante leverage).

15. See Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1442–44 (1989) (discussing latecomer terms, how they are implemented and their impact on shareholder value).

16. *Id.*

owners of a company, but they do not collectively vote on every firm decision. Rather, they cede power to a small group of representatives who are entrusted to call most of the shots. By default, only the most extreme decisions require direct investor approval.¹⁷

This representative system makes sense, given the widely distributed ownership of many firms and the complexity of corporate activity, but it does present a risk that appointed managers may abuse their discretion. There is no way to solve this agency cost problem, although corporate law does seek to mitigate its effects by giving shareholders some tools to respond when ill deeds do come to light. To date, the primary vehicles for shareholder power are the right to vote, sue, or sell. Equity owners may expel lousy directors during annual elections, launch a lawsuit to punish bad managers, or just sell their shares in disgust and walk away. Like any delegation of power, however, these tools can be corrupted in their own right. Much of corporate law seeks (or should seek) to strike a governance balance that will promote decisions that enhance the overall value of a corporation, while also minimizing the transaction costs (broadly construed) of regulatory compliance.

Historically, much of the governance interplay between managers and shareholders has been retrospective. Shareholders expelled directors or sued their firms when something went wrong, not in anticipation that something bad might occur. Directors defended against (or, more likely, settled) questionable lawsuits as the cases arose; they did not enact structural incentives to discourage specious filings. Yet this is changing: corporate governance tactics are increasingly shifting from the ex-post to the ex-ante. As this Part will discuss, both shareholders and directors are turning to strategies that might shape the future balance of power instead of just reacting to historical concerns.¹⁸

A. Shareholder Side Governance

1. Proposals and Pressure

The gateway obstacle for shareholder side governance is coordination. Communicating and gathering support for initiatives across a large and diverse body of shareholders is no easy task. Conceivably, an activist shareholder might fund a personal campaign to connect shareholders and lobby for change. But unless that shareholder has a very significant stake in the firm (or a very passionate private agenda) it is unlikely that she will foot the entire bill for reforms that seek to spread benefits broadly among all shareholders.

Instead, shareholders will typically attempt to leverage the existing communications infrastructure of the corporation by filing a shareholder proposal that asks management to

17. Examples of these extreme decisions include a merger or an amendment to the corporate charter. Even here, shareholder power is typically concurrent with board power and not exclusively reserved to shareholders. Adjustments to this delegation default do happen, particularly in closely held corporations, where shareholders may remain involved in the corporation's daily operations and want more control over firm activity.

18. I wish to concede at the outset that the difference between an ex-ante and an ex-post governance initiative is not necessarily binary. Shareholders might replace a director, for instance, because they feel that the new appointee will make better decisions in the future (ex-ante). This same action may be sparked by an explicit bad act of the current director (ex-post). Indeed, both motivations may be present. As the subsequent discussion should make clear, however, key corporate players and advisors are focusing more on proactive structural tactics (not reactive individualized disputes), and this is the point I seek to emphasize.

include an issue on the firm's upcoming proxy materials.¹⁹ If the board is willing to include the proposal, then the issue can be considered by shareholders during the next voting cycle—along with director elections, the appointment of auditors, and other annual business. Many proposals are only precatory, but strong shareholder support might still pressure directors to act (if for no other reason than avoiding an implied threat of ouster). In some cases, a firm might even negotiate a governance accommodation if it learns that an influential shareholder intends to submit a proposal.

Often, however, a board of directors will seek to exclude any given proposal from the firm's communications with shareholders. Because public proxy materials are governed by federal securities law, the SEC has authority to regulate decisions about shareholder proposals. Accordingly, it has promulgated a series of rules that help managers determine whether a firm should distribute a given shareholder proposal.²⁰ Specifically, a corporation must include a shareholder proposal in its proxy materials unless the proposal suffers from a procedural defect²¹ or falls within one of thirteen current grounds for exclusion.²² A board wishing to exclude a proposal will typically seek preapproval for this decision by requesting a no-action letter from the SEC,²³ and failure to obtain such a letter usually means that the shareholder proposal is distributed.²⁴

Consider a recent example of how activist shareholders have successfully used proposals and pressure to execute an ex-ante governance agenda. As mentioned above, shareholders only vote on the most fundamental corporate decisions, such as who will serve as a director, whether to amend the corporate charter, or whether to merge with another company. But even within this limited context there is room to adjust shareholder voting power. For example, fifteen years ago approximately 300 firms in the S&P 500 index had staggered (or classified) boards.²⁵ This presented an obvious dilution of voting power:

19. For example: The firm should “form a committee to study the methods by which its French supplier produces paté de foie gras, and report to the shareholders its findings and opinions, based on expert consultation, on whether this production method causes undue distress, pain or suffering to the animals involved and, if so, whether further distribution of this product should be discontinued until a more humane production method is developed.” *Lovenheim v. Iroquois Brands*, 618 F. Supp. 554 (D.D.C. 1985).

20. See Securities Exchange Act of 1934, 17 C.F.R. § 240.14a-8 (2015) (addressing shareholder proposal requirements).

21. For example, a shareholder must hold a position worth at least \$2000 (or 1% of the total shares), limit herself to one proposal that is 500 words or less per meeting, and submit the proposal at least 120 days before the date of the prior year's annual meeting proxy statement.

22. These grounds for exclusion include problems such as proposals that concern a matter that is beyond the firm's power to effectuate, proposals that involve ordinary business decisions, or proposals that are excessively vague or misleading. See 17 C.F.R. § 240.14a-8(i) (explaining on what grounds a company may exclude a proposal).

23. Under this process, the firm presents its arguments for why a given proposal may be excluded and asks the SEC to concur with its judgment—by stating that the regulators will take no legal action if the firm omits the proposal. The shareholder will typically respond by making her case to the SEC that the proposal must be circulated. The SEC will then evaluate the situation and decide whether to issue a no-action letter, render no decision, or announce that it will take action against the firm if the proposal is excluded.

24. The SEC's ruling is subject to challenge in federal court, but as a practical matter most firms simply include the proposal if they do not receive a no-action letter.

25. See Lucian Bebchuk et al., *Toward Board Declassification in 100 S&P 500 and Fortune 500 Companies: A Report of the SRP for the 2012 and 2103 Proxy Seasons*, SSRN (Feb. 2014), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2400652&download=yes (providing an overview of several board declassification proposals).

shareholders at these firms could elect just one-third of the directors each year.²⁶ In the ensuing years, however, and especially since 2012,²⁷ the prevalence of staggered boards has plummeted.²⁸ Recent accounts estimate that just one-tenth of the S&P 500 firms continue the practice.²⁹ Activist shareholders have executed a strategy of increasing voting power (relative to the previous status quo)³⁰ in a way that yields greater governance leverage.

How have shareholders convinced so many firms to roll back staggered boards? In theory, this should have been a particularly difficult tactic to execute because most corporations enshrined staggered board provisions in the articles of incorporation.³¹ The answer lies in a combination of proposals and pressure. A handful of institutional shareholders, working with a clinic at Harvard Law School, filed precatory shareholder proposals at large firms with staggered boards. These proposals could not be excluded under SEC proxy rules, so most firms were forced into a position where they would either need to appease the shareholders or include the proposal on their proxy materials. Many firms opted for the former—agreeing to sponsor a charter amendment (already approved by the board) for shareholder ratification during the next election cycle.³² This was a salient issue, and shareholders at many of the firms voted yes. Boards that resisted this sort of accommodation strategy were still forced to watch shareholders vote on the precatory proposal. Many of these proposals received majority approval, which put enough pressure on some boards to support a change. And boards that refused to yield received yet another proposal the following year.³³ It was an effective campaign.

Shareholders are also placing other types of ex-ante governance pressure on firms. There has been a surge, for instance, of shareholder proposals seeking annual reporting on

26. Staggered boards allow directors to take a seat with a term longer than one year. For example, a firm with nine directors might have three-year staggered terms such that three seats are placed on the ballot each year. This means that shareholders who are angry with board decision-making may not be able to replace a majority of directors in a single year. Lucian Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 890 (2002). One justification for staggered boards rests on the argument that they provide protection against subpar hostile takeover offers and, when combined with the poison pill, allow directors to extract maximum value for shareholders in a takeover situation. This is ultimately an empirical debate.

27. In 2012, Harvard Law School launched a clinic that worked with pension funds and other shareholder organizations to promote board declassification proposals at large firms. This project has generated recent controversy related to the sufficiency of the research disclosures offered in the shareholder proposals. Daniel M. Gallagher & Joseph Grundfest, *Did Harvard Violate Federal Securities Law? The Campaign Against Classified Boards of Directors* (Rock Center for Corporate Governance at Stanford University, Working Paper No. 199, 2014), http://papers.ssm.com/sol3/papers.cfm?abstract_id=2536586.

28. See generally Guhan Subramanian, *Delaware's Choice*, 39 DEL. J. CORP. L. 1 (2014) (describing the shift from staggered boards to annual elections).

29. See generally Bebchuk et al., *supra* note 25 (reporting the results of recent work by the Harvard Law School clinic); Liz Hoffman, *Bidders Pounce on Firms' Weakened Defenses*, WALL STREET J., Aug. 26, 2014, at C1 (citing research by ISS that also estimates that share of large U.S. companies with staggered boards dropped from 60% in 2002 to 10% in 2014).

30. Of course, the rise of staggered boards in the 1990s (when this idea gained traction as a defense against hostile takeovers) should also be seen as an example of ex-ante corporate governance. The more recent development of rolling back classified boards simply re-tilts the playing field.

31. Bebchuk et al., *supra* note 25, at 2. A small number of firms in the S&P 500 housed their staggered board rules in a bylaw, which made for an easier change.

32. *Id.*

33. *Id.*

a corporation's lobbying activity and political expenditures in the wake of *Citizens United*.³⁴ The motivation for this trend is undoubtedly an expression of concern, on the part of some owners, about the extent of corporate lobbying, possibly combined with a hope that greater disclosure will curb this activity. The unwillingness of the SEC to enact a mandatory reporting rule for corporate political activity may be another contributing factor. Other examples include proposals that seek to study the impact of a firm's activity on climate change, block accelerated option vesting for executives, require independent board chairs, or facilitate proxy access (especially conditions under which a firm must place a shareholder's competing board nominee on the firm's ballot).³⁵ The wisdom of these campaigns is debatable, and they have proceeded far more slowly than the elimination of staggered boards. But we should expect continued efforts to influence important or controversial decisions.³⁶

2. Shareholder Initiated Bylaws in Delaware

Supporters of shareholder power are also trying to move beyond the use of precatory initiatives and non-binding pressure tactics to enact compulsory bylaws.³⁷ The chief coordinating mechanism is still the shareholder proposal, which can also be used to organize shareholder voting on a new bylaw. For example, an activist shareholder might submit a bylaw proposal that mandates unanimous board approval for the adoption of a poison pill antitakeover device and limits the term of the pill to one year.³⁸ While advocates of shareholder bylaws celebrate this strategy as promoting private ordering related to the

34. See GIBSON DUNN, SHAREHOLDER PROPOSAL DEVELOPMENTS DURING THE 2014 PROXY SEASON (June 25, 2014), <http://www.gibsondunn.com/publications/Documents/Shareholder-Proposal-Developments-During-2014-Proxy-Season.pdf> [hereinafter GIBSON DUNN REPORT] (reporting that the number of shareholder proposals in this area dwarfed those in other topics, accounting for roughly 126 out of 900 proposals during the first half of 2014 and 115 out of 840 proposals during all of 2013). The *Citizens United* ruling famously expanded the degrees of freedom for corporations seeking to influence political events. See *Citizens United v. Fed. Election Comm'n*, 558 U.S. 310, 365 (2010) (holding that corporations have rights to finance political activity).

35. See GIBSON DUNN REPORT, *supra* note 34, at 2. In particular, proxy access enabling rules—and whether they should be mandatory for all firms or implemented only upon shareholder request—has become a hot topic in recent years. The bottom line is that shareholder proxy access is not currently mandated for all firms. But the SEC has also stated that a shareholder request to establish enabling rules, within certain parameters, may itself not be excluded from the firm's proxy materials. Thus far, little shareholder energy has been spent on securing these enabling rules for proxy access. According to one study, only four shareholder proposals for proxy access were approved by a majority of shareholders in 2014. This represents a very slight increase from the three approved proxy access proposals in 2013. *Id.*

36. Certainly the total number of proposals is growing, though much of the activity is driven by a handful of very lively investors. *Id.* (reporting that 901 shareholder proposals were filed during the first half of 2014, a large increase over the 840 proposals filed during all of 2013).

37. Typically, shareholder bylaw initiatives are offered in the face of board resistance. If the board wants to enact a bylaw, after all, it can just do so unilaterally. Conceivably, however, there might be legal or strategic reasons why a board would welcome a shareholder bylaw initiative. For example, Hal Scott and Leslie Silverman have argued that firms should consider adopting a bylaw that establishes mandatory individual arbitration for shareholder lawsuits. Hal S. Scott & Leslie N. Silverman, *Stockholder Adoption of Mandatory Individual Arbitration for Stockholder Disputes*, 36 HARV. J.L. & PUB. POL'Y 1187, 1209 (2013). The authors suggest that shareholders are better positioned to propose and approve this type of bylaw because unilateral managerial adoption might raise concerns about unequal bargaining power and fairness. *Id.* at 1217. Further, even if a managerial initiative would not run afoul of legal review, some insider managers may fear a political backlash from proxy advisors or other activist shareholders.

38. See, e.g., *Bebchuk v. CA, Inc.*, 902 A.2d 737, 739 (Del. Ch. 2006) (advocating for this type of bylaw).

governance of heterogeneous corporations,³⁹ the efficacy of shareholder bylaw initiatives under Delaware law remains clouded in technical uncertainties. Some background is in order.

a. Background: The “Recursive Loop”

How much control can shareholders assert through a unilateral bylaw? It is not easy to determine whether a given act amounts to illegal usurpation of board power in Delaware because of two apparently conflicting statutory provisions—a phenomenon that Jeffrey Gordon has coined the “recursive loop.”⁴⁰ The problem arises because section 109 of the Delaware General Corporate Law (DGCL) allows shareholders to enact bylaws that 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 . . . or the rights or powers of its stockholders, directors, officers or employees.”⁴¹ This language seems to endorse bylaws that reserve some decision-making authority with shareholders or constrain a board’s ability to take certain actions.

But section 141(a) of the DGCL adds that “the business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors, except *as may otherwise be provided in this chapter* or in its certificate of incorporation.”⁴² Taken together, these two provisions seem to present a circular reference error. Does this mean that a shareholder bylaw amendment that purports to constrain board authority is invalid because it is unlawful under section 141 and therefore impermissible under section 109? Or does section 109’s grant of bylaw adoption power to shareholders become part of *this chapter* of law referenced by section 141? If so, then board-constraining initiatives should be allowed.

Numerous commentators have tried to cut this loop, which is central to understanding how far shareholders might go when engaging in ex-ante governance by bylaw.⁴³ There are at least three possible ways to understand the situation.⁴⁴ First, section 109 might fail to authorize any shareholder initiated bylaw because section 141 renders such efforts illegal. Second, section 109 might be broadly construed as overriding any limitation that would otherwise be imposed by section 141. Neither of these interpretations seem particularly persuasive,⁴⁵ however, and, in my view, the best way to understand the

39. See Gordon Smith et al., *Private Ordering with Shareholder Bylaws*, 80 FORDHAM L. REV. 125, 127 (2011) (discussing Delaware rules and private ordering).

40. See Jeffrey N. Gordon, “Just Say Never?” *Poison Pills, Deadhand Pills, and Shareholder Adopted Bylaws: An Essay for Warren Buffett*, 19 CARDOZO L. REV. 511, 546 (1997) (illustrating the “recursive loop” present in Delaware corporate law).

41. DEL. CODE tit. 8, § 109 (1953) (emphasis added).

42. DEL. CODE tit. 8, § 141(a) (1953) (emphasis added).

43. See Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted Bylaws: Taking Back the Street?*, 73 TUL. L. REV. 409, 444–45 (1998) (discussing the application of 141(a) and 109); Brett McDonnell, *Shareholders Bylaws, Shareholder Nominations, and Poison Pills*, 3 BERKELEY BUS. L.J. 205, 214 (2005) (analyzing the three possible readings of section 109 and 141(a)); Smith et al., *supra* note 39, at 140–45 (explaining possible understandings of the Delaware code); Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role*, 80 TEX. L. REV. 261, 320–21 (2001) (articulating various statutory readings); Julian Velasco, *Just Do It: An Antidote to the Poison Pill*, 52 EMORY L.J. 849, 852–53 (2003) (exploring arguments that avoid the recursive loop).

44. McDonnell, *supra* note 43, at 214.

45. Granting shareholders unlimited bylaw power would undermine the “large reservoir of authority” that

situation is that section 109 allows some room for shareholder bylaws but that section 141 also operates to limit how far these provisions might go.⁴⁶

The obvious question that remains is where to draw the line. Could shareholders pass a bylaw that requires the board to abstain from political expenditures? Or one that requires a certain type of contraceptive to be provided in the firm's health care plan? What about a bylaw that conditions all investments above a certain threshold on a shareholder vote? Finding a middle ground will clearly depend on context. Unfortunately, there has been very little judicial guidance on this question until quite recently—for reasons that this Article will now address.

b. A Second "Hellerian" Challenge

In 2006, Harvard professor Lucian Bebchuk led the effort to establish a framework for evaluating permissible shareholder bylaw activity down a second rabbit hole. Bebchuk filed a shareholder proposal that would have required the technology firm CA, Inc. to include a bylaw proposal on its proxy statement.⁴⁷ If approved by a majority of shareholders, this bylaw would restrict the firm's ability to use a poison pill anti-takeover device by requiring unanimous board approval to adopt the pill and by limiting the term of the pill to just one year (but permitting renewals).⁴⁸

As should now be apparent, it is hardly clear from the text of the DGCL that a shareholder bylaw can tie a board's hands in this manner. The unanimous board voting requirement is fine,⁴⁹ but the one-year term limit is questionable. Bebchuk filed a Delaware lawsuit seeking a declaratory judgment that the bylaw was permissible. At the same time, CA petitioned the SEC for a no-action letter. CA claimed that it could exclude the proposal because the bylaw illegally intruded on the board's prerogative to manage the firm under section 141 of the DGCL.⁵⁰ This was, of course, the exact issue that Bebchuk sought to test in court. The SEC was unwilling to take a position on CA's no-action letter, and it stated that it held "no view" on whether CA could exclude the proposal.⁵¹ Attention thus swung back to how Delaware would respond to Bebchuk's declaratory judgment claim. But the Chancery Court also refused to sort this out, asserting instead that the issue was not ripe for adjudication because a bylaw must be enacted (not just proposed) in order for the situation to reach a "justiciable controversy."⁵²

Taken together, these developments trapped shareholder bylaw initiatives in a vexing "catch-22." Shareholders could not easily enact a new bylaw unless they gained access to

the board clearly enjoys under DGCL section 141. *See Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 953 (Del. 1985). But it is also clear that a board's authority to manage the firm may be limited by shareholder bylaws that regulate the processes used by the board to act. *See, e.g.*, DEL. CODE tit. 8, § 141(b) (2015) (authorizing a bylaw that requires supermajority or unanimous director voting for certain decisions).

46. McDonnell, *supra* note 43, at 214.

47. *Bebchuk v. CA, Inc.*, 902 A.2d 737, 737 (Del. Ch. 2006).

48. *Id.*

49. Bylaws imposing heightened board voting requirements are expressly sanctioned by DEL. CODE tit. 8, § 141(b) (2014).

50. SEC Shareholder Proposals Rule, 17 C.F.R. 240.14(a)-8(i)(2) (2014) (allowing a firm to exclude a shareholder proposal "if the proposal would, if implemented, cause the company to violate any state, federal, or foreign law to which it is subject").

51. *Bebchuk*, 902 A.2d at 739.

52. *Id.* at 741.

the corporate proxy machinery. But the SEC was unwilling to endorse bylaw proposals that approached substantive business constraints on the board (such as Bebchuk's one-year restriction⁵³) without more guidance from Delaware about what the DGCL would sanction. And Delaware would apparently not issue this guidance until a bylaw had actually been passed. It was a maddening stalemate.

Fortunately, this second-order "log jam" was soon resolved by the Delaware General Assembly. It amended the state constitution to permit the Delaware Supreme Court to "hear and determine questions of law certified" to the court by the SEC.⁵⁴ This development offered a path forward for direct evaluation of shareholder bylaw power.⁵⁵ Indeed, within a year, the SEC certified a questionable shareholder bylaw proposal to the Delaware Supreme Court.

c. Development

In 2008, a group of shareholders filed another bylaw proposal with CA, Inc.'s board of directors (the hapless firm had apparently become ground zero for corporate governance disputes). The bylaw sought to require CA to reimburse stockholders for "reasonable expenses . . . incurred in connection with nominating one or more candidates in a contested election of directors."⁵⁶ CA danced the now-familiar steps by seeking a no-action letter from the SEC on the grounds that the proposal was improper under Delaware law. The SEC promptly certified the question to the Delaware Supreme Court, and everyone leaned in to watch how the court might cut the recursive loop.

Unfortunately, only a hazy answer emerged. Robert Thompson summed it up well when he wrote that the "court . . . seemed to simultaneously point in two directions."⁵⁷ The SEC certified two questions for review: "(1) Is the . . . [p]roposal a proper subject for action by shareholders as a matter of Delaware law? (2) Would the . . . [p]roposal, if adopted, cause CA to violate any Delaware law to which it is subject?"⁵⁸ The court answered each question in the affirmative.

The court reached its answer to question one by retreating into the well-trod, if often

53. The division between substance and process is obviously a thin one. Bebchuk might argue, for example, that this bylaw was completely focused on process because it did not mandate or prohibit the use of the pill; it only regulated the process by which a pill could be enacted. The board, on the other hand, might claim that the duration of the pill is a substantive term, akin to the share ownership threshold that would trigger the pill or some other feature of the securities used to deliver the pill. Both arguments seem plausible: bylaws routinely regulate the term of board seats as a matter of process, but time constraints must eventually become substantive. Imagine, for example, a bylaw that requires a shareholder vote for all firm expenditure decisions that will last longer than a year.

54. DEL. CONST. art. IV, § 11(8).

55. See, e.g., J.W. Verret, *Federal vs. State Law: The SEC's New Ability to Certify Questions to the Delaware Supreme Court*, CORP. GOVERNANCE ADVISOR, Mar.–Apr. 2008, at 12–14 (hinting that the Delaware Supreme Court might be called to answer questions about shareholders' ability to constrain director power to repeal bylaws, shareholders' ability to constrain or manage the board election process, and many other fundamental questions of corporate governance).

56. CA, Inc. v. AFSCME Emp. Pension Plan, 953 A.2d 227, 229–30 (Del. 2008) (detailing additional conditions applied to the reimbursement mandate).

57. Robert B. Thompson, *Defining the Shareholder's Role, Defining a Role for State Law: Folk at 40*, 33 DEL. J. CORP. L. 771, 782 (2008).

58. AFSCME, 953 A.2d at 231.

nebulous, distinction between process and substance.⁵⁹ Specifically, it asserted that “it is well-established Delaware law 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.”⁶⁰ This was a puzzling statement, especially since the court cited only two lower court opinions to support this proposition—neither of which insisted that bylaws *had* to be procedural.⁶¹

But having embraced the process-substance distinction for bylaws, the court might have then been expected to rule that the CA shareholder bylaw was invalid. After all, the bylaw obligated the corporation to spend money from the corporate treasury to support qualified board nominees—which seemed to be a substantive command. Yet it held that while this bylaw may have been “infelicitously couched as a substantive-sounding mandate to expend corporate funds, [it actually] has both the intent and the effect of regulating the process for electing directors of CA.”⁶² This led to an affirmative answer to the first certified question: this was indeed a proper subject for shareholder action.

What the court gave with one hand, however, it took back with the other. Despite ruling for the shareholders on question one, the justices held that the proposed bylaw would cause CA to violate Delaware law, because one could imagine circumstances where a board of directors might breach fiduciary duties when it complied with the proposal. For example, the court speculated that a CA shareholder group might affiliate with a competing technology firm to elect a slate of directors who would then send proprietary strategic information to the competitor.⁶³ In the court’s view, mandatory funding of such an effort by the old board would be problematic. Said differently, the court wanted a fiduciary out for the bylaw.⁶⁴

All of this has left corporate law scholars scratching their heads, and future litigation or legislation is clearly required to sort out the limits of shareholder bylaws. The difference between process and substance is always difficult to parse, but it seems especially slippery in this context. It is also conceivable that Delaware might decide to walk back its “process-

59. Along the way, the court also offered an obscure assertion that is perhaps relevant to shareholder-initiated bylaws. Specifically, the court stated that “the DGCL has not allocated to the board and the shareholders the identical, coextensive power to adopt, amend and repeal the bylaws.” *Id.* What does this mean? It is technically a true statement in that shareholders are delegated unilateral (and immutable) bylaw modification power by statute (DGCL section 109), while the board may only be given such power through a provision in the charter. But so what? See Smith et al., *supra* note 39, at 150–51 (questioning the meaning of the distinction).

60. *AFSCME*, 953 A.2d at 234–35.

61. In *Hollinger International, Inc. v. Black*, the Chancery Court stated that there was a “general consensus that bylaws that regulate the process by which the board acts are statutorily authorized” and that “bylaws may pervasively and strictly regulate the process by which the board acts, subject to the constraints of equity.” *Hollinger Int’l, Inc. v. Black*, 844 A.2d 1022, 1978–79 (Del. Ch. 2004). But it never stated that bylaws *had* to be procedural. Similarly, in *Gow v. Consolidated Coppermines Corp.*, the Chancery Court stated that “the by-laws are generally regarded as the proper place for self-imposed rules and regulations deemed expedient for [the firm’s] convenient functioning to be laid down.” *Gow v. Consolidated Coppermines Corp.*, 165 A.2d 136, 140 (Del. Ch. 1933). Again, there is nothing about this statement that prohibits substantive bylaws. See Smith et al., *supra* note 39, at 152–53 (noting that though the purpose of bylaws is generally procedural, that does not mean they must be exclusively so).

62. *AFSCME*, 953 A.2d at 236.

63. *Id.* at 239–40.

64. This case also illustrates a potential drawback of the certification process: the Delaware Supreme Court is unable to review questions with reference to a specific set of facts developed in a lower court decision; it must consider general questions of law and the attendant hypotheticals.

only” limit on bylaws.⁶⁵ What is becoming clear, however, is that Delaware courts are willing to uphold new breeds of ex-ante bylaws as long as the proposals are carefully crafted, and do not purport to encroach too far on substantive corporate decision-making. For some, this is a welcome development—but also one that may not go far enough.

d. Shareholder Bylaws, Contracts, and Private Ordering

Buoyed by these recent events, several commentators are celebrating the dawn of an era where shareholders might be able to tinker much more freely with corporate governance. Gordon Smith, Matthew Wright, and Marcus Kai Hintz, for example, have argued that shareholder initiated bylaws are a positive development because different types of firms will benefit from different governance features.⁶⁶ As they put it, “by facilitating private ordering, we would expect each corporation to become a laboratory of corporate governance, experimenting with different models of shareholder participation and ultimately producing a diversity of governance forms and practices.”⁶⁷ In short, shareholders should be granted the same flexibility as individual contracting parties in order to tailor governance to key features of their firm.

Indeed, Smith, Wright, and Hintz would embrace four structural changes to Delaware law that could clarify and extend a shareholder’s right to adopt sweeping bylaws. First, they would amend section 141(a) of the DGCL to state that a firm’s bylaws provide another limit on the board’s freedom to act—thereby breaking the recursive loop through a blanket endorsement of shareholder bylaw primacy.⁶⁸ Second, they would amend section 109 of the DGCL to state that bylaws may be procedural *or* substantive, thereby overruling the procedural limitation imposed by the Delaware Supreme Court in *CA v. AFSCME*.⁶⁹ Third, they would advocate judicial reconsideration of the declaration (in that same case) that directors can breach a fiduciary obligation to a firm by carrying out a shareholder imposed bylaw.⁷⁰ And fourth, they would eliminate the ordinary business exclusion in SEC Rule 14a-8—which would make it much easier for shareholders to leverage the proxy materials of a firm to propose a new bylaw.⁷¹ These seemingly technical tweaks would have broad consequences, and I will return to some of these ideas later.

These proposals are modest, however, when compared to those of the strongest advocates for shareholder power. For instance, Lucian Bebchuk has argued that shareholders should not only be able to modify bylaws, but they should also be empowered (by legal default) to unilaterally conduct charter amendments or change their firm’s state of incorporation.⁷² These more extreme suggestions face strong headwinds, however, and the near-term action will likely focus on shareholder initiated bylaws.

In any event, while there has been significant activity on the investor side of the ledger, shareholders are not the only party to recognize the benefits of ex-ante corporate

65. These are topics I will revisit *infra* Part IV.

66. See Smith et al., *supra* note 39, at 174 (discussing the benefits of varying degrees of shareholder participation).

67. *Id.*

68. *Id.* at 181–83.

69. *Id.* at 184.

70. *Id.* at 184–85.

71. Smith et al., *supra* note 39, at 185–87.

72. See Lucian Arye Bebchuk, *The Case for Shareholder Power*, 118 HARV. L. REV. 833, 900 (2005) (discussing the benefits of an effective staggered board).

governance. We now turn to the recent action of corporate boards.

B. Director Side Governance

1. Exercising Residual Power

As a practical matter, directors and managers hold what we might call residual rights to run a firm. They can already decide how to muster and deploy corporate assets. Controversial actions may trigger a shareholder (or regulatory) response, of course, but managers, in contrast to shareholders, have less need to focus on upfront strategies for influencing ordinary decision making power. Directors are still gravitating towards ex-ante governance efforts, however, especially ones that might limit or channel a shareholder's right to vote, sell, or sue.

While it is conceivable that ex-ante board governance might seek to influence voting or share marketability, most of the attention is on shareholder litigation. Shareholder voting seems sacrosanct, as this right has been carefully guarded by corporate law as a primary legitimizing force for representative decision making.⁷³ Still, there is some room to tinker. Recall how the pervasive shift to staggered boards in the 1990s can be viewed as an ex-ante strategy for diluting the shareholder vote—albeit one that has been rolled back.⁷⁴ And establishing plurality voting or new classes of voting securities might present different opportunities for weakening the vote.

Similarly, unilateral board action to hinder the freedom of shareholders in large public firms to sell their shares would undoubtedly attract harsh criticism.⁷⁵ Equity owners do not like restrictions on the ability to dispose of supposedly liquid investments, and there are also statutory requirements related to exit rights.⁷⁶ But unilateral board action to limit stock alienability is not unthinkable on the extreme margins. Again, consider the poison pill. By effectively blocking the right of large shareholders to buy stock from smaller shareholders, this device does create a minuscule ex-ante limit on share transferability—though small shareholders are still free to dump their stock elsewhere.

In any event, while boards may attempt to use devices like charter amendments or preferred stock to conduct ex-ante governance, the reach of these efforts is limited. For this reason, the most interesting ex-ante board governance strategies increasingly involve unilateral bylaws.

73. See, e.g., Robert Thompson & Paul Edelman, *Corporate Voting*, 62 VAND. L. REV. 127, 129 (2009) (discussing information theory for shareholder voting). This remains true despite the widespread recognition that many shareholders do not vote and lack incentives to do so. Likewise, the fact that the back office plumbing used to run corporate elections does not always function effectively has not undermined the perception that shareholder voting serves as an important justification for representative leadership. See generally Marcel Kahan & Edward Rock, *The Hanging Chads of Corporate Voting*, 96 GEO. L.J. 1227 (2008) (describing recurring problems with corporate voting).

74. See *supra* notes 25–31 and accompanying text (discussing the shift toward staggered boards).

75. There are limited contexts where restricting the transfer of shares may be desirable. But these typically involve situations where a small group shareholders wish to control who is involved with the business (perhaps by embracing a right of first refusal on future sales) or where constraints are imposed for some other reason (such as when inside managerial shares are locked after an initial public offering). It is unimaginable that a board initiated bylaw in a large public firm would seek to impose a rule that all sales must be approved by the board.

76. E.g., DEL. CODE. tit. 8, § 202 (1953).

2. Board Initiated Bylaws in Delaware

Fortunately, the path to understanding director-initiated bylaws is less tortuous than that of shareholder bylaws. While the Model Business Corporation Act (MBCA) expressly provides a default rule that permits unilateral modification by directors,⁷⁷ in Delaware that default rule is reversed: shareholders are statutorily empowered to make unilateral bylaw modifications, but the board is only granted this power through an explicit provision in the corporate charter.⁷⁸ Most large Delaware corporations seem to adjust this default, however, to convey such rights to the board.

As mentioned above, recent director-side activity has concentrated on shareholder lawsuits. The theoretical justification for constraining these claims is that a given shareholder might conceivably file an action that benefits the plaintiff (or her lawyers) individually but does not reflect the best interests of the firm. Because any monetary recovery from the corporation diminishes the value of the corporate assets that support the stock price,⁷⁹ the majority of investors may prefer a structure that limits specious or duplicative lawsuits. Commentators have pointed to the rising incidence of merger litigation, for example, as evidence that shareholder lawsuits have become de-coupled from legitimate inquiry into managerial misdeeds.⁸⁰ Moreover, a single alleged wrong will often trigger identical lawsuits in multiple jurisdictions,⁸¹ which can give rise to inefficiencies and other legal problems.⁸²

Of course, just because some shareholders are willing to bring a strike suit does not mean that all claims are spurious. And even the threat of shareholder action might serve as a meaningful check on managerial misconduct. So while the purported aim of director initiated bylaws is to promote considered evaluation of a claim's merits before filing a complaint, we should also worry about the possibility that some managers may attempt to obviate all lawsuits as a way to sidestep shareholder monitoring and facilitate agency abuses.

With this tension in mind, it is worth a brief exploration of three important developments related to director side governance: exclusive forum selection provisions, litigation fee-shifting requirements, and binding shareholder arbitration clauses.

77. MODEL BUS. CORP. ACT § 10.20(b) (AM. BAR ASS'N 1950). This default can be altered in the articles of incorporation to take this power away from directors, and shareholders may also state that a given bylaw initiated by shareholders cannot be altered or repealed by the board. *Id.*

78. DEL. CODE tit. 8, § 109(a) (1953).

79. This effect is sometimes clouded by the presence of insurance policies that cover judgments against the firm. *See* TOM BAKER & SEAN J. GRIFFITH, ENSURING CORPORATE MISCONDUCT: HOW LIABILITY INSURANCE UNDERMINES SHAREHOLDER LITIGATION 106 (2011). But even if a given claim is insured, other shareholders may incur a penalty if there is a corresponding adjustment to future premiums.

80. *See, e.g.*, CORNERSTONE RESEARCH, SHAREHOLDER LITIGATION INVOLVING MERGERS AND ACQUISITIONS (2014), <https://www.cornerstone.com/GetAttachment/897c61ef-bfde-46e6-a2b8-5f94906c6ee2/Shareholder-Litigation-Involving-Acquisitions-2014-Review.pdf> (reporting that 94% of merger transactions that were announced in 2013 and greater than \$100 million in size attracted at least one shareholder lawsuit).

81. It is often possible to raise claims in more than one jurisdiction because one shareholder can sue in the state where the firm is incorporated, while another shareholder can sue in the state that comprises the firm's headquarters or primary place of business.

82. *See, e.g.*, George S. Geis, *Shareholder Derivative Litigation and the Preclusion Problem*, 100 VA. L. REV. 261 (2014) (discussing the preclusion problem in the context of shareholder derivative litigation).

a. Forum Selection

Multi-jurisdiction lawsuits can raise problems. Litigating the same shareholder concern in two or more states is rarely an efficient use of legal resources. And the duplication also triggers fears about inconsistent verdicts and the preclusive effect of one judgment on another state's proceeding.⁸³ Accordingly, some commentators are promoting board initiated forum selection bylaws that channel shareholder litigation into a single jurisdiction (often Delaware).⁸⁴

The legitimacy of this strategy remained unclear until 2013, when *Boilermakers Local 154 Retirement Fund v. Chevron Corp.* upheld forum selection bylaws in Delaware.⁸⁵ This decision was notable for explicitly embracing a contract theory of board initiated bylaws.⁸⁶ The court did reserve the right to strike down a forum selection bylaw under an "as applied" analysis if it would lead to an unfair and unjust result for any given plaintiff.⁸⁷ It is not entirely clear, however, what it will take to mount a successful challenge, and the legality of forum selection provisions may continue to be litigated in specific contexts.⁸⁸

Following *Boilermakers*, numerous boards have adopted forum selection bylaws,⁸⁹

83. *Id.*

84. See Sarah Lewis, Note, *Transforming the "Anywhere but Chancery" Problem into the "Nowhere but Chancery" Solution*, 14 STAN. J.L. BUS. & FIN. 199, 199 (2008) (discussing an increase in shareholder suits against directors and officers and offering forum selection provisions as a proposed solution to the issue); Edward B. Micheletti & Jenness E. Parker, *Multi-Jurisdiction Litigation: Who Caused this Problem and Can it be Fixed?*, 37 DEL. J. CORP. L. 1, 17-18 (2012); Brian JM Quinn, *Shareholder Lawsuits, Status Quo Bias, and Adoption of the Exclusive Forum Provision*, 45 U.C. DAVIS L. REV. 137, 137 (2011); Faith Stevelman, *Regulatory Competition, Choice of Forum, and Delaware's Stake in Corporate Law*, 34 DEL. J. CORP. L. 57, 57 (2009).

85. *Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934, 962 (Del. Ch. 2013). The analysis is discussed *infra* notes 152-156 and accompanying text.

86. See *infra* Part III (discussing contract theory of board initiated bylaws).

87. *Boilermakers*, 73 A.3d at 957. The "as applied" carve out is a direct application of *M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 1 (1972), upholding the general validity of forum selection provisions but also stating that these terms will not be enforced if the resisting party can demonstrate that this would lead to unreasonable consequences. Specifically, "[a] contractual choice-of-forum clause should be held unenforceable if enforcement would contravene a strong public policy of the forum in which suit is brought, whether declared by statute or by judicial decision." *Id.* at 15. Delaware explicitly adopted this standard with *Ingres Corp. v. CA, Inc.*, 8 A.3d 1143, 1146 (Del. 2010), holding that forum selection provisions are valid but will be subjected to an "as-applied" review under *M/S Bremen* to test whether they are being used unreasonably or unjustly.

88. The limited commentary suggests that it will not be easy for a plaintiff to win these challenges. See generally Walter W. Heiser, *Forum Selection Clauses in State Courts: Limitation on Enforcement After Stewart and Carnival Cruise*, 45 FLA. L. REV. 361 (1993) (discussing issues arising with forum selection provisions); Michael D. Moberly & Carolyn F. Burr, *Enforcing Forum Selection Clauses in State Court*, 39 SW. L. REV. 265 (2009). The Delaware cases reinforce this point. See, e.g., *HealthTrio Inc. v. Margules*, No. 06C-04-196, 2007 WL 544146, at *3 (Del. Super. Ct. Jan. 16, 2007) ("Mere inconvenience or additional expense is not the test of unreasonableness. In light of present day commercial realities, a forum clause should control absent a strong showing that it should be set aside."); *Elia Corp. v. Paul N. Howard Corp.*, 391 A.2d 214, 216 (Del. Super. Ct. 1978) ("Such an agreement is unreasonable only when its enforcement would, under the circumstances then existing, seriously impair the plaintiff's ability to pursue his cause of action."). But see *MICH II Holdings LLC v. Schron*, No. 6840-VCP, 2012 WL 2499507, at *4 (Del. Ch. June 29, 2012) (refusing to enforce a forum selection provision because the provision was not written broadly enough to apply to a specific type of lawsuit and because the case had already made considerable progress in a separate New York proceeding).

89. See SULLIVAN & CROMWELL LLP, *EXCLUSIVE FORUM BYLAWS GAIN MOMENTUM 1* (2014), http://www.sullcrom.com/siteFiles/Publications/SC_Publication_Exclusive_Forum_Bylaws_Gain_Momentum.pdf (reporting that more than two dozen large corporations adopted forum selection bylaws in 2013 and 2014).

and it is likely that the trend will continue.⁹⁰ Importantly, these provisions must also be enforced by other states if a shareholder tries to initiate litigation in a non-designated forum. The early returns suggest, however, that foreign courts are usually honoring forum selection bylaws.⁹¹

Channeling a lawsuit into a single jurisdiction might minimize duplicative litigation and thus act as an ex-ante governance constraint. But it does not eliminate the ability of a rogue shareholder to file an unfounded nuisance claim in that chosen state. To counter this possibility—or potentially to further insulate themselves from shareholder monitoring—boards have also turned to bylaws that require a shareholder to cover the firm’s legal costs if the plaintiff loses. Here the story is more complicated.

b. Litigation Fee Shifting

The move to fee shifting should perhaps have been expected in the wake of broad judicial support for private ordering in *Boilermakers*, but an unusual dispute involving men’s professional tennis actually provided the spark for this fire.⁹² In 2006, the board of ATP Tour, Inc., an association of tennis professionals that organizes and manages tournaments around the world, adopted a litigation fee-shifting bylaw. Specifically, it stated that a current or former member of the association (ATP was a Delaware non-stock membership corporation) who brought a suit or counterclaim against ATP but failed to “obtain a judgment on the merits that substantially achieve[d], in substance and amount, the full remedy sought” would need to reimburse ATP for attorney’s costs, fees, and other litigation expenses.⁹³

This new bylaw was soon put to the test. In 2007, ATP decided to reorganize its tour schedule in a way that downgraded the Hamburg tennis tournament from a “top tier” event.⁹⁴ The German and Qatar members of the association were mad at this change, and they sued ATP in U.S. District Court, alleging antitrust claims under federal law and breach of fiduciary duty claims under Delaware law.⁹⁵ The plaintiffs lost on all counts, and ATP immediately moved to recover its legal fees under the new bylaw.

The District Court denied ATP’s fee recovery, stating that the bylaw interfered with public policy concerns of federal antitrust law.⁹⁶ In effect, the court held that “federal law

90. Certainly a number of legal advisors are promoting the move. *E.g.*, PAUL SCRIVANO & NOAH KORNB�ITH, WACHTELL LIPTON ROSEN & KATZ, EXCLUSIVE FORUM BYLAW MEMORANDUM (2013), <http://www.wlrk.com/docs/ForumSelectionBylawBODmemo.pdf>. *But see* O’MELVENY & MYERS, EXCLUSIVE FORUM BYLAWS: FURTHER CONSIDERATION RECOMMENDED (2014), <http://www.omm.com/exclusive-forum-bylaws-further-consideration-recommended-03-11-2014/> (counseling caution).

91. *See, e.g.*, Transcript of Hearing at 38, *Miller v. Beam Inc.*, No. 2014-CH-00932 (Ill. Cir. Ct. Mar. 5, 2014) (enforcing a forum selection bylaw in Illinois); *Edgen Group Inc. v. Genoud*, C.A. No. 9055 (Del. Ch. Nov. 5, 2013) (enforcing a forum selection charter provision in Louisiana); *Hemg Inc. v. Aspen Univ.*, No. 650457/13, 2013 WL 5958388, at *3 (N.Y. Sup. Ct. Nov. 4, 2013) (enforcing a Delaware forum selection bylaw in New York). *But see infra* notes 134–136 and accompanying text (discussing a California court’s refusal to uphold a forum selection bylaw).

92. *ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554, 555–56 (Del. 2014).

93. *See id.* at 556 (paraphrasing the ATP fee-shifting bylaw).

94. *Id.* ATP also moved the tournament to a less desirable summer date.

95. *See id.* (giving background on the litigation).

96. *See Deutscher Tennis Bund v. ATP Tour, Inc.*, No. 07-178, 2009 WL 3367041, at *4 (D. Del. 2009) (reasoning that the significant costs associated with bringing an antitrust case, heightened by such bylaws, would have a chilling effect on parties filing meritorious actions).

preempts the enforcement of fee-shifting agreements when antitrust claims are involved.”⁹⁷ ATP appealed, and the United States Court of Appeals for the Third Circuit vacated the lower court’s decision, stating that the legality of the bylaw should first be determined as a matter of Delaware corporate law.⁹⁸ The District Court, in turn, handed this question over to the Delaware Supreme Court as a novel question of first impression.

In 2014, the Delaware Supreme Court accepted certification of the issue and determined that litigation “fee-shifting provisions in a non-stock corporation’s bylaws can be valid and enforceable under Delaware law.”⁹⁹ The logic paralleled that of *Boilermakers*: corporate relationships are contracts,¹⁰⁰ and litigation fee-shifting provisions are a valid subject for contractual agreement.¹⁰¹ Moreover, the Supreme Court ruled that the bylaw was enforceable against members who joined the association before the new rule was adopted—stamping the Delaware Supreme Court’s approval on the unilateral modification framework employed by the Court of Chancery in *Boilermakers*. The Supreme Court refused to determine, however, whether this specific bylaw was valid because the Court lacked the facts necessary to evaluate whether the bylaw should be annulled for unreasonable application.¹⁰² What it did say was that adopting the bylaw with an intent to deter litigation was not, without more, an improper purpose for a bylaw.¹⁰³

This decision quickly caught the attention of corporate lawmakers, scholars, and practitioners. Although ATP was a non-stock membership corporation, the relevant provisions of Delaware corporate law apparently applied in the same manner to stock corporations. The ruling thus seemed to pave the way for fee-shifting bylaws, especially one adopted “on a clear day,” that is, in an ex-ante manner that could not be linked to a specific lawsuit that the board might wish to avoid.

The reaction from some parties was one of alarm. The Corporate Law Section of the Delaware State Bar Association, for instance, quickly sought to curb the practice, expressing concern that widespread fee-shifting bylaws would go too far by chilling meritorious shareholder lawsuits.¹⁰⁴ Some also suggested that the bylaws might run afoul of limited liability protection afforded to shareholders under corporate law.¹⁰⁵ Legal

97. *Deutscher Tennis Bund v. ATP Tour Inc.*, 480 Fed. Appx. 124, 126 (3d Cir. 2012).

98. *See id.* (holding that the validity of the fee-shifting bylaw must be determined before addressing constitutional preemption concerns).

99. *ATP Tour*, 91 A.3d at 555.

100. Interestingly, while *Boilermakers* emphasized that the contract ran between shareholders and the firm, the *ATP* decision focused on contractual privity among the individual shareholders. *Id.* at 558. As discussed *infra* Part III, the differing views of the contractual relationship have implications for who might bring a lawsuit (though it is possible that both types of legal relationships are created).

101. *See ATP Tour*, 91 A.3d at 557–59 (holding that “contracting parties may agree to modify the American Rule and obligate the losing party to pay the prevailing party’s fees”).

102. *See id.* at 559 (asserting that certifications may only address questions of law).

103. *See id.* (“Fee shifting provisions, by their nature, deter litigation.”).

104. *See* Liz Hoffman, *Delaware Fight Over Corporate Legal Bills on Hold*, WALL STREET J. (June 18, 2014, 7:18 PM), <http://blogs.wsj.com/law/2014/06/18/delaware-fight-over-corporate-legal-bills-on-hold/> (reporting how the Delaware State Bar crafted legislation to prevent companies from adopting such bylaws).

105. *Id.* Arguably, requiring shareholders to reimburse the corporation in connection with a failed lawsuit violated the rule that shareholders are not exposed to personal risk beyond the amount of their investment in the firm. The counter-argument, however, is that a shareholder still enjoys limited liability for corporate activity but has now chosen to expand the risk by launching a lawsuit. A cynic might also speculate that the state bar association, often a staunch defender of corporate rights, feared that widespread use of fee-shifting bylaws would vastly decrease the amount of corporate litigation and have an adverse effect on the market for legal services.

advisors counseled firms to watch and wait,¹⁰⁶ but several public corporations soon put fee-shifting bylaws to the test.¹⁰⁷ At least two of these firms faced rapid legal challenges.¹⁰⁸

The resolution of these cases was ultimately unimportant, however, because recent legislation has effectively struck down fee-shifting bylaws (and charter amendments) as a matter of statutory law. On March 13, 2015, the Corporate Law Section of the Delaware State Bar offered an amendment to the DGCL that explicitly eradicated fee shifting for state law claims by shareholders.¹⁰⁹ John Coffee has shrewdly noted that the language does not exclude fee shifting provisions related to federal securities claims (which, if attempted, will raise interesting preemption issues).¹¹⁰ But broad use of fee-shifting bylaws clearly ran into a dead end as an ex-ante governance strategy in Delaware when the statutory reforms were enacted during the summer of 2015.¹¹¹

Litigation fee-shifting is such a salient issue that other states might be able to attract firms away from Delaware by enforcing this type of bylaw.¹¹² Before that occurs, however, it seems more likely that boards will turn their attention to the use of alternative ex-ante strategies, such as binding shareholder arbitration, to mitigate shareholder litigation.

106. See, e.g., Skadden Arps, *Fee Shifting Bylaws: The Current State of Play* (June 20, 2014), http://www.skadden.com/newsletters/Fee-Shifting_Bylaws_The_Current_State_of_Play.pdf (citing continuing uncertainty over the legality of these provisions as well as the risk of a hostile reaction from proxy advisors and activist shareholders).

107. See Tom Hals, *U.S. Companies Adopt Bylaws That Could Quash Some Investor Lawsuits*, REUTERS (July 7, 2014, 4:07 P.M.), <http://www.reuters.com/article/2014/07/07/us-usa-litigation-companies-idUSKBN0FC26O20140707> (reporting on the first six companies to adopt fee-shifting bylaws in Delaware).

108. See Alison Frankel, *Early Test of Delaware 'Loser Pays' Bylaw Looms in the Biolase Dispute*, REUTERS (July 8, 2014), <http://blogs.reuters.com/alison-frankel/2014/07/08/early-test-of-delaware-loser-pays-bylaws-looms-in-biolase-dispute/> (documenting the fee-shifting debate within company in-fighting at Biolase). The most interesting challenge was brought in connection with a shareholder derivative lawsuit. A group of shareholders brought a claim against a firm named Hemispherx to invalidate roughly \$2.5 million in bonuses that the firm had awarded to senior managers. See *Motion to Invalidate Bylaw, Katsis v. Carter*, No. 8657-CB (July 21, 2014), <http://www.law.du.edu/index.php/corporate-governance/governance-cases/katsis-v.-carter>. Hemispherx formed a special litigation committee to evaluate the claim and also adopted a fee-shifting bylaw shortly after Delaware's ATP decision (the bylaw also claimed to reach anyone who offered "substantial assistance to the Claimant"). This bylaw thus presented distinct problems related to purported retroactivity and broader application to outside parties. *Id.*

109. The proposed language reads as follows: "The certificate of incorporation may not contain any provision that would impose liability on a stockholder for the attorneys' fees or expenses of the corporation or any other party in connection with an intracorporate claim . . ." Intracorporate claims are separately defined as "claims, including claims in the right of the corporation, (i) that are based upon a violation of a duty by a current or former director or officer or stockholder in such capacity, or (ii) as to which this title confers jurisdiction upon the Court of Chancery." S.B. 75, 2015 Gen. Assemb., 148th Sess. (Del. 2015), <http://legis.delaware.gov/LIS/lis148.nsf/vwLegislation/SB%2B75/%24file/legis.html?open>.

110. John C. Coffee, *Delaware Throws a Curveball*, CLS BLUE SKY BLOG (Mar. 16, 2015), <http://clsbluesky.law.columbia.edu/2015/03/16/delaware-throws-a-curveball/>.

111. See generally Stephen M. Bainbridge, *Fee Shifting: Delaware's Self-Inflicted Wounds* (UCLA Law & Econ. Res. Paper Series Working Paper, Paper No. 15-10, 2015) (stating that "[i]n March 2015, the Delaware bar proposed legislation that would limit the availability of fee-shifting bylaw to nonprofit corporations" and arguing that the passage of this was a mistake).

112. *Id.* at 15.

c. Binding Shareholder Arbitration

In 2013, the Supreme Court held that mandatory individual arbitration (excluding the possibility of class arbitration) is enforceable as a matter of contract law.¹¹³ The coincidental timing of this decision with the Delaware Chancery Court's *Boilermakers* case raises an interesting question: could a corporate bylaw requiring individual arbitration for shareholder litigation survive legal scrutiny?

Hal Scott and Leslie Silverman, for example, have recently recommended that shareholders adopt an individual arbitration bylaw to opt out of private securities class action lawsuits.¹¹⁴ The authors argue that these provisions should be upheld because mandatory individual arbitration (1) "is [p]ermitted by [the] Federal Arbitration Act" (FAA); (2) does not deny shareholders the right to litigate; and (3) "[d]oes [n]ot [v]iolate [federal] [s]ecurities [l]aw[.]"¹¹⁵ Notably, they also claim that this bylaw is more likely to be enforced if shareholders (not directors) adopt the initiative—though this article was written before Delaware issued its *Boilermakers* and *ATP* decisions.¹¹⁶ The authors also offer some ideas for increasing the palatability of a unilateral bylaws, such as a sunset provision that requires re-approval of the bylaw every few years.¹¹⁷

What about a director-side arbitration bylaw for state claims by shareholders? Claudia Allen offers a nice assessment of this tactic under state corporate law.¹¹⁸ The issue is complicated because the FAA, as interpreted by the Supreme Court, treats arbitration agreements as regulating process, not substance.¹¹⁹ This means that even if Delaware ruled that an arbitration bylaw violated state corporate law, there is a good possibility that this outcome could be preempted by the FAA.¹²⁰ At the same time, Congress continues to explore legislation for restricting mandatory arbitration in some contexts.¹²¹ And the SEC may also try to play a role in this debate, as SEC regulators seem to disfavor mandatory individual arbitration and have refused to accelerate the registration statements of some firms with such a provision.¹²²

113. *Am. Express Co. v. Italian Colors Rest.*, 133 S. Ct. 2304, 2310–12 (2013).

114. Scott & Silverman, *supra* note 37, at 1190–91.

115. *Id.* at 1214–23.

116. *See id.* at 1217–18 (suggesting that a board-initiated bylaw might raise concerns about unequal bargaining power and fairness). The *Boilermakers* and *ATP* decisions clearly offer more support for the validity of board action constraining shareholder lawsuits.

117. *Id.* at 1211–12.

118. *See generally* Allen, *supra* note 9 (arguing "that there are opportunities for corporations to craft bylaws that take into account company-specific issues, while responding to many likely criticisms").

119. *See Rodríguez de Quijas v. Shearson / Am. Express, Inc.*, 490 U.S. 477, 482–83 (1989) (treating binding arbitration as a brand of forum selection).

120. Allen, *supra* note 9, at 755–56. Such an outcome would parallel *AT&T Mobility v. Concepcion*, 131 S. Ct. 1740, 1753 (2011), where the Supreme Court ruled that the FAA preempted a California state law purporting to outlaw mandatory individual arbitration terms in contracts. *See* Peter B. Rutledge & Christopher R. Drahozal, *Sticky Arbitration Clauses? The Use of Arbitration Clauses after Concepcion and Amex*, 67 VAND. L. REV. 955, 995 (2014) (describing the possible effects of *Concepcion* on franchises).

121. *See e.g.*, The Arbitration Fairness Act of 2013, H.R. 1844, S. 878, 113th Cong. § 402 (2013) (proposing to invalidate pre-dispute arbitration agreements related to employment, consumer, antitrust, or civil rights disputes—but apparently *not* those involving shareholder litigation).

122. The most prominent example of this arose when the Carlyle Group sought to impose binding individual arbitration in connection with an initial public offering. Three U.S. Senators encouraged the SEC to block the offering unless the provision was removed, and Carlyle eventually dropped the arbitration clause. *See* Kevin Roose, *Carlyle Drops Arbitration Clause from IPO Plans*, N.Y. TIMES: DEALBOOK (Feb. 3, 2012, 2:06 PM),

A complete assessment of these legal issues is beyond the scope of this Article. But the question likely looms on the horizon for corporate law. The topic of arbitration also offers a nice segue into matters of contract law, for as we will see, binding arbitration presents an especially difficult test case for the limits of private ordering.

As both shareholders and directors explore these and other strategies for shaping corporate governance, lawmakers will increasingly need to assess whether a given type of bylaw should be upheld. I have suggested already that some courts and commentators are advocating a permissive attitude—based in part on the connections between contract law and the corporate relationship. But can contract doctrine really shed much light on this problem?

III. CONTRACTUAL FOUNDATIONS OF BYLAW MODIFICATION

Corporate relationships have long been viewed as a species of contract law. As far back as 1930, the Delaware Supreme Court insisted that the corporate charter represented two contractual relationships: (1) an agreement between the firm and the state; and (2) an agreement between the firm and its shareholders.¹²³ Recent decisions support this understanding and perhaps even establish a third type of association—among the individual shareholders of the firm.¹²⁴ Likewise, corporate bylaws are sometimes described as contracts.¹²⁵

This all sounds quite reasonable. But the summoning of contract law is often made without an explicit discussion of how the creation or modification of corporate relationships might satisfy the agreement and bargained-for consideration doctrines that underpin the formation of legally binding contracts. Can this be justified (especially for unilateral modification)?

Moreover, it is difficult to state exactly how far principles of contract law should run in corporate law. The link is typically made when courts need to make sense of an ambiguous bylaw or charter provision, thereby allowing a judge to refer to the collection of principles that guide contract interpretation.¹²⁶ But the invocation of contract law raises legitimate questions about whether a party seeking to contest a bylaw might be able to raise a variety of contractual defenses. Can a bylaw be annulled for indefiniteness? For duress? For unconscionability?

<http://dealbook.nytimes.com/2012/02/03/carlyle-drops-arbitration-clause-from-i-p-o-plans/> (describing how Carlyle dropped the proposed arbitration agreement); Miles Weiss et al., *Carlyle Drops Class-Action Lawsuit Ban as Opposition Mounts*, BLOOMBERG (Feb. 3, 2012, 4:57 PM), <http://www.bloomberg.com/news/2012-02-03/carlyle-drops-class-action-lawsuit-ban.html>.

123. See, e.g., *Lawson v. Household Fin. Corp.*, 152 A. 723, 727 (Del. 1930) (stating “it has been generally recognized in this country that the charter of a corporation is a contract between the corporation and the state and the corporation and its stockholders”).

124. See, e.g., *Staar Surgical Co. v. Waggoner*, 588 A.2d 1130, 1136 (Del. 1991) (“[A] corporate charter is both a contract between the State and the corporation, and the corporation and its shareholders. . . . The charter is also a contract among the shareholders themselves.”).

125. E.g., *Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934, 957 (Del. Ch. 2013); *Stolow v. Greg Manning Auctions Inc.*, 258 F. Supp. 2d 236, 249 (S.D.N.Y. 2003); *Centaur Partners, IV v. Nat’l Intergroup, Inc.*, 582 A.2d 923 (Del. 1990).

126. Typically these tools include a focus on plain meaning, reference to the intent of the parties at the time of agreement, and the contra proferentem rule (which states that a judge should interpret an ambiguous clause in a manner unfavorable to the drafting party). See, e.g., *Centaur Partners*, 582 A.2d at 928; *Berlin v. Emerald Partners*, 552 A.2d 482, 488 (Del. 1989); *Hibbert v. Hollywood Park, Inc.*, 457 A.2d 339, 342–43 (Del. 1983).

Relatedly, who has standing to object? Can a tiny shareholder bring a claim against a majority shareholder under the theory that bylaws are contracts *among* shareholders? Might a bylaw that has been unanimously approved by both board and shareholders nevertheless be challenged by the state as contrary to contractual public policy? How about a third-party beneficiary to the contract, such as a preferred stockholder, who lacks approval rights but is nevertheless significantly impacted by a bylaw proposal (possibly even as an intended beneficiary)?¹²⁷

In short, what does it mean for bylaws to be contracts? And should the resolution of corporate governance policy questions turn on general principles of contract doctrine? This Part takes up these questions.

A. Corporation as Contract

Do fundamental corporate relationships actually form legally binding contracts? Or is the rhetoric of contract simply a device used by courts and commentators to describe a conceptual vision of unanimous agreement akin to the “social contracts” of political theorists? This inquiry is compounded by the numerous contexts in which the question can arise. Clearly many corporate contracts are *real*—including those with suppliers, vendors, employees, creditors, and so on. But it is one thing to say that a corporation can make contracts and another thing to assert that a corporation *is* a contract. The latter implies that contract doctrine might regulate the governance relationship between shareholders and the firm (or among shareholders). For the purposes of this Article, the most interesting question is whether it makes sense to assess unilateral bylaw modification under contract doctrine. But let us start at the beginning.

Perhaps the least controversial understanding arises when a corporation conducts a primary issuance of stock. As Easterbrook and Fischel have described, “the corporate venture has many real contracts . . . [including] the rules in force when the firm raises money . . . the terms of which affect the price of the [equity] issue.”¹²⁸ Of course investors do not gather at an incorporation conference and haggle over these terms, but the initial purchase of stock hardly differs from the modern consumer take-it-or-leave-it contract (or a bond indenture contract). Shareholders can be understood to make an offer, to purchase shares from the firm subject to a given set of governance rules at a given price, which the corporation accepts (or vice versa).¹²⁹

The implied agreement is perhaps more nuanced if the relevant contract is thought to run between the individual shareholders.¹³⁰ We might ask whether there has been an initial

127. Third-party beneficiary rights allow outsiders, in some contexts, to sue for breach of contract even when they lack contractual privity. *See, e.g.*, E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 10.3 (3d ed. 2004); RESTATEMENT (SECOND) OF CONTRACTS § 302 (Am. Law. Inst. 1981) [hereinafter RESTATEMENT SECOND].

128. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 113 (1991).

129. Of course a valid contract also requires bargained for consideration, but it does not seem contentious to suggest that consideration is present in this situation. Shareholders invest money in the firm in exchange for a promise of future financial and governance benefits. Likewise, they obtain a property interest in the firm’s stock which they are free to sell to others (assuming compliance with securities laws and any other negotiated limitations on alienability).

130. This is especially true for large share issues, such as those that take place in an initial public offering. With closely held ventures it is quite plausible that explicit discussions are held among the shareholders.

subscription document circulated, whereby each individual shareholder can see who else is investing. If not, we could embrace another implied-in-fact theory of acceptance—under which offer and acceptance arises through the act of buying individual shares with an expectation that other co-investors will do the same.¹³¹ Likewise, the purchase of shares on a secondary market does not neatly fit into a model of contractual privity (either with the firm or with other, non-selling shareholders), but we might understand this deal to include an implied understanding that the acquiring investor takes the shares subject to the operating rules of governance.

What if we move to modification? It is a well-established principle of contract law that the modification of a contract *is* a new contract; valid adjustments must typically satisfy the agreement requirement.¹³² There are exceptions, but under normal circumstances I cannot announce that the deal we just made to sell you my car for \$3000 is now modified to a new purchase price of \$5000. You must acquiesce to the change.

It seems easy to locate an agreement for corporate charter modifications. The need for explicit approval from firm, shareholders, and state for these amendments should satisfy any understanding of the relevant counterparties.¹³³

But when a bylaw modification is adopted unilaterally by the board or by shareholders, finding a real contract becomes more complicated. Consider *Galaviz v. Berg*,¹³⁴ a 2011 case involving Oracle Corporation. A group of shareholders brought suit in California federal court against the directors of Oracle in connection with the alleged overbilling of the United States government for software. Oracle's board had adopted a forum selection bylaw several years earlier, and the firm sought to remove the case to Delaware under this provision. The California judge was asked to decide whether the bylaw was valid, and his analysis focused on whether one-sided modification could satisfy the agreement requirement of contract law.

The judge held that the answer to this question was no because “it represented a unilateral change to the provisions of the bylaws that Oracle would not have been able to accomplish under ordinary principles of contract law.”¹³⁵ Specifically, the forum selection

131. It may be more difficult to find bargained for consideration in this context, since the primary motivating factor for the investment seems to be access to future financial and governance benefits. But we could understand each shareholder as making an investment in the firm in order to induce others to do the same; these parallel detriments might suffice. Related to this, some scholars have remarked that a chief purpose of the corporate form is to “lock-in” shareholder commitment. See generally Margaret M. Blair, *Locking In Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387 (2003). Resolving this question may also require an understanding of the underwriting arrangement.

132. The consideration requirement, on the other hand, has been relaxed considerably in the modification context. See U.C.C. § 2-209 (1) (2002); RESTATEMENT SECOND, *supra* note 127, § 89(a).

133. If we view the agreement as running from firm to shareholder, then the concurrent vote of board and shareholders is enough. If we view the contract as running from firm to state, then the corporation's submission of the amendment and the resulting acceptance of the filing by an agent of the state should suffice. And if we view the charter as a contract among shareholders, then a majority vote of shareholders does the trick. This last combination requires a little more analytical work, as an individual dissenting shareholder could obviously argue that she does not agree with the change. The response is likely that we have moved away from unanimous shareholder agreement requirements for charter amendments, such that any individual shareholders should be understood to have entered a modification framework where they have agreed to be bound by a collective vote of other shareholders. In short, the analysis must mirror that of unilateral bylaw modifications in this contracting context.

134. *Galaviz v. Berg*, 763 F. Supp. 2d 1170 (N.D. Cal. 2011).

135. *Id.* at 1174 n.4.

bylaw was adopted “without the consent of existing shareholders who acquired their shares when no such bylaw was in effect.”¹³⁶ The court continued that consent could not be presumed by the general framework of the corporate relationship because while “a party’s consent to a written agreement may serve as consent to all the terms therein . . . it does not follow that a contracting party may thereafter unilaterally add or modify contractual provisions.”¹³⁷

This analysis represents poor thinking on the subject and reveals a considerable lack of understanding about recent events in contract law. The *Galaviz* opinion is surely correct that any modification requires some agreement of the parties. But it ignores the possibility that counterparties might agree to establish an ex-ante modification framework where one or both of the participants are empowered to make certain types of unilateral adjustments. To be sure, there are plausible arguments why a given unilateral modification might fail to satisfy the requirements of contractual agreement. But these arguments are more subtle than simply asserting the blanket statement that unilateral modification is impossible under an ex-ante framework. The proper scope of this arrangement, which raises concerns that are sometimes described as the “latecomer term” problem, is subject to ongoing debate in contract law.

B. The Latecomer Term Problem

Imagine that you accept a new credit card with a provision (you probably did not read) stating that the issuer has the right to unilaterally modify the contractual relationship.¹³⁸ If the bank bumps up your interest rate from 10–12%, you are going to have a very difficult time fighting this modification. Courts have allowed parties to pre-approve unilateral modifications in this manner—at least within certain limits.¹³⁹ The general logic is that parties should enjoy the contractual freedom to embrace this sort of term if they wish.

But what if the bank modifies the contract to state that you will now provide a security interest in your home to guarantee the outstanding balance on your card? Or perhaps it changes the deal to require you to sell the bank your house at a price determined by last year’s tax appraisal minus \$100,000. Even setting aside lending laws or other consumer protections,¹⁴⁰ these adjustments would almost certainly be deemed ineffective as a matter of contract law, despite the expansive modification language in the initial agreement. Yet what legal rule supports this result?

Broadly speaking, contract law might constrain “abusive” unilateral modification through one of two different paths. The first route is to strike down the entire contract, perhaps by declaring that the deal lacks mutuality because unlimited modification rights

136. *Id.* at 1174.

137. *Id.*

138. An illustrative clause might read as follows: We may add, delete, or amend terms and services at any time, including fees and charges for the Service. We will notify you of such changes by mail or email, by posting a notice of a change online, or by any other means permitted by law. Use of the Service after the effective date of the change will constitute your acceptance of such amendment. Peter A. Alces & Michael M. Greenfield, *They Can Do What!?: Limitations on the Use of Change-of-Terms Clauses*, 26 GA. ST. U. L. REV. 1099, 1101 n.5 (2010).

139. See Oren Bar-Gill & Kevin Davis, *Empty Promises*, 84 S. CAL. L. REV. 1, 12 (2010) (noting that approximately a third of credit card holders polled in a 2009 survey reported a unilateral change in terms by their card issuer).

140. The Statute of Frauds might also raise concerns here.

render any promise illusory.¹⁴¹ In the credit card example, the bank might simply modify away any of its obligations, and the fact that it could do this (even if it does not) denudes consideration. Alternative bases for tossing out the entire contract might include unconscionability¹⁴² or possibly even promissory fraud.¹⁴³ These arguments are not slam dunks, however, and this would reverse a longstanding tendency to invoke a good-faith limitation on conferred discretion as a way to maintain consideration.¹⁴⁴

The second path for restraining seemingly over-reaching modifications is to uphold the contract but use interpretation principles to narrow the zone of modifiable terms. In other words, a judge must interpret the scope and meaning of the unilateral modification provision, like any other term in the contract, and even a valid modification clause might be properly understood as relating only to a close contextual nexus. In the credit card example, a court might hold that interpretation of the modification provision is limited to changes that hew closely to the credit relationship (such as a small adjustment in interest rates) but not ones that stretch too far (like a forced home sale). This latter interpretative option is, in my view, the more sensible path, even though it raises all the usual questions about how to make sense of a contract. Indeed, delineating the precise limits of preauthorized modification is shaping up to be a very difficult task for contract law.

Consider an attempt to impose an arbitration provision via unilateral modification. A seller and consumer strike up a relationship, with unilateral modification rights, and the seller subsequently imposes an arbitration clause. The consumer continues to use the service but later argues—after a dispute emerges—that she is not required to arbitrate. Is this indeed part of the contract?

Courts have split on this exact question. One court, for example, began its inquiry by asking “whether the parties intended the change-in-terms provision to be sufficiently broad to authorize the addition of significant terms, including an arbitration clause.”¹⁴⁵ It then designated the unilateral modification provision ambiguous and invoked general principles of contract interpretation to flesh out the meaning of this right. The judge ultimately ruled that the provision should be interpreted narrowly: it might support minor changes that are related to a core aspect of the relationship,¹⁴⁶ but it would not permit imposition of a dispute resolution mechanism that seemed further afield.¹⁴⁷

Other courts have reached the opposite conclusion. In another banking case, for instance, customers were sent notice of a proposed arbitration clause with a one-month opt-

141. See, e.g., *Badie v. Bank of Am.*, 79 Cal. Rptr. 2d 273, 284–85 (Cal. Ct. App. 1998) (“[P]ermitting [one party] to exercise its unilateral rights under the change of terms provision, without any limitation on the substantive nature of the change permitted, would open the door to a claim that the agreements are illusory.”).

142. See *Bar-Gill & Davis*, *supra* note 139, at 30 (noting unconscionability as a potential invalidation justification for a modifiable contract).

143. See *Curtis Bridgeman & Karen Sandrik, Bullshit Promises*, 76 TENN. L. REV. 379, 399 (2009) (arguing that a party should be liable in promissory fraud if she makes a promise without possessing “the intention to perform [what her] promise implied” because she plans to modify away an obligation).

144. This band aid of good faith is commonly used, for example, with best efforts clauses, satisfaction clauses, and output/requirement contracts. See VICTOR GOLDBERG, *FRAMING CONTRACT LAW: AN ECONOMIC PERSPECTIVE* 95–99, 148 (2006) (discussing use of good faith with various contract clauses).

145. See *Stone v. Golden Wexler & Samese*, 341 F. Supp. 2d 189, 193 (E.D.N.Y. 2004) (applying Virginia law).

146. *Id.* at 197–98. This was a banking relationship, and the court acknowledged, for example, that modest adjustments in banking fees would be permissible.

147. *Id.* at 198.

out period.¹⁴⁸ One customer did not opt-out but argued later that the modification provision could not authorize the imposition of arbitration. The court disagreed, ruling that the plaintiff had empowered the bank to make adjustments without limitation and that the change-in-terms provision was not unconscionable (in part because the agreement used clear language and a legible font).¹⁴⁹ Identifying the scope of pre-authorized unilateral modification invites disagreement, and contract doctrine has not arrived at a clean answer.¹⁵⁰

Further, this latecomer term problem matters because it raises real questions about whether a party to the contract will be able to recognize and price the full risk and impact of downstream modification into the deal at the moment of agreement. Indeed, Easterbrook and Fischel raised this exact point 25 years ago as one of the principal difficulties to understanding corporations as contracts:

If an amendment reduces the expected profitability of the firm by an amount worth one dollar per share, the price will fall and existing investors will experience a capital loss of one dollar per share. They can sell but they can't avoid the loss The mechanism by which entrepreneurs and managers bear the cost of unfavorable terms does not work . . . for latecomer terms.¹⁵¹

This insight has only taken on greater importance with the rise of one-sided modification.

How should we address this problem? Returning to the corporate governance context, we have already seen that both directors and shareholders will typically possess pre-authorization for unilateral modification of governance terms. In this manner, ex-ante governance initiatives present concerns that parallel those of contract law. But this does not necessarily mean that contract law should provide the basis for answering important questions in corporate law.

Rather, lawmakers should not outsource the resolution of this problem to contract doctrine for at least three reasons. First, as we have seen, contract law is still struggling with the latecomer-term problem, and it is not in a position to supply a decoder for this cipher. Second, even if a given bylaw were to clear a legal hurdle imposed by contract law, it would still need to pass muster as a matter of corporate law. It is not obvious that a scheme of duplicative review is worth developing. Finally, before continuing too far in a direction that evaluates corporate bylaws under contract law, we need to recognize that the invocation of a contractual framework comes with additional "legal baggage." Much of this baggage seems tangential to the design of optimal governance (at best) or may

148. *Bank One v. Coates*, 125 F. Supp. 2d 819 (S.D. Miss. 2001).

149. *Id.* at 830–32.

150. Many other cases, all with a very similar factual setup, can be found on either side of the arbitration question. *Compare* *Perry v. FleetBoston Fin. Corp.*, No. Civ. A.04-507, 2004 WL 1508518, at *1 (E.D. Pa. 2004) (rejecting attempt at unilateral modification to impose arbitration provision); *Sears Roebuck & Co. v. Avery*, 593 S.E.2d 424, 426 (N.C. Ct. App. 2004) (rejecting an attempt to compel arbitration); *Discover Bank v. Shea*, 827 A.2d 358, 368 (N.J. 2001) (rejecting attempts to compel arbitration); *Long v. Fidelity Water Sys., Inc.*, No. C-97-20118RMW, 2000 WL 989914, at *1 (N.D. Cal. 2004) (denying arbitration); *Badie v. Bank of Am.*, 79 Cal. Rptr. 2d 273, 291 (Cal. Ct. App. 1998) (rejecting arbitration); *with* *Hutcherson v. Sears Roebuck & Co.*, 793 N.E.2d 886, 888 (Ill. App. 2003) (upholding attempt at unilateral modification to impose arbitration provision); *Bank One, N.A. v. Williams*, No. 301CU24DD, 2002 WL 1013161, at *1 (N.D. Miss. 2002) (imposing arbitration); *Beneficial Nat'l Bank v. Payton*, 214 F. Supp. 2d 679, 691 (S.D. Miss. 2001) (compelling arbitration); *SouthTrust Bank v. Williams*, 775 So. 2d 184, 191 (Ala. 2000) (granting motion for arbitration).

151. Easterbrook & Fischel, *supra* note 15, at 1443.

introduce additional structural concerns for corporate law (at worst). The balance of this Section develops these last two points in more detail.

C. Duplicative Review

The important Delaware case of *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*,¹⁵² mentioned above in the context of forum selection bylaws,¹⁵³ offers a nice contrast to the *Galaviz* dispute, while also highlighting concerns about duplicative review.

In 2010, Chevron's board adopted a forum selection bylaw that designated Delaware as the exclusive jurisdiction for a variety of shareholder lawsuits.¹⁵⁴ A group of plaintiffs sued to invalidate the provision on two grounds, arguing that the shareholders had not expressly agreed to the modification (as a matter of contract law) and that forum selection was an improper subject for a bylaw (as a matter of corporate law).¹⁵⁵ Both claims failed.

While the Chancery Court concurred with the assertion that bylaws are contracts, it plainly rejected the argument that there was some defect in the agreement process:

Stockholders are on notice that, as to those subjects that are subject to regulation by bylaw [under Delaware law], the board itself may act unilaterally to adopt bylaws addressing those subjects. Such a change by the board is not extra-contractual simply because the board acts unilaterally; rather it is the kind of change that the overarching statutory and contractual regime the stockholders buy into explicitly allow the board to make on its own.¹⁵⁶

In short, the parties had already acceded to a framework that authorized unilateral modification. We should certainly view the Chancery Court's assessment of contract modification as closer to the mark than that expressed in *Galaviz* (though *Boilermakers* perhaps declares a freedom to modify more broadly than warranted).¹⁵⁷ But this was hardly the end of the matter.

The fact that a unilateral bylaw is deemed a legitimate contractual modification only tees up the question of whether forum selection is permissible as a proper subject for bylaws under Delaware corporate law. To answer this question, the court returned to the text of section 109 of the DGCL, which states that "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."¹⁵⁸ The court ultimately concluded that a forum selection bylaw comfortably fit within this language.¹⁵⁹

But this analysis only invites the question of what work, if any, contract law is performing. A modification is deemed permissible under contract law as long as it relates

152. *Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934, 953 (Del. Ch. 2013).

153. See *supra* notes 85–88 and accompanying text (discussing enforceability of choice-of-forum clauses).

154. *Boilermakers*, 73 A.3d at 942.

155. *Id.* at 945.

156. *Id.* at 955–56.

157. See *supra* notes 145–147 and accompanying text (discussing legal limitations on unilateral modification efforts).

158. DEL. CODE tit. 8, § 109(b) (2015).

159. See *Boilermakers*, 73 A.2d at 950–53. More specifically, it found that the imposition of a forum selection bylaw regulated the internal right of shareholders as shareholders and related to the conduct of the firm's affairs. *Id.*

to a proper subject for a bylaw—presumably to comply with a fair interpretation of the scope of modification. A bylaw that purports to subject individual shareholders to a forum selection provision for personal tort claims against the firm, for example, would fall outside any zone of contractual agreement (just like your credit card company’s attempt to buy your house).¹⁶⁰ But in order to know that this is true, we need to ask whether a given bylaw meets a proper purpose under corporate law. For this reason, the substantive inquiry arguably collapses into corporate law.

To be sure, it is possible that some “space” might be created between corporate law’s requirement that bylaws relate to a proper purpose and contract law’s interpretive understanding about the permissible scope of a unilateral amendment. This space could go either way—that is, a bylaw might be deemed proper under corporate law but improper as a matter of contract interpretation, or vice versa. But I would contend that it is not worth breathing life into this theoretical gap. The questions line up so closely that it is doubtful that a separate interpretive analysis of contractual preauthorization should do any heavy lifting.

Boilermakers thus illustrates a fear that efforts to shape fundamental corporate relationships will increasingly be subject to two parallel inquiries, as lawmakers test whether a disputed bylaw is proper as a matter of both corporate and contract law. One might respond as follows: “So what? If the inquiry into a bylaw’s permissibility as a matter of contractual agreement effectively collapses into one about legitimate corporate purpose, then what is the harm? Courts can quickly dispense of the contract argument and move on to the real analysis.”

This point has some validity, but one concern might be that requiring an assessment under contract law will bring a collection of additional “legal baggage,” much of which seems tangential—or potentially even damaging—to efforts at striking a sensible corporate governance balance.

D. Other “Legal Baggage”

Why do lawmakers even bother to describe corporate charters and bylaws as contracts? Courts will typically make this connection for one purpose only: when they want to adopt principles of contract interpretation to sort out ambiguous language.¹⁶¹ Indeed, the tools of contract interpretation seem to work quite well for resolving uncertain meaning in corporate instruments. This should not be surprising, as both fields wrestle with the same problem: giving content to imprecise language in order to manage unexpected contingencies that arise after a legal relationship is formed. There is, of course, no singular way to perform the interpretation task in contract law either, and jurisdictions differ over a preference for textualist or contextualist strategies.¹⁶² In general, however, courts will set

160. *Id.*

161. *See supra* note 126 (discussing canon of interpretation and providing examples).

162. Some states, such as New York, seem to prefer a “textualist” strategy where much of the interpretation is conducted with reference to the text of the contract itself combined with reasonable inferences about what that language means. By contrast, California is known for adopting a “contextualist” interpretation strategy where the surrounding circumstances and actual subjective intent of the parties plays more of a role in the court’s interpretation of the contractual commitment. *See, e.g.*, Alan Schwartz & Robert E. Scott, *Contract Interpretation Redux*, 119 *YALE L.J.* 926, 926 (2010) (discussing difference between textualist and contextualist interpretations).

legal meaning by examining other parts of the contract itself, analyzing preliminary negotiations, identifying common trade customs, hearing the testimony of expert witnesses in the industry, reviewing the conduct of the parties in the course of previous dealings, and so on.¹⁶³ Most of these methods resonate for the corporate governance interpretative task.¹⁶⁴

But a judge could say that an ambiguous bylaw will be interpreted using methods from contract law without insisting that bylaws *are* contracts. Contracts carry additional “legal baggage.” We have already seen some of the challenges related to determining whether a real commitment has arisen: Who are the parties? What is the offer? When is the acceptance? And so on. These are not just hypothetical questions, as some parties, emboldened by the rhetoric of contract law, are starting to raise these exact questions in corporate governance disputes.¹⁶⁵

The imposition of a binding contract can also be resisted if one party demonstrates a defect undermining the formation of the relationship. Will these contract defenses, such as incapacity or unconscionability, also serve to invalidate a bylaw? They should, if bylaws really are contracts, but this would give rise to a whole new set of arguments that firms or shareholders might use to challenge an unwanted proposal.

Take the incapacity defense. Contract law is only available when a party possesses the legal capacity to determine that a given exchange increases her welfare. This means that someone who is underage, mentally ill, or highly intoxicated may avoid a contract that would otherwise be valid.¹⁶⁶ Can a seventeen-year-old shareholder therefore challenge an unwanted bylaw that is adopted by the board?¹⁶⁷ If successful, would the entire bylaw be cancelled or would some other remedy be awarded? Either outcome could be problematic for corporate law. Striking down the bylaw’s impact for a sole shareholder might reinstate a version of the “vested rights doctrine” that corporate law has sensibly abandoned.¹⁶⁸ Perhaps the shareholder should be granted the right to put the stock back to the firm, along

163. Perhaps the most famous interpretation case in contract law is *Frigalment Importing Co. v. B.N.S. International Sales Corp.*, 190 F. Supp. 116, 118 (S.D.N.Y. 1960), where Judge Friendly employed all of these steps and more in an effort to decide whether a contract to sell “chicken” meant young plump broilers or old tough fowl. *Id.*

164. I should note that a contextualist approach to a bylaw interpretation may be more difficult to implement than a textualist approach since the former presents challenges related to pinpointing a collective understanding among heterogeneous shareholders and directors.

165. *E.g.*, Brief for Petitioner at 11, *Strougo v. Hollander*, 111 A.3d 590 (2015) (C.A. No. 9770-CB) (arguing, among other things, that “bylaws cannot operate retroactively against former stockholders under principles of Delaware contract law,” and “non-parties to a contract cannot be bound by the terms of the contract”).

166. RESTATEMENT SECOND, *supra* note 127, § 12.

167. The plaintiff’s argument would run as follows: “I lacked capacity to agree on the corporate framework that granted the board a future right to unilaterally modify bylaws.” As a matter of contract law, the minor could almost certainly void the contract by stating that her consent at the time of purchase was invalid, such that she did not legally accede to the corporate framework permitting unilateral modification.

168. The vested rights doctrine states that existing shareholders may not have rights removed through unilateral board action that is not specifically approved by the affected shareholder. In other words, the rights shareholders enjoy upon purchase of the shares are frozen in time. This theory has been clearly rejected in corporate law as unduly static and therefore unworkable. *See, e.g.*, *Fed. United Corp. v. Havender*, 11 A.2d 331, 335 (Del. 1940); *see also* WILLIAM MEADE FLETCHER, *FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS* § 4176 (2012) (“It is presumed that a person who becomes a shareholders in . . . a corporation does so with knowledge and implied assent that its bylaws may be amended.”).

the lines of an appraisal claim or some other remedy, but this would establish a novel departure from current practice.¹⁶⁹

Other defenses present similar concerns. Key contract terms, for instance, must be specified with sufficient definiteness or the deal will be annulled.¹⁷⁰ Can a board of directors challenge a shareholder bylaw that does not spell out its proposal in great detail under the indefiniteness doctrine?¹⁷¹ Can a shareholder argue unilateral mistake or duress? Some of these possibilities may be remote, but we should expect these types of claims to creep into corporate governance disputes if the tether with contract doctrine is tightened.

And how should we think about breach? Assume, for example, that a group of shareholders enacts a new bylaw requiring the firm to provide detailed disclosures on all lobbying expenditures by the corporation. The text is clear and unambiguous, and no other contractual defenses exist, but the board still refuses to comply. If the shareholders sue, can the firm argue that it has breached the contract but that it should only be required to pay money damages, if any, to the shareholders? After all, specific performance is not generally available in contract law; so, unless the shareholders can assert some reason why money damages are inadequate, it is at least conceivable that the board might not need to strictly comply as a matter of contract doctrine.¹⁷²

There are other potential concerns, but this should be enough to gain a flavor for the challenge. It is not clear that contract law will help resolve ex-ante corporate governance disputes, and it may sponsor some vexing sideshows. But if contract law is not the optimal regime for regulating ex-ante corporate governance, then this leads to an obvious final question: how should lawmakers govern unilateral attempts to tilt the balance of power?

IV. GOVERNING EX-ANTE CORPORATE GOVERNANCE

If corporate governance initiatives are indeed emphasizing ex-ante tactics, we should expect to see a wide range of innovative bylaws in the coming years. Shareholder groups may seek rules that influence executive compensation, limit corporate lobbying, establish social directives, or even purport to assume direct control over certain corporate decisions. Managerial groups may continue efforts to constrain shareholder litigation—perhaps by adopting new bylaws that shorten statutes of limitations, increase standards of proof,

169. Appraisal is only available under limited triggering circumstances, such as a merger. *See, e.g.*, DEL. CODE tit. 8, § 262 (2013).

170. *See* RESTATEMENT SECOND, *supra* note 127, § 33(1). The rule is justified as “reflect[ing] the fundamental policy that contracts should be made by the parties, not by the courts.” *Id.* § 33(2) cmt.B; *see also* JOHN EDWARD MURRAY, JR., MURRAY ON CONTRACTS § 39 (5th ed. 2011) (discussing reasonable certainty and indefiniteness).

171. Something like this may already be taking place with shareholder proposals in the SEC review context. One of the justifications the board can raise when requesting a no-action letter is that a given bylaw proposal is excessively vague or indefinite. *E.g.*, H&R Block, Inc., SEC No-Action Letter, 2012 WL 3903410, *3–10; *14–18 (July 25, 2012) (debating whether a given shareholder proposal may be excluded because it is impermissibly vague). Yet incorporating the indefiniteness doctrine into a parallel analysis would go further by permitting challenges after the bylaw is adopted and (perhaps) by permitting other parties to raise a void for vagueness arguments. The initial decision-maker would also shift, of course, from the SEC staff to the judiciary.

172. It is also difficult to imagine how the breached-against shareholders would be able to prove significant money damages with reasonable certainty. They will surely be upset by the noncompliance, but has there been a recognizable financial impact? Moreover, do the shareholders have a duty to mitigate, perhaps by selling their shares and buying equity in a firm that is perfectly willing to provide the disclosures? This all seems quite ridiculous, but questions like this follow from the contract law invocation.

reduce access to some categories of evidence, or adopt binding individual arbitration. How should lawmakers, especially those in Delaware, govern novel governance initiatives as a matter of corporate law? It is helpful to begin with the “twice-tested” framework of Adolf Berle:

In every case, corporate action must be twice tested: first, by the technical rules having to do with the existence and proper exercise of the power; second, by equitable rules somewhat analogous to those which apply in favor of a . . . trust to the trustee’s exercise of wide powers granted to him in the instrument making him a fiduciary.¹⁷³

This framework for evaluating governance initiatives has recently been affirmed as Delaware law.¹⁷⁴ Test one, the legal test, asks whether one can take a given action and still behave in conformity with the various sources of authority in corporate law. Test two, the equitable test, then applies a standard of review, such as intrinsic fairness or the business judgment rule, to evaluate a given governance tactic in context.

Twice-testing a governance initiative also requires a basis for evaluating sources of hierarchy in law. There are at least four levels: (1) the state’s corporate law statute; (2) the corporate charter; (3) the corporate bylaws; and (4) individual agreements between some or all players in the corporate system (such as a buy–sell agreement).¹⁷⁵ Accordingly, the starting place for adjudicating a novel governance initiative in Delaware must be the DGCL.

A. By Statute

One possible approach for regulating a bylaw is to draft statutory language that authorizes or prohibits the given initiative. The DGCL currently offers little explicit guidance for evaluating the permissibility of contested bylaws. But this may be changing, and it is at least conceivable that Delaware’s General Assembly will begin to weigh in more directly on the topic. Recall, for example, that litigation fee shifting bylaws have prompted a legislative response to categorically prohibit this type of governance term.¹⁷⁶ At the same time, the legislative amendments explicitly endorse forum selection bylaws—the legality of which was not really in doubt after *Boilermakers*. Notably, the changes also overrule existing case law by prohibiting any bylaw that tries to exclude jurisdiction in Delaware.¹⁷⁷ (You can pick your forum, just not one outside Delaware.). These developments offer at least anecdotal evidence that legislatures might begin setting more specific rules related to bylaw initiatives.

173. A. A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049, 1049 (1931).

174. See, e.g., *Quadrant Structured Prods. Co. v. Vertin*, No. 6990-UCL, 2014 WL 5465535, at *3 (Del. Ch. Oct. 28, 2014) (“Delaware law adheres to the twice-testing principle.”).

175. *Id.*

176. See *supra* notes 108–111 and accompanying text (discussing legal challenges that led to the Delaware State Bar offering an amendment to the DGCL to eradicate fee shifting).

177. The language reads as follows: “Section 115. The certificate of incorporation or the bylaws may require, consistent with applicable jurisdictional requirements, that any or all internal corporate claims shall be brought solely and exclusively in any and all of the courts in this State [Delaware], and no provision of the certificate of incorporation or the bylaws may prohibit bringing such claims in the courts of this State.” DEL. CODE tit. 8, § 115 (2015). This latter provision overrules a recent Delaware Chancery Court decision upholding a North Carolina forum section bylaw for a Delaware corporation. *City of Providence v. First Citizens BancShares, Inc.*, 99 A.3d 229 (Del. Ch. 2014).

In my view, however, governing ex-ante bylaws with ex-post statutes is unlikely to be practical. Corporate actors require more timely guidance about the permissibility of a potential initiative. Few governance tactics will grab as much attention as litigation fee-shifting, and it is unrealistic to expect rapid legislative updating, even in Delaware. Further, corporate actors are creative, and the legislature may not be the best institution to draw fine-grained distinctions between bylaw variants. Even statutory rules can invite new questions (query whether a shareholder bylaw that requires forum selection bylaws to have a sunset clause would be valid). For better or worse, much of the work here will likely be shouldered by the judiciary.

B. By Judicial Review—Law

How should a court evaluate the permissibility of a new bylaw in the absence of explicit statutory guidance? Under the twice-tested framework, a judge should evaluate whether the initiative is legally acceptable and then conduct an equitable review. The balance of this Article offers some thoughts on how this inquiry might proceed—highlighting areas of corporate law that will likely need to take on greater significance with the rise of ex-ante governance.

Even if the DGCL does not provide explicit guidance for most bylaws, a judge may find it helpful to consider structural inferences as a way to evaluate the legality of a given tactic. One conceivable starting point is DGCL section 102(a), which defines what *shall* be included in the corporate charter.¹⁷⁸ Specifically, section 102(a)(4) states that “[t]he certificate of incorporation shall . . . set forth a statement of the designations and the powers, preferences, and rights, and the qualifications, *limitations or restrictions* thereof, which are permitted by section 151 of this title in respect of any class . . . of stock”¹⁷⁹ Section 151 continues by indicating that a class of stock may have voting powers, preferences, and other rights and limitations “as shall be stated and expressed in the certificate of incorporation.”¹⁸⁰

One could interpret these provisions as mandating that limitations of fundamental shareholder rights—perhaps including the right to vote, sell, or sue—must therefore be expressed in the corporate charter.¹⁸¹ If so, unilateral bylaws that purport to scale back these rights might be deemed invalid. DGCL section 109(b) can also be read consistently with this understanding. Recall that it provides that “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.” While this language appears to empower the creation of bylaws that limit shareholder rights, if sections 102 and 151 do mandate that limitations on fundamental shareholder rights be contained in the charter, then any efforts to do so by bylaw would be inconsistent with law—and therefore invalid under

178. DEL. CODE tit. 8, § 102(a) (2015). This should be contrasted with section 102(b) which defines features that *may also* be contained in the charter.

179. DEL. CODE tit. 8, § 102(a)(4) (2015) (emphasis added). This section also continues by requiring the charter to delegate an express grant of authority to directors to adjust these rights and limitations—such as might occur with “blank check” preferred stock. *Id.*

180. DEL. CODE tit. 8, § 151(a) (2015).

181. Vice Chancellor Laster has made an argument along these lines. See, J. Travis Laster, *The Limits of Corporate Bylaws* (Oct. 10, 2014) (making an argument along these lines at an address at Brooklyn Law School).

section 109.¹⁸²

But this line of reasoning only spawns two follow-up questions that corporate law will need to address if it is to proceed down this path. First, what exactly are the “fundamental rights” of shareholders?¹⁸³ Second, what do we really mean by “limitation,” and might there be a difference between an attempt to limit a right and an attempt to govern or regulate it?¹⁸⁴

On question one, a textual reading of DGCL section 151 suggests only that voting rights and other financial preferences are fundamental rights. It says nothing about a shareholder’s right to sell, sue, or do anything else. To be sure, other provisions might create fundamental shareholder rights. DGCL section 202, for instance, offers some protections related to a shareholder’s right to sell.¹⁸⁵ Likewise, Delaware courts have held that a shareholder’s right to sue is fundamental.¹⁸⁶ But does this mean that any limitation related to selling or suing must be in the charter? And are there other fundamental rights? These are important questions—and ones that will likely require far greater clarification by lawmakers seeking to regulate ex-ante governance initiatives.

Second, Delaware courts will need to flesh out what it really means to “limit” shareholder rights. Many bylaws, currently thought to be valid, place some restrictions on shareholders seeking to exercise their rights. A forum selection bylaw regulates (or limits?) where shareholders can sue. An advance notice bylaw regulates (or limits?) how shareholder can vote—by requiring nominations for board elections to be submitted in advance of annual meetings.¹⁸⁷ Indeed, even the designation of a location for the annual meeting may impact the ability of some shareholders to vote: it is tougher to trek to Toledo. Planners need to understand what types of ex-ante restrictions are OK under corporate bylaws.

To approach an answer, Delaware courts are starting to import the proverbial distinction between substance and process. Substantive changes might require a charter amendment, while procedural ones might go in the bylaws. Several important cases, including *AFSCME*¹⁸⁸ and *Boilermakers*¹⁸⁹ have taken large steps in this direction. But it is not clear that distinguishing process from substance can really do much work here because many governance provisions can be couched in procedural or substantive terms. Are litigation fee shifting provisions procedural because they merely set rules by which a

182. *Id.*

183. *See, e.g.,* Thompson, *supra* note 4, at 216 (exploring the fundamental rights of shareholders).

184. *See* Laster, *supra* note 181 (addressing the rights of shareholders and how they could be affected).

185. DEL. CODE tit. 8, § 202(b) (“No restrictions [on the transfer of securities] shall be binding with respect to securities issued prior to the adoption of the restriction unless the holders of the securities are parties to an agreement or voted in favor of the restriction.”) Query whether an attempt to limit share transfer rights through an ex-ante bylaw might comply with section 202(b) under the logic of *Boilermakers*: shareholders *are* parties to an agreement because they delegated unilateral bylaw modification rights to the board.

186. *See, e.g.,* Strougo v. Hollander, 111 A.3d 590, 595 (Del. Ch. 2015) (affirming “the right to sue to vindicate their interests as stockholders”).

187. *See, e.g.,* JANA Master Fund Ltd. v. CNET Networks, Inc., 954 A.2d 335, 344 (Del. Ch. 2008) (upholding the advance notice bylaw).

188. *See supra* notes 59–62 and accompanying text (parsing out the differences between substantive and procedural changes).

189. *See* *Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934, 939 (Del. Ch. 2013) (stating that forum selection only “regulate[s] the forum in which stockholders may bring claims” and therefore establishing the “procedural rules for the operation of the corporation”).

shareholder can prosecute a lawsuit or are they substantive because they impose a “show-stopping tax” on the ability to sue? Which side of the divide does an arbitration bylaw fall? And recall that even in *AFSCME*, the court acknowledged that a mandate to reimburse director nominees from the corporate purse looked substantive but was actually procedural.¹⁹⁰ The distinction is not always helpful, and some other theory of corporate governance may be better suited for sorting permissible bylaw initiatives.

Perhaps a better approach would be to walk back the process versus substance distinction and move to a framework that directly evaluates the permissibility of bylaws according to the party seeking to enact the change.¹⁹¹ As discussed earlier, shareholder-initiated bylaws would need to clear any limits imposed by DGCL section 141’s requirement that directors shall manage the firm’s business and affairs.¹⁹² This would obviously require a framework for breaking the “recursive loop.” Director initiated bylaws might be governed through the development of a jurisprudence related to fundamental shareholder rights. Taken together, this would force Delaware to weigh in more directly on acceptable ranges for balancing power between shareholder and the board—which would be a very welcome development in corporate law.

C. By Judicial Review—Equity

Delaware’s Chancery Court retains the power of equitable review, and its system of corporate law continues to rest on the foundation of both law and equity.¹⁹³ Just because an action is legally permitted by the DGCL does not necessarily mean that it is justifiable.¹⁹⁴ Rather, a judge will conduct the second part of the “twice-tested” framework by examining whether that action is equitable under the circumstances. The standards of equity are often used to determine whether insiders have complied with fiduciary obligations. But equitable discretion—and even the fact that this discretion will be available for later disputes—is also taking on greater importance in the evaluation of ex-ante governance initiatives.

Corporate law did not have to take this direction. In 1967, Delaware completed a comprehensive revision of the DGCL, and the resulting product led some commentators to believe that the new statutes should essentially occupy the entire field of corporate law.¹⁹⁵ In other words, the “twice-tested” framework could now become a “once-tested” framework because the new statutes were more complete.

Four years later, the Delaware Supreme Court rejected that proposition with *Schnell*

190. See *supra* note 62 and accompanying text (pointing to where the court ruled the change was not substantive, but procedural).

191. See Smith et al., *supra* note 39 (advocating this step, at least for shareholder initiated bylaws). Notably, there is at least one structural hint in the DGCL that the process/substance distinction may be untenable in this context: section 202(b) apparently permits substantive limits on the right to sell stock to occur in the *bylaws*—though, as mentioned earlier, this section also requires any affected shareholder to be parties to a restriction agreement or to have voted to approve the restriction. DEL. CODE tit. 8, § 202(b) (2015).

192. See *supra* Section II.A.2.a (addressing the degree to which shareholders can assert unilateral bylaws).

193. See Jack B. Jacobs, *The Uneasy Truce Between Law and Equity in Modern Business Enterprise Jurisprudence*, 8 DEL. L. REV. 1, 2 (2005) (tracing the origins of equitable principles as a source of substantive corporate law in Delaware).

194. See Leo E. 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, 877 (2005) (discussing judges use of equitable oversight).

195. *Id.* at 881.

v. *Chris-Craft*.¹⁹⁶ In that case, the board of Chris-Craft Industries faced a challenge by a group of shareholders who wanted to oust the directors in a proxy fight. To counter the threat, the board executed a two-step plan: (1) move up the annual meeting from January to December; and (2) shift the meeting location from New York City to a remote upstate venue.¹⁹⁷ Both of these countermeasures were perfectly legal under the DGCL and the firm's governing instruments.

Nevertheless, the Delaware Supreme Court held that the tactics were impermissible as a matter of equity. It saw this as a mindful manipulation of the election process, motivated by the board's desire to retain power. The directors argued that these steps were sanctioned by the legal rules of the DGCL, but the court responded as follows: "The answer to that contention, of course, is that inequitable action does not become permissible simply because it is legally possible."¹⁹⁸

Despite *Schnell's* broad language, Delaware has been hesitant in the subsequent decades to make explicit use of this equitable escape valve. In the words of the Delaware Supreme Court, equity should only step in under circumstances "that threaten the fabric of the law, or which by an improper manipulation of the law, would deprive a person of a clear right."¹⁹⁹ According to one study, just 13 cases have invalidated a corporate action under the *Schnell* doctrine—a rate of roughly one case every three years—and almost all of these disputes involve director election contests.²⁰⁰ But the possibility that a judge might act to invalidate an otherwise permissible governance initiative in the face of invidious circumstances seems to have provided some comfort to the court when it did approve several controversial governance measures—such as the poison pill or, more recently, a unilaterally adopted forum selection bylaw.²⁰¹

Does this mean that a *Schnell* level of equitable review will increasingly be used to evaluate ex-ante governance bylaws? I think this is likely to be the case—despite the warning of the current Chief Justice that Delaware should remain cautious about invoking equity as a basis for striking down corporate action.²⁰² One reason for this prediction is that Delaware courts may be reluctant to establish bright legal lines related to the "recursive loop" or "fundamental" shareholder rights. As with poison pills and forum selection provisions, lawmakers may prefer to accept a general governance tactic under a forgiving legal review but strike down extreme variants or applications of this tactic under narrower equitable review. (Invalidation of the slow-hand poison pill may be a good example of the latter.²⁰³) Judges are perhaps most tempted to embrace equitable review when practitioners

196. *Schnell v. Chris-Craft*, 285 A.2d 437 (Del. 1971).

197. *Schnell v. Chris-Craft*, 285 A.2d 430, 432 (Del. Ch. 1971).

198. *Id.* at 439.

199. *Alabama By-Products Corp. v. Neal*, 588 A.2d 255, 258 (Del. 1991). The opinion went on to emphasize that "the invocation of equitable principles to override established precepts of Delaware corporate law must be exercised with caution and restraint. Otherwise, the stability of Delaware law is imperiled." *Id.*

200. Mary Siegel, *The Illusion of Enhanced Review of Board Actions*, 15 U. PA. J. BUS. L. 599, 644–46 (2013).

201. See *Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934, 954 (Del. Ch. 2013) (citing *Schnell* and stating that one safeguard against future managerial overreaching is that "the real-world application of a forum selection bylaw can be challenged as an inequitable breach of fiduciary duty.")

202. See Strine, *supra* note 194, at 903 (noting the warning especially extends to categorical exclusions of actions that would be permissible under the legal test).

203. *Quickturn Design Sys. v. Shapiro*, 721 A.2d 1281, 1282 (Del. 1998).

“push the envelope,”²⁰⁴ and the unilateral bylaw envelope pushing will undoubtedly continue.

What principles should guide the equitable review of ex-ante governance tactics? This is a difficult question to answer, just as any effort to define equity defies crisp analysis. The common law of *Schnell* does not seem to provide much help, though it seems probable that equitable review will mostly be used to invalidate managerial-side initiatives. It is true that investors enjoy an extra theoretical safeguard against oppression by managerial bylaw: shareholders who do not care for a given governance rule may simply repeal the bylaw by majority vote.²⁰⁵ Nevertheless, shareholder coordination can make even this a difficult task, and the need for greater judicial development of *Schnell* principles will be an important part of any effort to govern ex-ante governance.

V. CONCLUSION

Bylaws are increasing in importance as an ex-ante mechanism of corporate governance. Shareholder-side initiatives, including board declassification campaigns and other activist proposals, have blossomed in recent years. And director-side bylaw initiatives, including forum selection provisions and litigation fee shifting clauses, are also commanding serious attention in the board room. The legal limits of these and other bylaw modifications remain unclearly defined, but, taken together, this reflects a stronger move towards ex-ante corporate governance—where key players strive to enact structural rules that may tilt the resolution of future disputes in their favor.

One clear driver of these initiatives is a renewed emphasis on corporate bylaws as contracts. By conceptualizing the corporate relationship as an unfolding agreement between shareholders and firms, lawmakers can view bylaw modification efforts as the permissible product of flexible private ordering. This theory is not untenable, but it acutely presents what some commentators have called the “latecomer term” problem: the mechanisms by which governance terms are thought to be priced into corporate relationships may not work seamlessly for one-sided modifications.

This Article has argued that contract law is a clumsy tool for adjudicating ex-ante governance disputes. Unilateral modification presents complex challenges in corporate law, brought on, in part, by collective action problems, agency cost distortions, and information asymmetries. Accordingly, contract law’s loose (though still controversial) embrace of latecomer terms does not offer much guidance for optimal theories of corporate governance. Instead of outsourcing the resolution of these disputes to contract law, legal assessment of bylaws should be governed by corporate law. This means that Delaware’s jurisprudence for delineating legal and equitable bylaws will likely require much greater clarification in the coming years.

204. Strine, *supra* note 194, at 894.

205. DEL. CODE tit. 8, § 109 (2015). The reverse is not thought to be true: directors may not overrule a shareholder initiated bylaw. *Id.*