

Governance by Contract: The Implications for Corporate Bylaws

Law Working Paper N° 350/2017

March 2017

Jill E. Fisch
University of Pennsylvania

© Jill E. Fisch 2017. All rights reserved. Short sections of text, not to exceed two paragraphs, may be quoted without explicit permission provided that full credit, including © notice, is given to the source.

This paper can be downloaded without charge from:
http://ssrn.com/abstract_id=2930529

www.ecgi.org/wp

ECGI Working Paper Series in Law

Governance by Contract: The Implications for Corporate Bylaws

Working Paper N° 350/2017

March 2017

Jill E. Fisch

Thanks to Sean Griffith, Steven Davidoff Solomon and Frank Partnoy for comments on earlier drafts. I am also grateful for helpful comments I received from presentations at The Corporate Contract in Changing Times: Is the Law Keeping Up? at UC Berkeley Law School and Can Delaware Be Dethroned? Evaluating Delaware's Dominance of Corporate Law at UCLA Law School.

© Jill E. Fisch 2017. All rights reserved. Short sections of text, not to exceed two paragraphs, may be quoted without explicit permission provided that full credit, including © notice, is given to the

Abstract

Boards and shareholders are increasing using charter and bylaw provisions to customize their corporate governance. Recent examples include forum selection bylaws, majority voting bylaws and advance notice bylaws. Relying on the contractual conception of the corporation, Delaware courts have accorded substantial deference to board-adopted bylaw provisions, even those that limit shareholder rights.

This Article challenges the rationale for deference under the contractual approach. With respect to corporate bylaws, the Article demonstrates that shareholder power to adopt and amend the bylaws is, under Delaware law, more limited than the board's power to do so. As a result, shareholders cannot effectively constrain the board's adoption of bylaws with which they disagree. The resulting power imbalance offers reasons to question the scope of the contract paradigm.

This analysis has two implications. First, it suggests that the Delaware courts and possibly the legislature may want to re-consider existing constraints on shareholder power in order to realize the contractual paradigm fully. In so doing, they will have to consider the normative implications of greater shareholder empowerment. Second, to the extent that Delaware law retains the existing limitations on shareholder power, this analysis suggests that courts should scrutinize board-adopted bylaws more closely.

Keywords: Corporations, Corporate Governance, Delaware, Amendments to Bylaws, Charters, Shareholder Rights, Board Power, Scrutiny of Board-Adopted Bylaws, Contractual Approach to Corporate Law, Limits of the Contract Analogy, Limits to Shareholder Power

JEL Classifications: D21, G34, K12, K22

Jill E. Fisch*

Perry Golkin Professor of Law and Co-Director

University of Pennsylvania Law School, Institute for Law and Economics

3501 Sansom Street

Philadelphia, PA 19104, United States

phone: +1 215-746-3454, fax: +1 215-573-2025

e-mail: jfisch@law.upenn.edu

*Corresponding Author

GOVERNANCE BY CONTRACT: THE IMPLICATIONS FOR CORPORATE BYLAWS

Jill E. Fisch*

(forthcoming 106 California Law Review __ (2018))

Abstract

Boards and shareholders are increasingly using charter and bylaw provisions to customize their corporate governance. Recent examples include forum selection bylaws, majority voting bylaws and advance notice bylaws. Relying on the contractual conception of the corporation, Delaware courts have accorded substantial deference to board-adopted bylaw provisions, even those that limit shareholder rights.

This Article challenges the rationale for deference under the contractual approach. With respect to corporate bylaws, the Article demonstrates that shareholder power to adopt and amend the bylaws is, under Delaware law, more limited than the board's power to do so. As a result, shareholders cannot effectively constrain the board's adoption of bylaws with which they disagree. The resulting power imbalance offers reasons to question the scope of the contract paradigm.

This analysis has two implications. First, it suggests that the Delaware courts and possibly the legislature may want to re-consider existing constraints on shareholder power in order to realize the contractual paradigm fully. In so doing, they will have to consider the normative implications of greater shareholder empowerment. Second, to the extent that Delaware law retains the existing limitations on shareholder power, this analysis suggests that courts should scrutinize board-adopted bylaws more closely.

* Perry Golkin Professor of Law and Co-Director, Institute for Law & Economics, University of Pennsylvania Law School. Thanks to Sean Griffith, Steven Davidoff Solomon and Frank Partnoy for comments on earlier drafts. I am also grateful for helpful comments I received from presentations at *The Corporate Contract in Changing Times: Is the Law Keeping Up?* at UC Berkeley Law School and *Can Delaware Be Dethroned? Evaluating Delaware's Dominance of Corporate Law* at UCLA Law School. .

Introduction

The contractual approach to corporate law has its roots in the work of leading economists such as Ronald Coase¹ and Oliver Hart.² Although scholars widely accept the utility of contract metaphor, they debate its implications for regulatory policy.³ Some argue that contract principles support substantial deference to the structural arrangements chosen by corporate participants;⁴ others question the appropriate scope of this deference.⁵ Hart himself, for example, observed that, within public corporations, contracts are particularly likely to be incomplete.⁶

The contractual approach has become particularly influential in supporting deference to the participants' agreed-upon governance terms on both autonomy and efficiency grounds.⁷ Commentators have argued that corporate law should adopt an enabling approach in which default corporate law rules can be freely modified by firm participants rather than imposing one-size-fits-all mandatory regulations.⁸ Corporate participants

¹ Ronald H. Coase, *The Nature of the Firm: Meaning*, in *The Nature of the Firm: Origins, Evolution, and Development* (1991), at 56 (“the firm is essentially a choice of contractual arrangements”).

² Oliver Hart, *An Economist's Perspective on the Theory of the Firm*, 89 *Colum. L. Rev.* 1757 (1989).

³ See, e.g., William A. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 *Yale L.J.* 1521, 1563 (1982) (arguing that “The modern business organization can best be understood as a series of bargains made under constraints” but describing this position as positive rather than normative).

⁴ E.g., Frank Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* (1991).

⁵ E.g., Lucian Arye Bebchuk *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 *Harv. L. Rev.* 1820 (1989).

⁶ Oliver D. Hart, *Incomplete Contracts and the Theory of the Firm*, 4 *J. L. Econ. & Org.* 119 (1988).

⁷ See, e.g., Frank Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 *Colum. L. Rev.* 1416, 1446 (1989) (“The role of corporate law here, as elsewhere, is to adopt a background term that prevails unless varied by contract.”).

⁸ Troy Paredes, Troy, *Statement at Open Meeting to Adopt the Final Rule Regarding Facilitating Shareholder Nominations (“Proxy Access”)*, Aug. 25, 2010, <https://www.sec.gov/news/speech/2010/spch082510tap.htm> (“the enabling approach defers to private ordering to determine how each firm should be organized to advance its particular needs and interests most effectively”). Other forms of business entity law are more explicit in providing the maximum effect to the participants' agreed-upon terms. See Paul M. Altman & Srinivas M. Raju, *Delaware Alternative Entities and the Implied Contractual Covenant of Good Faith and Fair Dealing Under Delaware Law*, 60 *Bus. Law.* 1469, 1469 (2005) (explaining that Delaware LLC and LLP law are

are using private ordering to customize their corporate governance by adopting issuer-specific terms.⁹ I have described this trend as the “New Governance.”¹⁰ Recent examples include forum selection bylaws, majority voting bylaws and advance notice bylaws.¹¹

Then-Chancellor (now Chief Justice) Strine built upon this well-developed contractual model of the corporation in *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*¹² As Chief Justice Strine explained in *Boilermakers*, “the bylaws of a Delaware corporation constitute part of a binding broader contract among the directors, officers, and stockholders formed within the statutory framework of the DGCL.”¹³ In so reasoning, Strine was building upon a judicial tradition embracing the academic model of analyzing the power relationship among corporate constituencies in contractual terms.¹⁴

Chief Justice Strine’s contractual model of the corporation, as articulated in *Boilermakers*, relied on two components. The first was a theory of implied consent.¹⁵ Shareholders who buy stock in a corporation in which the charter confers the power to amend the bylaws on the board of directors implicitly consent to be bound by board-adopted bylaws. The second, according to Chief Justice Strine, is “the indefeasible right of the

“based upon and reflect a strong policy favoring broad freedom of contract in connection with almost all aspects of the formation, operation and termination of Delaware limited partnerships and limited liability companies . . .”). See also Larry E. Ribstein, *Unlimited Contracting in the Delaware Limited Partnership and Its Implications for Corporate Law*, 16 J. Corp. L. 299, 300 (1991) (arguing that contractual approach reflected in Delaware’s LLP statute should be extended to corporations).

⁹ D. Gordon Smith, Matthew Wright & Marcus Kai Hintze, *Private Ordering with Shareholder Bylaws*, 80 Fordham L. Rev. 125 (2011).

¹⁰ Jill E. Fisch, *The New Governance and the Challenge of Litigation Bylaws*, 81 Brooklyn L. Rev. 1637 (2016).

¹¹ See *id.* at 1654, 1666 (describing advance notice and forum selection bylaws); Stephen Choi, Jill Fisch, Marcel Kahan & Edward Rock, *Does Majority Voting Improve Board Accountability?*, 83 U. Chi. L. Rev. 1119, 1145 (2016) (describing majority voting bylaws).

¹² 73 A.3d 934 (Del. Ch. 2013).

¹³ *Id.* at 939.

¹⁴ See, e.g., *Airgas, Inc. v. Air Products & Chems., Inc.*, 8 A.3d 1182, 1188 (Del. 2010), citing *Centaur Partners, IV v. Nat’l Intergroup, Inc.*, 582 A.2d 923, 928 (Del. 1990) (describing bylaws as “contracts among a corporation’s shareholders”).

¹⁵ *Boilermakers*, 73 A.2d at 955-56.

stockholders to adopt and amend bylaws themselves”¹⁶ Chief Justice Strine describes the shareholders’ ability to do so as “legally sacrosanct.”¹⁷

The Court relied on this rationale in *ATP* to uphold a board-adopted bylaw that required a losing plaintiff-shareholder to pay the corporations’ litigation expenses.¹⁸ The *ATP* Court’s reasoning was not merely based on a contract analogy. The court specifically treated the bylaw in question as a contract term, explaining that that the bylaw was the equivalent of a “contractual exception to the American Rule.”¹⁹ Somewhat ironically, the Court based its conclusion on the fact that corporate bylaws are “contracts among a corporation’s shareholders,” despite the fact that the bylaw in question had been adopted by the board and had not been subjected to a shareholder vote.²⁰

The broad conception of the shareholders’ bylaw power reflected in *Boilermakers* and *ATP* is in tension with an earlier decision by the Delaware Supreme Court, however. In *CA Inc. v. AFSCME*, the Court held that a shareholder-adopted proxy expense reimbursement bylaw was inconsistent with Delaware law because the shareholders’ authority to adopt this type of bylaw is limited in scope.²¹ Specifically, the Court concluded that the board’s statutory authority to manage the corporation operated as a constraint on shareholder power. As the Court explained, “the internal governance contract--which here takes the form of a bylaw--is one that would also prevent the directors from exercising their full managerial power in circumstances where their fiduciary duties would otherwise require them to deny reimbursement to a dissident slate.”²²

The tension between *Boilermakers* and *AFSCME* poses a challenge to the contemporary understanding that the contractual nature of the corporate form warrants the high level of judicial deference to private ordering reflected in *Boilermakers*. Within the context of the New Governance, the board’s power to adopt and amend bylaw provisions may, for a variety of reasons, be greater than the corresponding shareholder power to do so. In turn, the resulting limit on the scope of the contract

¹⁶ Id. at 956.

¹⁷ Id.

¹⁸ *ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554, 557 (Del. 2014)

¹⁹ Id. at 558.

²⁰ Id. Concededly *ATP* was a non-stock corporation, but the Court did not limit its holding to non-stock corporations.

²¹ *CA, Inc. v. AFSCME Emples. Pension Plan*, 953 A.2d 227 (Del. 2008)

²² Id. at 239.

metaphor offers a reason to question the current judicial approach to litigation bylaws.

The implications are twofold. First, a commitment to a contractual paradigm suggests that the Delaware courts, and possibly the legislature as well, may want to re-consider the existing constraints on shareholder power in the name of facilitating private ordering. In so doing, they will have to consider the possible consequences of greater shareholder empowerment.²³ Second, to the extent that Delaware law retains the existing limitations on shareholder power reflected in AFSCME, the courts may have to engage in greater scrutiny of board-adopted bylaws because shareholders may be unable to remove those bylaws themselves.²⁴

This Article proceeds as follows. In Part I, the Article briefly sketches the foundation for the contractual model of the corporation and its application to issuer-specific bylaws. Part II identifies constraints on shareholder power to adopt and amend bylaws that create a disparity between the board's power and that of the shareholders. Part III considers the implications of this disparity for the contractual approach.

I. The Contractual Nature of Corporate Bylaws

The contractual model of the corporation has its origins in a strand of law and economics scholarship from the 1980s.²⁵ The model

²³ These consequences include the increased potential for shareholder activism and the consequences of that activism. Commentators have disagreed as to the normative implications of shareholder empowerment. Compare William Bratton & Michael Wachter, *The Case Against Shareholder Empowerment*, 158 U. Pa. L. Rev. 653, 658-659 (2010) (arguing that increased shareholder empowerment caused managers to manage to the market excessively) with Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 Harv. L. Rev. 833, 836 (2005) (claiming that "Increasing shareholder power to intervene . . . would improve corporate governance and enhance shareholder value by addressing important agency problems that have long afflicted publicly traded companies").

²⁴ The balance of authority between shareholders and directors to adopt governance bylaws has further implications for the scope of permissible shareholder proposals under SEC 14a-8(i)(1) & (2). Consideration of those implications is beyond the scope of this article.

²⁵ Michael Jensen and William Meckling first described the firm as a "nexus of contracts." Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J Fin Econ 305 (1976). The contractual approach was rapidly embraced by scholars in the law and economics tradition. See, e.g., Robert C. Clark, *Contracts, Elites, and Traditions in the Making of*

characterizes the relationship between managers and shareholders as contractual in nature. Prominent law and economics scholars argued that market discipline, imposed through stock prices, would lead to the adoption of optimal contract terms or, at least, terms that would be better than those imposed by regulation.²⁶ The contractual theory had important implications for corporate law.²⁷ Scholars argued that contract theory demonstrated that corporate law should facilitate the contracting process by accepting a wide range of firm-specific customized contract terms.²⁸ In addition, they reasoned that corporate law should not mandate a one-size-fits-all approach, both because policymakers are unlikely to identify successfully the optimal corporate law rules and because a single rule is unlikely to be optimal for all issuers.²⁹

The development of firm-specific governance terms has come to be known as private ordering.³⁰ Although a variety of scholars have identified limitations to the contractual approach and, as a result, questioned its use as a basis for limiting mandatory regulation,³¹ the contractarian

Corporate Law, 89 COLUM. L. REV. 1703, 1705 (1989) (observing that the “contractual theory of the firm . . . dominate[d] the thinking of most economists and economically oriented corporate law scholars”).

²⁶ Easterbrook & Fischel, *The Corporate Contract*, 89 Colum. L. Rev. at 1430-33.

²⁷ See generally, Symposium, *Contractual Freedom in Corporate Law*, 89 Colum. L. Rev. 1395 (1989) (discussing implications of contractual approach for the role of mandatory corporate law)

²⁸ Frank H. Easterbrook & Daniel R. Fischel, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 5 (1991). Frank Easterbrook and Daniel Fischel were among the most influential adherents to the contractual model. See Ian Ayres, *Review Essay, Making a Difference: The Contractual Contributions of Easterbrook and Fischel*, 59 U. Chi. L. Rev. 1391, 1491 (1992) (“Easterbrook and Fischel are worthy heirs to the contractual tradition begun by Coase more than fifty years ago”).

²⁹ Henry N. Butler & Larry E. Ribstein, *Opting out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 Wash. L. Rev. 1 (1990) 65 Wash. L. Rev. 1 (summarizing the debate over private ordering versus mandatory rules).

³⁰ D. Gordon Smith, Matthew Wright & Marcus Kai Hintze, *Private Ordering with Shareholder Bylaws*, 80 Fordham L. Rev. 125, 127 n.12 (2011) (discussing various uses of the term private ordering).

³¹ See, e.g., Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. Corp. L. 779, 784 (2006) (“The contractarian theory has turned out to be based largely on an entirely plausible, but in fact imaginary, world of contracting.”); Melvin Aron Eisenberg, *Corporate Law and Social Norms*, 99 Colum. L. Rev. 1253, 1275 (1999) (arguing against the application of a contractual approach to the duty of loyalty)

approach provides the normative basis for private ordering.³² Corporate bylaws offer a mechanism by which shareholders (and directors) can engage in this private ordering.³³

By virtue of its largely enabling structure, Delaware corporate law is consistent with the private ordering approach.³⁴ The Delaware statute contains relatively few mandatory provisions.³⁵ Instead, most of the statute provides default rules that can be modified through an appropriate charter or bylaw provision.³⁶ Thus, for example, the statute contains an antitakeover provision restricting business combinations with an interested shareholder for a period of five years but provides a variety of mechanisms by which a corporation can elect to avoid the application of that provision.³⁷ Similarly, the statute provides that the board of directors will be elected annually but allows a corporation to opt instead for a classified board through a charter provision or shareholder-adopted bylaw.³⁸

In addition to enabling individual corporations to modify the statutory default rules, the Delaware statute facilitates private ordering by allowing corporations to customize their charters and bylaws through the inclusion of a variety of optional contract-like terms. One of the better known provisions, DGCL 102(b)(7), allows corporations to adopt a

³² See, e.g., Jill E. Fisch, *The Destructive Ambiguity of Federal Proxy Access*, 61 *Emory L. J.* 435 (2012) (arguing that federal securities laws should facilitate experimentation with proxy access through private ordering).

³³ See, e.g. Smith et al., *supra* note __ at 130 (“We would promote private ordering in public corporations by lowering the barriers to contracting through the adoption of shareholder bylaws.”). Firms can also engage in private ordering by the adoption of firm-specific charter provisions. The critical distinction between the charter and the bylaws is that charter amendments typically require both shareholder and board approval. In contrast, most states allow boards and shareholders to amend the bylaws unilaterally. The requirement of joint action means that the contractual approach has different implications for the legitimacy of charter provisions, an issue that is beyond the scope of this article. In addition, the statute may impose different limits on the scope of permissible private ordering that can be effected pursuant to a charter provision. See, e.g., *Frechter v. Zier*, C.A. No. 12038-VCG (Del. Ch. Jan. 24, 2017) n. 19 (contrasting permissible supermajority requirements under section 109 with section 102(b)(4)).

³⁴ Jill E. Fisch, *Leave It to Delaware: Why Congress Should Stay Out of Corporate Governance*, 27 *Del. J. Corp. L.* 731 (2013).

³⁵ Fisch, *supra* note __, 81 *Brooklyn L. Rev.* at 1671.

³⁶ For exceptions see DGCL 211 (requiring an annual meeting of shareholders); 170 (restricting payment of dividends).

³⁷ DGCL § 203(a).

³⁸ DGCL §141(d).

charter provision that limits or eliminates certain director liability for monetary damages based on a breach of the duty of care.³⁹ Another provision authorizes corporations to adopt a charter provision renouncing an interest in specified business opportunities, thereby limiting potential claims under the corporate opportunity doctrine.⁴⁰ The statute also authorizes corporations to adopt supermajority voting requirements through the inclusion of an optional charter provision.⁴¹

Delaware law also allows corporations to customize their corporate governance through the adoption of bylaws. Under the Delaware statute, shareholders have the power to adopt, amend and repeal the bylaws. The corporation may also confer this power on the directors through a charter provision, but such a provision does not remove that power from the shareholders.⁴² The vast majority of Delaware corporate charters vest the board of directors with this authority.⁴³

The scope of potential governance bylaws is very broad. The Delaware statute authorizes corporations to adopt “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.”⁴⁴ Because of this broad scope and because shareholders and boards can each adopt governance bylaws unilaterally, a substantial amount of private ordering in Delaware corporations takes place through the adoption of issuer-specific bylaws.⁴⁵

³⁹ John L. Reed & Matt Neiderman, "Good Faith" and the Ability of Directors to Assert § 102(b)(7) of the Delaware General Corporation Law as a Defense to Claims Alleging Abdication, Lack of Oversight, and Similar Breaches of Fiduciary Duty, 29 Del. J. Corp. L. 111, 113. (2004) (describing history and scope of 102)(b)(7)). Concededly the section is not fully contractual in that it exempts four categories of conduct for which directors cannot be exculpated. *Id.*

⁴⁰ DGCL § 122(17).

⁴¹ DGCL § 102(b)(4).

⁴² DGCL 109(a).

⁴³ Ann Lipton, *Manufactured Consent: The Problem of Arbitration Clauses in Corporate Charters and Bylaws*, 104 Geo. L.J. 583, 589 n. 25 (2016) (“Universally, publicly traded corporations grant directors such powers from their inception”).

⁴⁴ DGCL § 109(b).

⁴⁵ See, e.g. E. Norman Veasey, *The Shareholder Franchise is not a Myth: A Response to Professor Bebchuk*, 93 Va. L. Rev. 811, 821 (2007) (explaining how shareholders can engage in private ordering by adopting bylaws that modify an issuer’s procedures for electing directors, including the implementation of majority voting).

The Delaware courts have largely accepted the contractual theory of corporate law.⁴⁶ As the Delaware Supreme Court explained in *Airgas*, “Corporate charters and bylaws are contracts among a corporation's shareholders....”⁴⁷ The contractual theory provides a methodology for interpreting the charter and bylaws – they are to be interpreted, using contract principles.⁴⁸ It also provides support for a basis for enforcing them. As then-Chancellor Strine explained in the *Boilermakers* decision, “the bylaws constitute a binding part of the contract between a Delaware corporation and its stockholders.”⁴⁹

Boilermakers concerned the validity of a board-adopted forum selection bylaw. In upholding the bylaw, the court relied on two factors. The first was a theory of implied consent. Chancellor Strine reasoned that the Delaware statute contemplates that directors will, if the charter so provides, have the authority to adopt bylaws unilaterally. Given the framework established by the statute, shareholders of a corporation in which the charter authorizes the board to amend the bylaws implicitly agree that they “will be bound by bylaws adopted unilaterally by their boards.”⁵⁰ Shareholder consent through their decision to invest in the corporation.⁵¹

Chancellor Strine found further support for the contractual analysis in the rights conferred on shareholders by the statute if they disagree with a board-adopted bylaw. First, as Strine noted, the shareholders possess a right, comparable to that of the board, to adopt or amend bylaws.⁵² Second, shareholders have the further power to discipline boards who refuse to accede to a shareholder vote concerning a bylaw by removing recalcitrant directors from their position. Strine therefore concluded that “Thus, a corporation's bylaws are part of an inherently flexible contract between the stockholders and the corporation under which the stockholders have powerful rights they can use to protect themselves if they do not want board-adopted forum selection bylaws to be part of the contract between themselves and the corporation.”⁵³

⁴⁶ See, e.g., *Airgas, Inc. v. Air Prods. & Chems., Inc.*, 8 A.3d 1182, 1188 (Del. 2010).

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*, 73 A.3d 934, 955 (Del. Ch. 2013).

⁵⁰ *Id.* at 956.

⁵¹ *Id.*

⁵² *Id.*, quoting *CA, Inc.*, 953 A.2d at 232.

⁵³ *Id.*

The *Boilermakers* decision reflected a powerful endorsement of contractual freedom in corporate law. As such, it encouraged corporations to engage in private ordering through the adoption and amendment of the corporate bylaws.⁵⁴ Corporations responded to this invitation. With respect to forum selection bylaws, which had been used to a limited extent prior to the *Boilermakers* decision, issuer adoption of the bylaws “rapidly accelerated” after *Boilermakers*.⁵⁵

Issuers also began to experiment with other governance bylaws.⁵⁶ In *ATP*, the Delaware Supreme Court upheld a board-adopted fee-shifting bylaw, reasoning that the contractual analysis in *Boilermakers* was similarly applicable.⁵⁷ Similarly, a number of issuers adopted director qualification bylaws to prohibit certain types of compensation agreements for activist-nominated director candidates.⁵⁸ Commentators argued that the reasoning in *ATP* and *Boilermakers* allowed issuers to adopt bylaws compelling arbitration instead of litigation.⁵⁹ Several courts upheld the

⁵⁴ Issuers had previously adopted various types of governance bylaws that, prior to *Boilermakers*, had rarely been challenged in court. For example, advance notice bylaws, which require a shareholder to provide the issuer with advance notice of the intention to nominate competing director candidates, were prevalent prior to the *Boilermakers* decision. See WilmerHale, 2015 M&A Report, at 5 (2015), available at https://www.wilmerhale.com/uploadedFiles/Shared_Content/Editorial/Publications/Documents/2015-WilmerHale-MA-Report.pdf (citing www.SharkRepellent.net). (estimating that “95 percent of the S&P 500 and 90 percent of the Russell 3000 had advance notice provisions at 2014 year-end.”)

⁵⁵ Roberta Romano & Sarath Sanga, *The Private Ordering Solution to Multiform Shareholder Litigation*, <http://ssrn.com/abstract=2624951>, at 11 and figure 2. The Delaware legislature explicitly approved endorsed the validity of forum selection bylaws in 2015. See DEL. CODE ANN. tit. 8, §§ 102(f), 109(b) (West 2015).

⁵⁶ See generally, Fisch, *supra* note __ Brooklyn (describing range of board-adopted governance bylaws).

⁵⁷ *ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554, 556 (Del. 2014). The Delaware legislature subsequently amended the statute to prohibit fee-shifting bylaws. DEL. CODE ANN. tit. 8, §§ 102(f), 109(b) (West 2015).

⁵⁸ See Matthew D. Cain, Jill E. Fisch, Sean J. Griffith & Steven Davidoff Solomon, *How Corporate Governance Is Made: The Case of the Golden Leash*, 164 U. PA. L. REV. 649, 651-56 (2016).. Notably, the golden leash bylaw experience was consistent with Strine’s reasoning in *Boilermakers*; when shareholders who objected to the bylaws by withholding their votes from directors who adopted them, the offending board responded by repealing the provisions. *Id*

⁵⁹ See Claudia Allen, *Bylaws Mandating Arbitration of Stockholder Disputes?*, 39 DEL. J. CORP. L. (2014); see also Letter from Jeff Mahoney, Gen. Counsel, Council of Institutional Investors, to Keith F. Higgins, Dir., Div. of Corp. Fin., SEC, and John

decision to adopt an arbitration bylaw by one issuer, a Massachusetts REIT, although the analysis did not implicate Delaware corporate law.⁶⁰

Shareholders also increased their efforts to engage in private ordering through the adoption of governance bylaws. In recent years, shareholders have proposed a variety of governance reforms through bylaw amendments including majority voting, proxy access, and the right of shareholders to call a special meeting. (Fisch 2016) These proposals have enjoyed considerable voting support. As of January 2014, for example, “almost 90% of S&P 500 companies ha[d] adopted some form of majority voting.”⁶¹ The year 2015 was a “break-through year” for proxy access shareholder bylaws, due in part to a shareholder proposal campaign by the New York City Comptroller.⁶² Most proxy access proposals received support by a majority of shareholders, and a growing number of issuers are adopting some form of proxy access.⁶³

II. Limits of the contract analogy

As noted above, boards and shareholders are using private ordering to adopt issuer-specific governance bylaws. If these bylaws are properly understood as negotiated terms of a contract, courts should give them broad deference.⁶⁴ The *Boilermakers* and *ATP* decisions relied on this rationale to uphold forum selection and fee-shifting bylaws, respectively.

Ramsey, Acting Dir., Div. of Trading and Mkts., SEC (Dec. 11, 2013), (reasoning that decisions like *Boilermakers* could lead corporations to adopt arbitration bylaws).

⁶⁰ Del. Cnty. Emps. Ret. Fund v. Portnoy, No. 13-10405-DJC, 2014 U.S. Dist. LEXIS 40107 (D. Mass. Mar. 26, 2014); Katz v. Commonwealth REIT, No. 24-C-13-001299 (Cir. Ct. Balt. City Aug. 31, 2015); Corvex Mgmt. LP v. Commonwealth REIT, No. 24-C-13-001111, 2013 Md. Cir. Ct. LEXIS 3 (Cir. Ct. Balt. City May 8, 2013).

⁶¹ Choi et al. Majority Voting, supra note __.

⁶² Avrohom J. Kess, Proxy Access Proposals, Harvard Law School Forum on Corporate Governance and Financial Regulation, 2015, avail. at

<https://corpgov.law.harvard.edu/2015/08/10/proxy-access-proposals/>

⁶³ Weil, Gotshal & Manges, Heads Up for the 2016 Proxy Season Navigating Proxy Access: A Roadmap for the Board of Directors, Oct. 21, 2015.

<https://corpgov.law.harvard.edu/2016/02/04/2016-proxy-season-engagement-transparency-proxy-access/> (reporting that 124 issuers adopted proxy access between January 1, 2015, and Feb. 4, 2016, either voluntarily or in response to a shareholder proposal).

⁶⁴ These need not undercut the contractual approach completely. Instead, it may suggest the higher level of judicial scrutiny applicable in some contractual contexts.

The problem with the contractual analysis however is that, for a variety of reasons, shareholder power to amend the bylaws is more limited than the *Boilermakers* decision suggests.⁶⁵ Although the board has broad power to adopt governance bylaws, shareholders do not enjoy analogous power. Accordingly, shareholders are limited in their ability to constrain board actions with which they disagree. This Part identifies several key limitations on shareholder power over the corporations' bylaws. The following part considers the implications of these limitations.

A. Substantive Limits on Shareholder Power under Section 109

Although *Boilermakers* and *ATP* describe shareholder power to adopt and amend bylaws under Delaware law as very broad, an earlier Delaware Supreme Court decision in *CA v. AFSCME* suggests a more limited shareholder role.⁶⁶ *AFSCME*, a union pension fund, submitted a shareholder proposal, pursuant to Rule 14a-8,⁶⁷ seeking to amend the bylaws to require the issuer, under certain circumstances, to reimburse reasonable proxy solicitation expenses incurred by a stockholder who nominates one or more candidates for election to the board of directors.⁶⁸ *CA* sought to exclude the shareholder proposal from its proxy statement on the basis that the proposed bylaw was not a proper subject for shareholder action and, if adopted, would be illegal under Delaware law, specifically §141(a).

In support of its request for no-action relief, *CA* submitted to the SEC an opinion letter from Delaware counsel arguing that the proposed bylaw was invalid because it would interfere with the board's authority

⁶⁵ Justice Strine's argument that shareholders consent to the terms of the charter and bylaws also warrants further scrutiny. This article does not consider the extent to which the argument is valid. For further discussion of this point see Verity Winship, *Shareholder Litigation by Contract*, 96 B.U.L. Rev. 485, 496 (2016).

⁶⁶ *CA, Inc. v. AFSCME Emps. Pension Plan*, 953 A.2d 227, 229 (Del. 2008). Prior to *CA*, the position of the Delaware courts on this issue was less clear. See *Frantz Mfg. Co. v. EAC Indus.*, 501 A.2d 401 (Del. 1985) upholding shareholder adopted bylaw amendments that "required attendance of all directors for a quorum and unanimous approval of the board of directors before board action can be taken, and they thereby limited the functioning of the Frantz board" even though the amendments were intended to limit the board's "anti-takeover maneuvering".

⁶⁷ 17 C.F.R. § 240.14a-8 (1988).

⁶⁸ *Id.* at 229-30.

under the statute and the charter to manage the corporation.⁶⁹ According to the letter, the board, not the shareholders, had the discretion to determine how to expend corporate funds, and the shareholders lacked the authority “unilaterally [to impose] limits on the Board’s discretion.”⁷⁰ The letter also argued that the bylaw would “impede the Board’s exercise of its fiduciary duties to manage the business and affairs of the Company.”⁷¹

The SEC sought guidance from the Delaware Supreme Court as to whether CA’s argument was correct as a matter of Delaware Corporate law.⁷² The Court used the occasion to provide several guiding principles about the scope of shareholder authority under section 109. First, and perhaps most important, the Court explicitly rejected the idea that the shareholder’s power to adopt bylaws is coextensive with that of the board of directors.⁷³ Instead, the Court explained that shareholder power is limited by section 141(a) which provides the board, but not the shareholder, with broad management power over the affairs of the corporation.⁷⁴ The court explained that a shareholder-adopted bylaw would be invalid if it limited “the board’s management prerogatives under Section 141(a).”⁷⁵

⁶⁹ Letter from Richards, Layton & Finger dated Apr. 17, 2008, p. 3, avail. at <https://www.sec.gov/divisions/corpfin/cf-noaction/2008/ca062708-14a8-incoming.pdf>.

⁷⁰ Id at 7, n.3.

⁷¹ Id. at 8, n.3.

⁷² CA used Delaware’s newly adopted certification procedure, 272 S.B. 62, 144th Gen. Assem., Reg. Sess. (Del. 2007), available at

<http://delcode.delaware.gov/sessionlaws/ga144/chp037>, to certify two questions to the Delaware Supreme Court:

1. Is the AFSCME Proposal a proper subject for action by shareholders as a matter of Delaware law?
2. Would the AFSCME Proposal, if adopted, cause CA to violate any Delaware law to which it is subject?

CA at 231.

⁷³ “[I]n isolation, Section 109(a) could be read to make the board’s and the shareholders’ power to adopt, amend or repeal bylaws identical and coextensive, but Section 109(a) does not exist in a vacuum. It must be read together with 8 Del. C. § 141(a). . . .” Id. at 232.

⁷⁴ See id. (“No such broad management power is statutorily allocated to the shareholders.”)

⁷⁵ Id. at 232.

The Court's analysis drew upon an argument that commentators had developed in response to pill redemption bylaws.⁷⁶ In the late 1990s, institutional investors attempted to adopt bylaws to restrict a board's use of a poison pill to resist a hostile tender offer.⁷⁷ These bylaws took various forms including requiring boards to redeem poison pills that had been adopted without shareholder approval and bylaws requiring boards to submit poison pills to the shareholders for approval.⁷⁸ These bylaws generated substantial controversy among corporate law experts, many of whom argued that they were invalid because they exceed shareholder power or interfered with the board's authority to run the corporation.⁷⁹

In a case involving an Oklahoma corporation, *International Bhd. of Teamsters v. Fleming Cos.*,⁸⁰ the Oklahoma Supreme Court upheld a bylaw requiring that the board submit a pill to its shareholders for ratification against the claim that the bylaw exceeded the shareholders' authority. Reading the Oklahoma corporation statute, the court concluded that absent specific statutory language granting the board autonomy to adopt a pill such as a rights plan endorsement statute (which Oklahoma did not have), the shareholders were free to adopt a bylaw that limited board authority to implement such a plan.⁸¹ The court reasoned, in particular, that a pill was similar to stock option plans and that there was "authority supporting shareholder ratification of stock option plans."⁸²

⁷⁶ Lawrence Hamermesh, *Corporate Democracy and Stockholder Adopted By-Laws: Taking Back the Street?*, 73 Tul. L. Rev. 409 (1998).

⁷⁷ See, e.g., John C. Coffee, Jr., *The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?*, 51 U. Miami L. Rev. 605, 610-12 (1997) (describing efforts by institutional investors to introduce pill redemption bylaws).

⁷⁸ See, e.g., *International Bhd. of Teamsters v. Fleming Cos.*, 975 P.2d 907, 909 (Okla. 1999) (describing bylaw proposed in 1996, which would have required board to redeem existing poison pill and bylaw proposed in 1997 which required shareholder ratification of a board-adopted poison pill).

⁷⁹ E.g. Hamermesh, *supra* note ___, 73 Tulane L. Rev. at, 421; John C. Coates IV & Bradley Faris, *Second Generation By-Laws: Post-Quickturn Alternatives*, 56 BUS. LAW. 1323, 1326 (2001) (arguing that bylaws which "conflict with the board's authority under section 141(a) . . . to manage the business and affairs of the corporation" are likely invalid).

⁸⁰ *International Bhd. of Teamsters v. Fleming Cos.*, 975 P.2d 907, 908 (Okla. 1999).

⁸¹ *Id.* at 913-14.

⁸² *Id.* at 911.

The Delaware courts did not have occasion to rule on whether a pill redemption bylaw was permissible under Delaware law,⁸³ and whether they would have followed the *Fleming* court's approach is unclear.⁸⁴ A number of prominent commentators argued that they would not.⁸⁵ They reasoned that Delaware law espouses a board-central model of the corporation. As Stephen Bainbridge has argued, various legal doctrines limit the control of shareholders of Delaware corporations over management decisions.⁸⁶ Bainbridge has identified a number of normative arguments in support of these limits, reasoning both that the corporate form involves the shareholders' decision to delegate this control to the board and that this delegation is efficient.⁸⁷

In the *AFSCME* case, the court offered guidance on the permissible scope of corporate bylaws in order to analyze the relationship between board authority under section 141(a) and shareholder power under section 109.

As a starting point, the court recognized that the statutory language was only "marginally helpful in determining what the Delaware legislature intended to be the lawful scope of the shareholders' power to adopt, amend and repeal bylaws."⁸⁸ The court went on to explain that the proper function

⁸³ See, e.g., Jonathan R. Macey, *The Legality and Utility of the Shareholder Rights Bylaw*, 26 Hofstra L. Rev. 835, 866 (1998) ("No Delaware court has addressed the legality of the shareholder rights bylaw.").

⁸⁴ See John C. Coffee, Jr., *The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?*, 51 U. Miami L. Rev. 605, 615 ("Delaware courts may see the law differently than the district court in *Fleming*"). In addition, the Oklahoma legislature responded to the *Fleming* decision by amending the corporation statute to provide that shareholders do not have the power to amend the bylaws unless such power is affirmatively conferred by the charter. See 18 Okla. Stat. 1013.

⁸⁵ See note ___, *supra* and accompanying text. See also Frederick Alexander & James Honaker, *Power to the Franchise or the Fiduciaries: An Analysis of the Limits on Stockholder Activist Bylaws*, 33 DEL. J. CORP. LAW 749, 756 n.24 (2008) (arguing that pill, proxy expense and proxy access bylaws are all invalid as beyond shareholder power to control board action). Cf. Macey, *supra* at 866.

⁸⁶ Stephen M. Bainbridge, *Director Primary, The Means and Ends of Corporate Governance*, 97 Nw. U. L. Rev. 547, 572 (2003).

⁸⁷ *Id.* See also Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. Rev. 601, 627 (2006) ("shareholder voting must be constrained in order to preserve the value of authority").

⁸⁸ *CA, Inc. v. AFSCME Emples. Pension Plan*, 953 A.2d 227, 234 (Del. 2008). It is worth noting that the Delaware corporate law statute does not contain any language explicitly endorsing a contractual approach, particularly in contrast to the Delaware LLC and LLP statutes which do so. See, e.g., Del. Code tit. 6, § 18-1101(b) (2011) ("It

of bylaws was to address procedural issues rather than to mandate substantive business decisions and that this substance/procedure distinction could be used to demarcate the scope of a permissible bylaw under Delaware law. Using this concept, it then framed the answer to the first certified question as requiring it to determine whether an expense reimbursement bylaw was “process-related.”⁸⁹ The court concluded that it was. Although the bylaw concededly involved the expenditure of corporate funds, the court reasoned that the expenditure was related to maintaining the integrity of the electoral process. The court concluded that, as such, the bylaw was a proper subject for shareholder action.

The substance/procedure distinction can be understood as a method of determining when a bylaw impermissibly infringes upon board authority under section 141(a).⁹⁰ Section 141(a) vests the board with authority over substantive business decisions such that a substantive bylaw could be understood to usurp that authority. A bylaw that addresses the procedure by which a decision is made but leaves the ultimate decision to the board would presumably be less problematic than a bylaw that purports to limit the board’s discretion.⁹¹ The upshot of this reasoning, however, is to create a different scope for board-adopted bylaws than for those adopted by shareholders in that it is unnecessary to limit the board to adopting only process-related bylaws.

The *AFSCME* court’s determination that the proxy reimbursement bylaw was process-based, and therefore legally permissible, did not conclude the analysis, however. The court went on to consider the second

is the policy of this chapter to give the maximum effect to the principle of freedom of contract”).

⁸⁹ *CA, Inc.*, at 236.

⁹⁰ Commentators have suggested other approaches to analyzing this question. For example, Ben Walther distinguishes between bylaws that attempt to circumscribe the managerial authority of the board and those that attempt to control or bind the board. Ben Walther, *Bylaw Governance*, 20 *Fordham J. Corp. & Fin. L.* 399, 414-15 (2015). Jack Coffee offers four criteria for distinguishing proper from improper shareholder bylaws: 1) bylaws that deal with fundamental versus ordinary matters; 2) bylaws that impose negative constraints as opposed to affirmative obligations; 3) bylaws that focus on procedure rather than substance; and 4) bylaws that concern corporate governance rather than business decisions. John C. Coffee, Jr., *The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?*, 51 *U. Miami L. Rev.* 605 (1997).

⁹¹ See also *Hollinger Int’l, Inc. v. Black*, 844 A.2d 1022, 1978-79 (Del. Ch. 2004) (stating that there is a “general consensus that bylaws that regulate the process by which the board acts are statutorily authorized”).

question -- whether the proposed bylaw would cause CA to violate Delaware law. The court concluded that it would. Reasoning that the bylaw could, hypothetically, require the board to reimburse a stockholders' proxy expenses in a situation in which reimbursement would violate the board's fiduciary duties, the court concluded this deficiency rendered the bylaw facially invalid.⁹²

The court reached this conclusion by analogizing to situations in which courts had invalidated contracts that imposed obligations on a board that arguably were inconsistent with the board's fiduciary duties.⁹³ Although those situations involved contractual obligations that the board had voluntarily assumed, as opposed to obligations imposed by a shareholder-adopted bylaw, the court concluded that "the distinction is one without a difference."⁹⁴ The court's rationale was that, in either case, the result would be to limit the board from exercising the full scope of its managerial authority.⁹⁵ Again, the touchstone of the analysis was the board's broad authority under section 141(a).⁹⁶

Although the *AFSCME* decision has been criticized,⁹⁷ and the Delaware legislature subsequently amended the statute explicitly to authorize both proxy expense reimbursement bylaws and proxy access

⁹² The court explained that it was required to view the bylaw as inconsistent with the law if there was "any possible circumstance under which a board of directors might be required to act [under which], the board of directors would breach their fiduciary duties if they complied with the Bylaw." *CA, Inc.*, at 238.

⁹³ See *id.* at 238, citing *Paramount Communications, Inc. v. QVC Network, Inc.*,

⁹⁴ *Id.* at 239.

⁹⁵ An open issue is the extent to which the inclusion of a fiduciary out in the bylaw would address this concern. See Sabrina Ursaner, Keeping "Fiduciary Outs" Out of Shareholder-Proposed Bylaws: An Analysis of *CA, Inc. v. AFSCME*, 6 *N.Y.U. J.L. & BUS.* 479, 507-08 (2010).

⁹⁶ Notably, however, the court suggested that the situation might be different if the limitation had been imposed through a charter provision rather than a bylaw. See *id.* at 240 (suggesting that shareholders might have recourse by seeking "to amend the Certificate of Incorporation to include the substance of the Bylaw"). Because the scope of charter provisions is similarly limited to what is permitted by the statute, it is unclear why using a charter provision instead of a bylaw would affect the outcome. The distinction however motivated an argument by the plaintiffs in *Boilermakers* that, to the extent that a forum selection provision was permissible, it had to be adopted through a charter provision rather than a bylaw. See *Boilermakers* at ___. The court rejected that argument. *Id.* at ___.

⁹⁷ See, e.g., Brett H. McDonnell, *Bylaw Reforms for Delaware's Corporation Law*, 33 *Del. J. Corp. L.* 651, 668 (2008).

bylaws,⁹⁸ the principle that shareholder authority under section 109 is more limited than director authority appears to have survived. In a 2015 decision, VC Noble invalidated a bylaw that authorized shareholders to remove and replace corporate officers without cause.⁹⁹ Notably, the plaintiff in that case, Gorman relied on statutory language that seemed expressly to authorize bylaws that dealt with the appointment and removal of corporate officers.¹⁰⁰

Significantly, Vice-Chancellor Noble relied on the *AFSCME* decision for the proposition that “Stockholders' ability to amend bylaws is ‘not coextensive with the board's concurrent power and is limited by the board's management prerogatives under Section 141(a).’”¹⁰¹ The court further held that the touchstone for determining whether the bylaw infringed on the board’s management function was the substance/procedure distinction developed by the *AFSCME* court.¹⁰² Applying this standard, the court concluded that the bylaw was invalid, reasoning that it “would allow [shareholders] to make substantive business decisions for the Company.”¹⁰³

B. Additional Statutory Limits on Shareholder Power

Although *AFSCME* distinguishes between shareholder and board power to adopt and amend the bylaws, it is only one case.¹⁰⁴ The structure and language of the Delaware corporation statute provide additional reasons to view the scope of shareholder power under section 109 as

⁹⁸ See DGCL §§112, 113.

⁹⁹ Gorman v. Salamone, 2015 Del. Ch. LEXIS 202.

¹⁰⁰ Paul M. Tiger & Carolyn Oh, Gorman v. Salamone: Delaware Court of Chancery Strikes Down Bylaw Granting Stockholders the Right to Remove and Replace Officers, *Cleary M&A and Corporate Governance Watch*, 2015, avail. at <http://www.clearymawatch.com/2015/08/gorman-v-salamone-delaware-court-of-chancery-strikes-down-bylaw-granting-stockholders-the-right-to-remove-and-replace-officers/> Section 142(b) provides “Officers shall be chosen in such a manner and shall hold their offices for such term as are prescribed by **the bylaws** or determined by the board of directors or other governing body.”) (emphasis added).

¹⁰¹ Gorman, 2015 Del. Ch. at *14, quoting CA.

¹⁰² Id. at *15 (“Valid bylaws focus on process”).

¹⁰³ Id. at *18.

¹⁰⁴ See also Walther, supra note ___ at 448 (arguing that CA’s “influence may be dwindling”).

limited.¹⁰⁵ One notable feature of the statute is that it contains a number of provisions expressly authorizing bylaws that address particular issues. Thus, for example, section 112 authorizes proxy expense reimbursement bylaws. Similar 113 authorizes proxy access bylaws. Section 141(d) allows shareholders to adopt a bylaw to classify the board of directors. Section 216 permits a bylaw to implement majority voting, and section 203(b)(3) authorizes the shareholders to adopt a bylaw opting out of the state antitakeover statute.

Although the statute does not contain any language indicating that the shareholders may only adopt bylaws addressing subjects expressly authorized by the statute, there are two possible reasons to read the list of explicit statutory authorizations as limiting the scope of shareholder power. First, if, as section 109 implies, shareholders can adopt bylaws containing “any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation . . .”,¹⁰⁶ the list of subject-specific authorizations is unnecessary.¹⁰⁷ Consequently, under a formalistic approach to statutory construction, the fact that the statute sets out a litany of subjects upon which a shareholder-adopted bylaw is permitted implies that, in the absence of statutory authorization, at least some types of shareholder-adopted bylaws are not allowed.¹⁰⁸

Second, the enabling provisions reinforce the idea that shareholder authority over corporate affairs is limited and that all residual authority is vested in the board of directors.¹⁰⁹ This perspective is consistent with the argument identified in the prior subpart that board power to manage the

¹⁰⁵ See also James Cox, *Corporate Law and the Limits of Private Ordering*, 93 Wash. U. L. Rev. 257, 291-292 (2015) (arguing that courts should “divert course from the deceptive nature of the nexus-of-contracts approach and return to the corporate statute to divine the relative rights of the board vis-a-vis the shareholders”).

¹⁰⁶ DGCL 109(b).

¹⁰⁷ Put differently, one could view a bylaw as inconsistent with the statute unless it deals with a subject upon which a bylaw is expressly permitted.

¹⁰⁸ See Hamermesh, *supra* note __, at 444 (“As a matter of formal statutory construction, then, it is preferable to read section 141(a) as an absolute preclusion against by-law limits on director management authority, in the absence of explicit statutory authority for such limits outside of section 109(b).”).

¹⁰⁹ The structure is similar to the federalist system imposed by the US Constitution in which Congress has limited authority and all residual power remains with the states. See generally John Yoo, *The Judicial Safeguards of Federalism*, 70 S. Cal. L. Rev. 1311, 1393 (1997) (explaining that “The Tenth Amendment states that ‘the powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.’”).

corporation is, pursuant to section 141(a) unlimited, but shareholders possess only those powers expressly conferred by the statute. It is also consistent with a statutory structure that confers specific and limited powers upon shareholders apart from their power to adopt bylaws. Thus the Delaware statute allows shareholders to vote on a limited set of issues -- the election of the board of directors, amendments to the certificate of incorporation and the approval of mergers and other structural changes.¹¹⁰

An additional concern with shareholder authority under section 109 is that, in virtually all corporations, it is non-exclusive. Although shareholders have the power to adopt and amend the bylaws, so does the board of directors. As a result, even if the shareholders adopt a bylaw, their action may be overturned by the board.¹¹¹

Although the Delaware statute contains provisions that explicitly protect a shareholder-adopted bylaw from board repeal, those provisions are applicable only to a few substantive issues, such as DGCL section 216, which provides that shareholder-adopted bylaw specifying the votes required for the election of directors “shall not be further amended or repealed by the board of directors.”¹¹² Absent language such as that found in section 216, it appears that the board of a Delaware corporation is free to amend or repeal a shareholder-adopted bylaw with which it disagrees.¹¹³

It is unclear under Delaware law whether shareholders can prevent the board from overturning a shareholder-adopted bylaw.¹¹⁴ Indeed, the

¹¹⁰ But see Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 18 *Harv. L. Rev.* 833 (2005) (arguing that the scope of subjects upon which shareholders can vote should be expanded).

¹¹¹ See Hamermesh, *supra* note ___, 73 *Tul. L. Rev.* at 415 (“Even if the stockholders could validly initiate and adopt a by-law limiting the authority of the directors, such a by-law amendment would accomplish little or nothing if the board of directors could simply repeal it after the stockholders adopted it.”).

¹¹² DGCL section 216.

¹¹³ Vice Chancellor Jacobs explicitly referenced the board’s power as a limitation on the contractual approach in *Kidsco Inc. v. Dinsmore*, 674 A.2d 483, 490 (Del. Ch. 1995). As VC Jacobs explained: “although the by-laws are a contract between the corporation and its stockholders, the contract was subject to the board's power to amend the by-laws unilaterally.”

¹¹⁴ See L. John Bird, *Comment: Stockholder and Corporate Board Bylaw Battles: Delaware Law and the Ability of a Corporate Board to Change or Overrule Stockholder Bylaw Amendments*, 11 *U. Pa. J. Bus. & Emp. L.* 217, 219 (2008) (observing that the Delaware statute places “no express limits on the application of such director amendment authority to stockholder-adopted by-laws.”). See also *In re Pennzoil Corp.*, 1993 SEC No-Act LEXIS 304 (Feb. 24, 1993) (approving on other grounds exclusion

Delaware Supreme Court stated in dictum that a shareholder-adopted bylaw that purported to be insulated from board override would be void, reasoning that the limitation was “in obvious conflict” with the directors’ “general authority to adopt or amend corporate by-laws.”¹¹⁵ Relatedly, a Delaware court explicitly upheld a board’s decision to repeal a critical bylaw despite the fact that the shareholders were about to vote to reject the bylaw’s repeal.¹¹⁶ The court reasoned that the shareholders had an appropriate remedy available in that they could call a special meeting, vote to reinstate the bylaw and then remove the offending directors.¹¹⁷

Delaware law differs in this regard from the Model Business Corporation Act.¹¹⁸ The Model Act explicitly authorizes shareholders to insulate any shareholder-adopted bylaw from board override, providing that “A corporation’s board of directors may amend or repeal the corporation’s bylaws, unless . . . the shareholders in amending, repealing or adopting a bylaw expressly provide that the board of directors may not amend, repeal, or reinstate that bylaw.”¹¹⁹ As one commentator notes, Delaware could amend its statute to take a similar approach.¹²⁰ Alternatively, Delaware could reinforce its director primary position by explicitly granting the board the power to amend any shareholder-adopted bylaw.¹²¹ Either approach would increase predictability over the current legal uncertainty.¹²²

On the other hand, a broadly construed board power to amend the bylaws might provide a solution to the question of shareholder authority

of a shareholder-proposed bylaw amendment that including language barring its repeal without shareholder approval).

¹¹⁵ Centaur Partners, IV v. National Intergroup, Inc., 582 A.2d 923, 929 (Del. 1990). But see American Int’l Rent-a-Car, Inc. v. Cross, 1984 Del. Ch. LEXIS 413 (Del. Ch. May 9, 1984) (suggesting in dictum that shareholders could amend the bylaws and remove the board’s power to amend the applicable provision further).

¹¹⁶ American Int’l Rent-A-Car, Inc. v. Cross, 1984 Del. Ch. LEXIS 413 (Del Ch. 1984).

¹¹⁷ Id.

¹¹⁸ Bird, supra note __.

¹¹⁹ - MODEL BUS. CORP. ACT § 10.20(b) (AM. BAR ASS’N 2010).

¹²⁰ Bird, supra note __ at 229 (observing that Delaware “could adopt the relevant provisions of the Model Business Corporation Act wholesale, giving shareholders the ability to adopt bylaws that cannot be further amended by the board when so stated within the bylaw”).

¹²¹ Id. (“the legislature could amend existing statutes to give the board explicit power to amend or revoke shareholder adopted bylaw amendments”).

¹²² Id. (noting that “the uncertainty created by the current statutory language and lack of precedent resolving this confusion is undesirable”).

raised in *AFSCME*. To the extent that a board retains the authority to repeal a shareholder-adopted bylaw that would infringe on the board's managerial authority or cause it to violate its fiduciary duties, arguably that power alone should save the bylaw from the infirmity identified in CA. At least at issuers in which the board has concurrent authority with the shareholders to amend the bylaws, its power to do so would seem to imply that a shareholder-adopted bylaw could not infringe on board authority under section 141 (a).

Then-Vice Chancellor Strine implicitly made this point in dictum in *General Datacomm Indus. v. Wisconsin Inv. Bd.*¹²³ In considering whether a shareholder-proposed bylaw that prevented the board from repricing options without shareholder approval was valid under Delaware law, VC Strine observed that the board could repeal the offending bylaw at any time if it determined that it was necessary to do so.¹²⁴ Accordingly, VC Strine concluded that the bylaw did not constrain board discretion in a way that would be analogous to a poison pill that could not be redeemed by a new board majority.¹²⁵

Boards can also block the shareholders' efforts to insulate a bylaw from board repeal by proactively adopting their own bylaw that does not preclude subsequent board amendment. Boards at a number of issuers have used this approach with respect to majority voting bylaws.¹²⁶ Currently, under the laws of many states, a shareholder-adopted majority voting bylaw is insulated from board repeal.¹²⁷ This restriction does not apply, however, to a board-adopted majority voting bylaw. As a result, boards can avoid the restriction on their power by adopting majority voting

¹²³ *General DataComm Indus. v. Wisconsin Inv. Bd.*, 731 A.2d 818 (Del. Ch. 1999).

¹²⁴ *Id.* at 821 (footnotes omitted) ("It may be that GDC is correct in stating that the Repricing Bylaw is obviously invalid under the teaching of *Quickturn*. But the question of whether a stockholder-approved bylaw that can potentially be repealed at any time by the GDC board of directors exercising its business judgment, see 8 Del. C. § 109, is clearly invalid under the teaching of a case involving a board-approved contractual rights plan precluding, by contract, a new board majority from redeeming the rights under the plan until six months after election seems to me to be a question worthy of careful consideration.").

¹²⁵ *Id.* (distinguishing the bylaw from the situation presented in *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281 (Del. Sup. 1998)).

¹²⁶ Mary Siegel, *The Holes in Majority Voting*, 2011 *Colum. Bus. L. Rev.* 364, 374.

¹²⁷ See, e.g., DGCL § 216 ("A bylaw amendment adopted by stockholders which specifies the votes that shall be necessary for the election of directors shall not be further amended or repealed by the board of directors.").

bylaws themselves.¹²⁸ As one commentator notes, “In so doing, directors doubly benefit: they not only gain approval from shareholders who support majority voting, but the directors have also assured themselves the opportunity to repeal, unilaterally, their own bylaw.”¹²⁹

A related issue is whether shareholders indeed have the power, as Chancellor Strine suggested in *Boilermakers*, to amend or repeal a board-adopted bylaw with which they disagree.¹³⁰ The issue is potentially problematic to the extent that, as suggested by *AFSCME*, the board’s bylaw authority is broader than that of the shareholders. If the board adopts a bylaw pursuant to its authority under section 141(a) that the shareholders could not have adopted on their own, it is not clear that the shareholders have the power to amend or repeal that bylaw. In other words, it is plausible that *AFSCME* sets analogous limits on both the shareholders’ power to adopt the bylaws and their power to amend or repeal board-adopted bylaws.¹³¹ Although the Delaware courts have not had occasion to address this question, as corporations increase their efforts at private ordering, and as shareholders become more willing to challenge board-adopted governance measures with which they disagree, the issue becomes more likely to arise.¹³²

Shareholders of course have other ways of responding to an issuer’s problematic governance provisions. One of the most powerful options is withholding voting support from director candidates who adopt

¹²⁸ Siegel, *supra* note __.

¹²⁹ *Id.* at 374.

¹³⁰ See *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*, 73 A.3d 934, 958 (Del. Ch. 2013) (observing that “stockholders retain the right to modify the corporation’s bylaws”). Notably, prior to the *Boilermakers* decision, shareholders at four issuers introduced non-binding proposals seeking to repeal a board-adopted forum selection bylaw. Claudia Allen, *Exclusive Forum Provisions: Putting on the Brakes*, Dec. 19, 2012, <http://tcbblogs.org/governance/2012/12/19/exclusive-forum-provisions-putting-on-the-brakes/>. Only two of those proposals went to a vote, and neither received the support of a majority of the shareholders. *Id.*

¹³¹ Cf. *Invacare Corp. v. Healthdyne Techs, Inc.*, 968 F. Supp. 1578 (N.D. Ga. 1997) (holding that, under Georgia corporate law, shareholders could not adopt bylaw to overturn “dead-hand” provision of poison pill because the law vested sole authority over the terms of a poison pill in the board of directors).

¹³² Relatedly, shareholders have actively sought to overturn corporate charter provisions establishing staggered boards, an endeavor aided by the Harvard Shareholder Rights Project. See Fisch, *supra* note __ (Brooklyn), at 1647 (describing Shareholder Rights Project).

or fail to repeal an objectionable governance provision.¹³³ The effectiveness of this approach has been enhanced by the role of the major proxy advisory firms, ISS and Glass Lewis.¹³⁴ The proxy advisory firms have highlighted both unilateral board actions that are viewed as reducing shareholder rights and board failures to respond to shareholder demands.¹³⁵ They have included these actions as critical factors influencing their recommendations with respect to director elections.¹³⁶ Shareholders take these recommendations very seriously.¹³⁷ For example, one commentator reports that, of the various reasons for ISS issuing a negative recommendation with respect to a director candidate, a “lack of ‘responsiveness’” is “clearly the most impactful.”¹³⁸

A recent example demonstrates the potential effectiveness of this approach. In 2013, ISS published a policy position indicating that it would recommend that shareholders withhold their votes from directors who had adopted a director compensation bylaw limiting a board candidate’s

¹³³ Stephen Choi, Jill E. Fisch and Marcel Kahan, Director Elections and the Role of Proxy Advisors, 82 S. Cal. L. Rev. 649 (2008-2009)(describing “withhold vote” campaigns by shareholders); Ertimur, Yonca and Ferri, Fabrizio and Oesch, David, Understanding Uncontested Director Elections (November 20, 2015). 27th Annual Conference on Financial Economics and Accounting Paper. Available at SSRN: <https://ssrn.com/abstract=2447920> (empirically analyzing factors driving shareholder withhold votes in uncontested elections).

¹³⁴ See Stephen J. Choi, Jill E. Fisch and Marcel Kahan, The Power of Proxy Advisors: Myth or Reality?, 59 Emory L.J. 868 (2010) (measuring the impact of a negative recommendation by a proxy advisor on voting outcomes).

¹³⁵ See e.g., Weil, Alert SEC Disclosure and Corporate Governance, Nov 12, 2014, avail. at http://www.weil.com/~media/files/pdfs/pcag_alert_nov2014.pdf (describing ISS and Glass Lewis policies, adopted in 2015, of generally issuing “issue negative vote recommendations against directors if the board amends the bylaws or charter without shareholder approval in a manner that materially diminishes shareholder rights or otherwise impedes shareholder ability to exercise their rights”). Ertimur, et al, supra note __ at 3 (reporting that of ISS board-level withhold recommendations, “72.2% are due to lack of responsiveness to shareholder proposals receiving a majority vote”).

¹³⁶ See Sullivan & Cromwell, 2015 Proxy Season Review July 20, 2015, at 19-21 (describing ISS’s practice of issuing withhold recommendations for unilateral board action and lack of responsiveness).

¹³⁷ Stephen J. Choi, Jill E. Fisch and Marcel Kahan, Who Calls the Shots? How Mutual Funds Vote on Director Elections, 3 Harv. Bus. L. Rev. 35 (2013).

¹³⁸ Sullivan & Cromwell, supra note __. at 21.

ability to receive compensation from a third party.¹³⁹ So-called golden leash bylaws were developed by the Wachtell law firm as a response to compensation arrangements between activist hedge funds and their director nominees.¹⁴⁰ Following ISS's announcement, directors at Provident Bank, the first issuer affected by the ISS position, received a withhold vote of 34% -- an extremely high level.¹⁴¹ Within the next six months, 28 of the 32 issuers that had adopted golden leash bylaws repealed them.¹⁴² Notably, the threat of shareholder voting pressure was sufficient to cause the issuers in question to repeal their bylaws without the need to litigation challenging the bylaws' validity.

The effectiveness of the shareholder vote on director elections has increased with the advent of majority voting. Under traditional plurality voting, it was not possible for shareholders to fail to elect a director candidate in an uncontested election. Under a majority voting rule, a director candidate must receive a majority of votes cast, and a large against or withhold vote can require the director to tender his or her resignation.¹⁴³ Thus, majority voting theoretically gives the shareholder vote on the election of director real teeth. In reality, however, even though a substantial percentage of issuers have adopted majority voting policies, the number of directors who fail to receive a majority vote is very small and, of those, even fewer wind up losing their jobs.¹⁴⁴

More importantly, although shareholders can use their voting power in director elections to apply pressure with respect to board-adopted governance provisions, the ability to apply pressure in response to unwanted board actions is not the equivalent of consenting to those

¹³⁹ CHRIS CERNICH ET AL., INSTITUTIONAL S'HOLDER SERVS. INC., WHEELING OUT THE PROCRUSTEAN BED: BYLAW RESTRICTIONS ON DISSIDENT NOMINEE COMPENSATION 1 (2013), http://www.thedeal.com/first_word/Wheeling_Out_the_Procrustean_Bed_-_Bylaw_Restrictions_on_Dissident_Nominee_Compensation-1.pdf.

¹⁴⁰ See Martin Lipton, *Bylaw Protection Against Dissident Director Conflict/Enrichment Schemes*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (May 10, 2013), <http://corpgov.law.harvard.edu/2013/05/10/bylaw-protection-against-dissident-director-conflictenrichment-schemes>. (proposing model golden leash bylaw).

¹⁴¹ Provident Fin. Holdings, Inc., Annual Meeting Results (Form 8-K) (Nov. 26, 2013).

¹⁴² Cain, et al., *supra* note __ at 675-76.

¹⁴³ See generally Choi et al., *supra* note __ (describing majority voting).

¹⁴⁴ *Id.* at 1122 (reporting that, between 2007 and 2013, only 8 directors failed to receive a majority of "for" votes at issuers with majority voting and that, of those, only 3 left the board following the election).

actions. The possibility that shareholders, if sufficiently mobilized, can pressure a board to amend or repeal an objectionable bylaw does not mean that shareholders have otherwise consented to the bylaw's adoption.

Finally, *Boilermakers* is a Delaware case and is premised on the fact that under Delaware law, shareholder authority to amend the bylaws cannot be eliminated.¹⁴⁵ Not every state corporation statute takes this approach, however. In some states, it is possible to structure a corporation so that directors have exclusive authority to amend the bylaws. In Texas, for example, a corporation may, through an appropriate provision in its charter, eliminate shareholder authority to amend the bylaws.¹⁴⁶ In Maryland, a corporation can grant the power to the board, the shareholders or both.¹⁴⁷ Indeed, following the *Fleming* decision, the Oklahoma legislature amended its corporation statute to provide that, as a default rule, only the board of directors has the power to amend or repeal the corporation's bylaws, although a corporation may voluntarily grant this power to the shareholders as well.¹⁴⁸ The Indiana statute is similar.¹⁴⁹

Even in states in which shareholders have the power to amend the bylaws, this power may be restricted by limitations on the types of governance provisions that can be adopted through a shareholder-adopted bylaw. For example, although Delaware authorizes shareholders to amend the bylaws to adopt majority voting,¹⁵⁰ as of 2011, only 19 states allowed shareholder-adopted majority voting bylaws without prior charter

¹⁴⁵ Other courts have relied on the *Boilermakers* decision to apply a contractual approach to governance issues involving Delaware corporations. See, e.g., *North v. McNamara*, 47 F. Supp. 3d 635, 642 (S.D. Ohio 2014) ("There is no question after *Boilermakers* that a forum-selection bylaw unilaterally adopted by a Delaware corporation's board of directors is facially valid under Delaware contract and corporate law"); *In re: CytRx Corp. Stockholder Derivative Litig.*, 2015 U.S. Dist. LEXIS 176966, *13 (C.D. Cal. Oct. 30, 2015) (same).

¹⁴⁶ 2 Texas Bus. Orgs. Code Sec. 21.057. Bylaws: "(c) A corporation's board of directors may amend or repeal bylaws or adopt new bylaws unless: (1) the corporation's certificate of formation or this code wholly or partly reserves the power exclusively to the corporation's shareholders...."

¹⁴⁷ Md. Corp. L. §2-109(b).

¹⁴⁸ 18 OKLA. STAT. tit. 18, § 1013 (2015).

¹⁴⁹ Indiana, IC 23-1-39-1 ("Unless the articles of incorporation or section 4 of this chapter provide otherwise, only a corporation's board of directors may amend or repeal the corporation's bylaws.").

¹⁵⁰ DGCL § 216.

authorization or board approval.¹⁵¹ In a corporation in which shareholders lack the authority to adopt, amend and repeal the bylaws, an essential predicate of Boilermakers' contractual approach is missing.

C. Practical limits to Shareholder Power

In addition to legal limits on shareholder power to act through the adoption and amendment of the bylaws, shareholders face practical limits on their power to implement changes to the bylaws. Indeed, as Chief Justice Strine has noted, the “practical realities of stock market ownership have changed in ways that deprive most stockholders of both their right to voice and their right of exit.”¹⁵² Strine and Walther have termed this a “separation of ownership from ownership.”¹⁵³

One such limit is the standard collective action problem.¹⁵⁴ An extensive literature observes that shareholders of U.S. public companies are dispersed, they face costs when they seek to act collectively, and shareholders, unlike directors, must typically bear those costs personally.¹⁵⁵ The rise of shareholder activism, and intermediaries such

¹⁵¹ Mary Siegel, *The Holes in Majority Voting*, 2011 COLUM. BUS. L. REV. 364, 371-72.

¹⁵² Leo E. Strine, Jr., & Nicholas Walter, *Conservative Collision Course?: The Tension Between Conservative Corporate Law Theory and Citizens United*, 100 Cornell L. Rev. 335, 370 (2015).

¹⁵³ *Id.* at 240, quoting Leo E. Strine, Jr., *Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance*, 33 J. Corp. L. 1, 6 (2007).

¹⁵⁴ See, e.g., Kelli A. Alces, *The Equity Trustee*, 42 Ariz. St. L.J. 717, 72325 (2010) (describing the shareholder collective action problem).

¹⁵⁵ See, e.g., Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. Rev. 601, 613 (2006) (“Collective action problems preclude the shareholders from exercising meaningful day-to-day or even year-to-year control over managerial decisions.”); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 Va. L. Rev. 247, 312 (1999) (“Shareholders still face collective action problems [making it] always extremely difficult, and often impossible, for shareholders to use their rights to vote on fundamental changes to oppose a transaction or policy the board favors.”); Stephen Choi & Jill E. Fisch, *How To Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 Yale L.J. 269, 271 (2003) (“shareholder collective action is rare, even though it may benefit shareholders as a group”).

as ISS have dramatically reduced these costs.¹⁵⁶ In addition, activist hedge funds have taken on a role as governance intermediaries and are able to identify governance failures and then mobilize traditionally passive institutional investors to respond to those failures.¹⁵⁷ Nonetheless, it is unlikely that governance issues are of sufficiently high value to attract the interest of hedge fund activists. Recent work supports the conclusion that hedge fund activism is focused largely on other areas such as sale, capital structure and corporate strategy.¹⁵⁸

In addition, supermajority voting requirements at specific issuers may limit shareholders' ability to amend or repeal a board-adopted bylaw.¹⁵⁹ Delaware law allows a corporation to require "a supermajority vote for adopting any subsequent bylaw amendment."¹⁶⁰ It is common for corporations to adopt supermajority voting requirements for some or all shareholder actions.¹⁶¹ Supermajority provisions are increasingly common in IPO charters; such provisions were present in 88% of IPO

¹⁵⁶ See Cain et al., *supra* note __ (discussing the role of governance intermediaries) and TAN *infra* (discussing proxy advisors).

¹⁵⁷ Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 *Colum. L. Rev.* 862, 897 (2013) (describing activists as "arbitraging governance rights that become more valuable through their activity monitoring companies to identify strategic opportunities and then presenting them to institutional investors for their approval").

¹⁵⁸ C.N.V. Krishnan, Frank Partnoy, & Randall Thomas, *The Second Wave of Hedge Fund Activism: The Importance of Reputation, Clout, and Expertise*, 40 *J. Corp. Fin.* 296 (2016).

¹⁵⁹ See, e.g., Klausner, *supra* note __, 65 *Stan L. Rev.* at 1348 ("charters commonly contain provisions that deter shareholders from amending bylaws—for instance, with supermajority vote requirements")

¹⁶⁰ Stephen M. Gill, Kai Haakon E. Liekefett & Leonard Wood, *Structural Defenses to Shareholder Activism*, *REV. SEC & COMMODITIES REG.*, June 18, 2014, at 151, 155. See DGCL 102(b)(4) (authorizing charter provision to require the vote "of a larger portion of the stock . . . than is required by this chapter"); 216 (authorizing corporations to specify the required vote for shareholder action and providing that, in the absence of a specific provision, the required threshold is "the majority of shares present in person or represented by proxy"). Other state statutes are similar. See, e.g., Scott Hirst, *Frozen Charters*, 34 *Yale J. on Reg.* __ (forthcoming 2017) ("All states permit a corporation to require a greater vote requirement by including a specific provision in their charter").

¹⁶¹ Scott Hirst, *Frozen Charters*, *supra* note __ at 42, n. 89 (reporting that, in author's sample of Russell 3000 companies, "41.9% [had] have supermajority provisions to amend one or more provisions of their bylaws.").

charters in 2015.¹⁶² Although the incidence of such requirements has declined in S&P 500 companies, approximately 30% retained a supermajority requirement in 2013.¹⁶³ Notably, if an issuer's charter contains a supermajority requirement, that requirement can only be repealed by that same supermajority.¹⁶⁴

Although shareholders can, in theory, obtain the necessary votes to adopt or amend a bylaw even in a corporation with a supermajority voting requirement, such a requirement heightens the collective action problem. As Scott Hirst has documented, voter turnout varies substantially among issuers.¹⁶⁵ Many issuers regularly experience turnout levels that are below the supermajority thresholds.¹⁶⁶ The problem of insufficient voter turnout has been exacerbated by the virtual elimination of broker discretionary voting.¹⁶⁷

¹⁶² Wilmer Hale, 2016 M&A Report at 5, https://www.wilmerhale.com/uploadedFiles/Shared_Content/Editorial/Publications/Documents/2016-WilmerHale-MA-Report.pdf. The reported data includes only Delaware corporations and includes those containing supermajority requirements “to approve mergers or change corporate charter and bylaws.” *Id.*

¹⁶³ Gill, *supra*. This number reflects a decline from 67.62% in 2003. *Id.* The number of issuers with supermajority requirements continues to decline, however, as shareholder proposals asking issuers to repeal supermajority requirements have been fairly common in recent years. See, e.g., Holly Gregory, Hot Topics for the 2016 Proxy Season, Practical Law, Oct. 2015, http://www.sidley.com/~media/publications/oct15_governancecounselor.pdf (identifying “Elimination or reduction of supermajority vote requirements” as one of the types of shareholder proposals receiving the highest average level of shareholder support in 2015 and observing that “Elimination of supermajority provisions to amend by-laws” as likely to “continue to be a focus of 2016 shareholder proposals”).

¹⁶⁴ 8 Del. C. § 242(b)(4) (“Whenever the certificate of incorporation shall require for action . . . by the holders of any class or series of shares or by the members, or by the holders of any other securities having voting power the vote of a greater number or proportion than is required by any section of this title, the provision of the certificate of incorporation requiring such greater vote shall not be altered, amended, or repealed except by such greater vote.”). See also Illumina Inc. No Action letter dated Mar. 18, 2016, <https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2016/mcritchieyoung031816-14a8.pdf> (upholding Illumina’s effort to exclude shareholder proposal seeking to repeal majority vote requirement on the basis that the proposal conflicted with the board’s proposal to retain the supermajority requirement).

¹⁶⁵ Hirst, *supra* note __.

¹⁶⁶ *Id.* at __ (documenting that, in 2013, 45% of issuers had a vote turnout of less than 80%).

¹⁶⁷ See Jill Fisch, Informed or Excluded? Advance Voting Instructions and Retail Investor Voting, working paper dated Dec. 2016, at 2 (describing amendments to

The impact of supermajority requirements is exacerbated by the standard vote-counting methodology.¹⁶⁸ According to a recent study, more than half of large public companies count abstentions with respect to shareholder proposals as “no” votes.¹⁶⁹ Because a shareholder-initiated bylaw amendment must necessarily take the form of a shareholder proposal, this methodology has the effect of allowing issuers to treat some shareholder proposals as failing even if they receive a majority of votes cast.¹⁷⁰ The study found 63 shareholder-sponsored proposals between 2004 and 2014 that were identified by issuers as failing but that would have passed under a so-called “simple majority” formula.¹⁷¹ A shareholder initiative has been filing resolutions seeking to have issuers shift to the simple majority approach that would eliminate abstentions from the vote count.¹⁷²

A final practical impediment to shareholder power is the SEC’s gatekeeping role. Shareholder resolutions seeking to amend the bylaws are typically, albeit not inevitably, presented to the issuer in the form of

NYSE and Nasdaq rules reducing the scope of issues on which brokers can exercise discretionary voting authority with respect to uninstructed shares).

¹⁶⁸ Notably, this methodology may not be consistent with the applicable statutes in all states. See, e.g., Abbott letter dated Dec. 18, 2015, at 3, <https://www.sec.gov/kennethsteinerabbot012916-14a8.pdf> (arguing that a simple majority approach was invalid under Ill. Bus. Corp. Act Section 7 .60 which provides that shareholder action requires the affirmative vote of a majority of the shares represented at the meeting and entitled to vote on a matter). The language of the Delaware statute is similar to that of the Illinois statute. See DGCL section 216(2) (“In all matters other than the election of directors, the affirmative vote of the majority of shares present in person or represented by proxy at the meeting and entitled to vote on the subject matter shall be the act of the stockholders”).

¹⁶⁹ See Investor Voice, Simple-Majority Standard for use in Corporate Proxies, 2015, avail. at http://www.investorvoice.net/wp-content/uploads/2015/03/Vote-Counting_Synopsis_Version-9e_2015.0315.pdf (describing simple majority formula);

¹⁷⁰ Bruce Herbert, Why Simple Majority Vote Counting Matters, Corporate Governance, 2015, <http://www.corpgov.net/2015/03/simple-majority-vote-counting-initiative-for-proxies/>

¹⁷¹ Investor Voice, *supra* note ____.

¹⁷² Gregory J. Millman, Why Shareholder Proposals Win More Votes, Lose Anyway, Wall St. J., Mar. 20, 2015, http://blogs.wsj.com/riskandcompliance/2015/03/20/why-shareholder-proposals-win-more-votes-lose-anyway/?mod=WSJ_hps_sections_riskcompliance To date these proposals have received limited shareholder support. See, e.g., Shirley Westcott, 2016 Proxy Season Review <https://corpgov.law.harvard.edu/2016/08/11/2016-proxy-season-review-2/> (stating that “the eight resolutions that came to a vote averaged only single-digit (7.9% support”).

Rule 14a-8 shareholder proposals.¹⁷³ It is commonplace for issuers to seek SEC approval to exclude from the proxy statement shareholder proposals that they do not support.¹⁷⁴ One basis for excluding a shareholder proposal is if that proposal, if implemented, would cause the issuer to violate state law.¹⁷⁵ This leaves the SEC staff in the awkward position of attempting to determine the scope of shareholder bylaw authority despite the fact that, as noted above, Delaware law is somewhat unclear on the issue.¹⁷⁶

Although Delaware amended its Constitution in 2007 to permit the SEC to certify questions regarding Delaware corporate law to the state Supreme Court,¹⁷⁷ a procedure used by the SEC in *AFSCME*,¹⁷⁸ the SEC is not required to make use of the certification procedure, and the Delaware Supreme Court is not required to accept a request for a ruling.¹⁷⁹ As a result, the SEC staff is repeatedly called upon to determine whether a shareholder-proposed bylaw is permissible with only the submissions of

¹⁷³ See Donna Nagy, *Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters: Current Problems and a Proposed Framework*, 83 *Cornell L. Rev.* 921 (1998). A shareholder may mount an independent proxy solicitation seeking to amend the bylaws but, given the costs of such a solicitation, shareholders are unlikely to do so outside the control context. Cf. *Airgas, Inc. v. Air Prods. & Chems., Inc.*, 8 A.3d 1182, 1187 (Del. 2010) (describing Air Product's proposal of three bylaw amendments in conjunction with proxy contest "[a]s part of its takeover strategy.").

¹⁷⁴ 17 C.F.R. § 240.14(a)-8(j) (designating required procedures for issuer seeking to exclude a shareholder proposal). See Alan Palmiter, *The Shareholder Proposal Rule: A Failed Experiment in Merit Regulation*, 45 *Ala. L. Rev.* 879 (1994) (explaining the no-action process).

¹⁷⁵ Rule 14a-8(i)(2).

¹⁷⁶ See John C. Coffee, Jr., *Bylaw Barricades: Unions and Shareholder Rights*, N.Y.L.J. Mar. 27, 1997, at 31 (observing that, in the Fleming case, "the district court read SEC Rule 14a-8 very differently than the SEC has read that rule on shareholder proposals in recent years and determined that a mandatory bylaw amendment was a proper subject under state law").

¹⁷⁷ See Article IV, Section 11(8) of the Delaware Constitution, 76 *Del. Laws* 2007, ch. 37 § 1, effective May 3, 2007.

¹⁷⁸ See CA, 953 A.2d 229, n. 1 (noting that the case was the first submitted by the SEC to the Court). See also Legal Opinion Letter of Richards, Layton & Finger to CA, Inc. (April 17, 2008), at 3 (arguing that proxy reimbursement proposal should be excluded under Rule 14a-8(i)(2)).

¹⁷⁹ See, e.g., Junis L. Baldon, *Taking a Backseat: How Delaware can alter the Role of the SEC in Evaluating Shareholder Proposals*, 4 *Entrepren. Bus. L.J.* 105, 125-126 (2009) (observing that "The opportunity still exists for the SEC to go astray and continue to issue pronouncement of state law with minimal state guidance").

the proponent and the issuer to guide it in making that determination.¹⁸⁰ Although a full analysis of the staff's approach to this question is beyond the scope of this Article,¹⁸¹ it is clear that the procedure has the practical effect of preventing many proposed bylaws from being presented to the shareholders.¹⁸²

III. Implications of the Disparity for the Contractual Model

The foregoing discussion demonstrates that the shareholder power to act through the adoption, amendment and repeal of the bylaws is, for a variety of reasons, less expansive than board power. As a result, the level of judicial deference reflected in *Boilermakers* and *ATP*, deference that is based on the analogy to contract principles, may be inappropriate. In particular, contract principles may not justify subjecting board-adopted governance provisions to limited oversight. If shareholders lack the power to block or overturn provisions with which they disagree, the courts should not presume that shareholders have consented to these provisions.

Two possible responses to this problem are possible. One response is to modify Delaware law to enhance shareholder power and have the effect of moving the operation of the corporation closer to the theoretical contract envisioned by the *Boilermakers* decision. Alternatively, it may be necessary for courts to play a greater role in policing board actions.

A. Invigorating the Corporate Contract

¹⁸⁰ An issuer seeking exclusion under this provision is required to submit a supporting opinion of counsel. Rule 14a-8(j)(2)(iii).

¹⁸¹ For a more detailed analysis and an argument that the SEC should adopt a policy of refusing to exclude shareholder proposals on the basis that they violate state law see Christopher Bruner, *Managing Corporate Federalism: The Least-Bad Approach to the Shareholder Bylaw Debate*, 36 *Del. J. Corp. L.* 1, 43 (2011).

¹⁸² See, e.g., *Scott's Liquid Gold-Inc.* (May 7, 2013) (allowing exclusion of a proposal on the basis that it impermissibly limited the board's authority by mandating specified disclosures); *Pfizer Inc.* (Feb. 22, 2012) (allowing exclusion of proposed dispute resolution bylaw); *Vail Resorts, Inc.* (Sep. 16, 2011) (approving exclusion of stockholder proposal to amend the by-laws to "make distributions to stockholders a higher priority than debt repayment or asset acquisition"); *Monsanto Co.* (Nov. 7, 2008, recon. denied, Dec. 18, 2008) (concurring with exclusion of stockholder proposal to amend the by-laws to require directors to take an oath of allegiance to the U.S. Constitution).

Chief Justice Strine is undoubtedly correct in observing that the courts have little reason to interfere with governance terms that are freely adopted by the corporation's participants. Private ordering is consistent with Delaware's enabling approach to corporate law as well as the widely-held expectation that market discipline will lead issuers to adopt governance terms that are value-enhancing.¹⁸³ Private ordering offers the opportunity to overcome informational issues that limit regulators' ability to identify optimal governance structures as well as individualized tailoring that enables firms to vary their governance structures to reflect firm-specific characteristics.¹⁸⁴ The problem with private ordering under Delaware corporate law is that the board's control over governance terms is far greater than that of the shareholders, and the board, acting alone, may fail, for a variety of reasons, to select optimal governance structures.¹⁸⁵

One remedy is to level the playing field. Delaware law could be modified to grant shareholders greater authority to engage in private ordering by reducing or eliminating the limitations on shareholder power to adopt and amend the bylaws described in this Article. This shift could be accomplished in various ways. One possibility is legislative action, either broadly to endorse shareholder power or to remove specific existing obstacles to the exercise of that power. For example, the Delaware legislature could reconcile the existing tension between sections 109 and 141(a) by providing that, notwithstanding 141(a), shareholders have the power to adopt any bylaw, substantive or procedural, relating to the business and affairs of the corporation.¹⁸⁶ Alternatively the legislature

¹⁸³ See, e.g., Barry Baysinger & Henry Butler, *Race for the Bottom v. Climb to the Top: The ALI Project and Uniformity in Corporate Law*, 10 J. CORP. L. 431, 446-449 (1985) (characterizing this position as that of the "corporate federalists").

¹⁸⁴ See Daniel Gallagher, *Commissioner Gallagher discusses Federal Preemption of State Corporate Governance*, CLS Blue Sky Blog, Apr. 7, 2014, <http://clsbluesky.law.columbia.edu/2014/04/07/commissioner-gallagher-discusses-federal-preemption-of-state-corporate-governance/> (describing Dodd-Frank Act's federalization of corporate governance as a "one-size-fits-none model"). See also David F. Larcker & Allan L. McCall, *Proxy Advisers Don't Help Shareholders*, Wall St. J, Dec 8 2013 (terming proxy advisor's one-size-fits-all governance practices "best guesses").

¹⁸⁵ See Michal Barzuza, *Do Heterogeneous Firms Select their Right "Size" of Corporate Governance Arrangements?* (working paper 2016) (arguing that agency problems interfere with firms' selection of efficient governance provisions).

¹⁸⁶ See *CA, Inc. v. AFSCME Emples. Pension Plan*, 953 A.2d 227, 234 (Del. 2008) (noting that the existing statutory language is "only marginally helpful in determining

could include a provision in the corporation statute analogous to those in the LLC and LP statutes that explicitly adopts a policy of giving maximum effect to freedom of contract. A more tailored approach might involve a provision explicitly providing that, notwithstanding any other provision of the statute, shareholders may amend or repeal a board-adopted bylaw by simple majority vote. Similarly, the statute could follow the ABA approach and preclude the board from amending or repealing a shareholder-adopted bylaw.

While legislative action would add useful clarity to the issue of shareholders' bylaw power, it is not necessary. The courts created the existing tension between sections 109 and 141(a), and they have the power to reread the statute to eliminate that tension. The Delaware courts are famous for their incremental and context-specific approach to corporate law, and for their sensitivity to market and institutional developments that warrant a reconsideration of their prior precedents.¹⁸⁷ Indeed, the courts' recent decisions have signaled a substantial shift in their approach to merger litigation.¹⁸⁸ Increasing investor activism including the growing use by institutional investors of shareholder proposals to introduce and support bylaw amendments relating to governance structures – as exemplified by the implementation of majority voting and proxy access – could warrant reconsideration of *AFSCME*'s narrow approach to shareholder bylaw power.

A variety of commentators have argued that Delaware law should afford shareholders broader power with respect to the adoption and modification of corporate governance bylaws, either as a check on management or based on the premise that such power is an inherent right of ownership. For example, Lucian Bebchuk proposed that shareholder have the authority to “initiate and adopt any rules-of-the-game decisions.”¹⁸⁹ Bebchuk would go so far as to enable shareholders to initiate

what the Delaware legislature intended to be the lawful scope of the shareholders' power to adopt, amend and repeal bylaws.”).

¹⁸⁷ See, e.g., Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. Cin. L. Rev. 1061, 1079 (2000) (noting the Delaware courts' willingness to reconsider their prior precedents rather than adhering to strong principles of *stare decisis*).

¹⁸⁸ See, e.g., *Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 304 (Del. 2015); *In re Trulia, Inc. Stockholder Litig.*, 129 A.3d 884 (Del. Ch. 2016).

¹⁸⁹ Lucian Ayre Bebchuk, *The Case for Increasing Shareholder Power*, 118 Harv. L. Rev. 833, 865 (2005), See also *id.* at 871 (proposing to “empower shareholders in public corporations by facilitating their ability to contract.”).

charter amendments and reincorporation decisions.¹⁹⁰ His view, consistent with the analysis in the preceding Part of this Article, is that existing law precludes shareholders from adopting value-increasing governance arrangements that management disfavors.¹⁹¹

Similarly Gordon Smith, Matthew Wright and Marcus Kai Hintze have broadly defended the value of private ordering and argued in favor of changes to the Delaware statute, case law and Rule 14a-8 that would, in their view make shareholder bylaw power “coextensive with board power.”¹⁹² Brett McDonnell observes that expansive shareholder bylaw power can be justified by the fact that the bylaws are the the main source for shareholder initiatives to shape corporate governance without board approval.¹⁹³ Accordingly, he proposes four statutory changes designed to increase shareholder power.¹⁹⁴

There are reasons to be cautious, however, about this response. As some scholars have noted, shareholder empowerment has its costs. One of the more powerful positions against shareholder empowerment is that of Bill Bratton and Michael Wachter, who argue that shareholder empowerment is likely to cause managers to manage to the market which is problematic for a number of reasons, including the incentive it creates for excessive risk-taking.¹⁹⁵ In addition, greater shareholder empowerment is in tension with the board-centric model of the corporation.¹⁹⁶ Stephen Bainbridge has challenged Bebchuk’s argument for greater shareholder power by identifying a variety of efficiency benefits that result from the separation of ownership and control.¹⁹⁷

¹⁹⁰ *Id.* at 913.

¹⁹¹ *Id.* at 845-46.

¹⁹² Smith et al., *supra* note __ at 181.

¹⁹³ Brett McDonnell, *Bylaw Reforms for Delaware’s Corporation Law*, 33 *Del. J. Corp. L.* 651, 656 (2008).

¹⁹⁴ *Id.* at 665. McDonnell’s suggestions include codifying the substance/procedure distinction, providing that shareholder-adopted bylaws may limit board discretion, explicitly authorizing shareholders to adopt bylaws dealing with poison pills, and providing that the board cannot amend a shareholder bylaw. *Id.*

¹⁹⁵ William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 *U. Pa. L. Rev.* 653, 660 (2010).

¹⁹⁶ Stephen Bainbridge is best known for arguing that shareholders’ interests are best served by empowering the board of directors as a strong central authority, a model he terms “Director Primacy.” Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 *Nw. U. L. Rev.* 547, 557-59 (2003)

¹⁹⁷ Stephen M. Bainbridge, *Response to Increasing Shareholder Power: Director Primacy and Shareholder Disempowerment*, 119 *Harv. L. Rev.* 1735, 1735 (2006).

Commentators also warn that shareholder empowerment creates a risk of self-dealing or interest group behavior because shareholders, unlike directors, do not owe fiduciary duties to the corporation and their fellow shareholders.¹⁹⁸ Finally, to the extent that contractual freedom is value-enhancing, business participants can obtain that freedom by selecting alternative business forms such as the LLC. By retaining the managerial approach in corporate law, Delaware thus offers businesses a range of structural options.

B. The Alternative – Increased Judicial Oversight

Because leveling the playing field with respect to corporate bylaws would reduce the imbalance between the board's role and that of the shareholders, those who favor director primacy or question the value of increased shareholder empowerment are likely to favor retaining the imbalance. The consequence of this approach, however, is that the imbalance undermines the justification for using contract principles to defer to private ordering provisions. Specifically, if Delaware law continues to limit shareholder bylaw authority in order to maintain director primacy, courts need to engage in greater judicial oversight of board-adopted governance terms.

Increased judicial oversight of board-adopted governance bylaws would not be unworkable. Indeed, existing case law offers a model that could readily be extended to the new governance – the analytical framework developed in the *Unocal* case.¹⁹⁹ In *Unocal*, the Delaware Supreme Court announced a new framework for judicial review of board-

Board primacy can also be justified for a number of pragmatic reasons. For example, as Jeff Gordon has observed, increased shareholder power may be misused due to the “risks of pathologies in shareholder voting and because of the chance that shareholders could use such initiative power to extract private gains.” Jeffrey N. Gordon, “Just Say Never?” *Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett*, 19 *Cardozo L. Rev.* 511, 546-47 (1997)

¹⁹⁸ See, e.g., Frederick H. Alexander & James D. Honaker, *Power to the Franchise or the Fiduciaries?: An Analysis of the Limits on Stockholder Activist Bylaws*, 33 *Del. J. Corp. L.* 749, 755 (2008). (“stockholders cannot use their statutory power to adopt bylaws to make management decisions: because stockholders do not owe fiduciary duties to the other stockholders”); Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 *UCLA L. Rev.* 561, 564 (2005) (“Shareholders ... may use any incremental power conferred upon them to pursue those interests to the detriment of shareholders as a class.”).

¹⁹⁹ *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985).

adopted antitakeover devices. The test involved a two-part inquiry. First, the “directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness.”²⁰⁰ Second, the board’s response must be “reasonable in relation to the threat posed.”²⁰¹

The same analysis can be applied to the board’s unilateral adoption²⁰² of a governance provision that materially diminishes shareholder rights.²⁰³ First, the court would consider whether the board reasonably believed that the provision was necessary to address a threat to the corporation. Second, the court would determine whether the provision was a reasonable response to that threat.

In evaluating the nature of the threat, the courts should consider the subject matter of the bylaw, keeping two principles in mind. First, in keeping with the rationale for director primacy, the courts should more readily accept actions designed to protect the board’s discretion with respect to decisions that are “is fundamental to its role in managing the company in the best interests of its shareholders and cannot, as a practical matter, be subject to direct shareholder oversight.”²⁰⁴ The case for shareholder authority is less compelling with respect to management’s basic business choices.²⁰⁵ Second, the courts should be mindful that the right of shareholders freely to elect the directors is a fundamental basis for the legitimacy of director primacy.²⁰⁶ Accordingly, bylaws that materially interfere with that election power require greater justification.

²⁰⁰ *Id.* at 955.

²⁰¹ *Id.* at 955. The Unocal court identified a third factor

²⁰² The approach advocated by this article applies specifically to unilateral board action. This Article does not take a position on whether this level of judicial oversight is necessary or appropriate for provisions that are subject to shareholder approval such as a charter amendment or shareholder-ratified bylaw.

²⁰³ This language is taken from the policy positions of the proxy advisory, ISS and Glass Lewis, that have adopted such a standard in deciding whether to recommend against the election of a director candidate. See Ellen Odoner & Lyuba Goltser, ISS and Glass Lewis Updated 2016 Voting Policies, Harv. L. Sch. For. On Corp. Gov. & Fin. Reg., Dec. 2, 2015, <https://corpgov.law.harvard.edu/2015/12/02/iss-and-glass-lewis-updated-2016-voting-policies/> (describing updates to ISS and Glass Lewis policies).

²⁰⁴ Amendments To Rules On Shareholder Proposals, Sec. Exch. Act Rel. No. 34-40018, 1998 SEC LEXIS 1001, (May 21, 1998) at *4.

²⁰⁵ *Trinity Wall St. v. Wal-Mart Stores, Inc.*, 792 F.3d 323, 348 (3d Cir. 2015)

²⁰⁶ See *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988) (“The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.”).

The application of this test can be illustrated with a few examples. The first is forum selection bylaws such as the bylaw at issue in the *Boilermakers* case. Boards adopted forum selection bylaws in response to the growth of shareholder litigation, particularly M&A litigation.²⁰⁷ Forum selection bylaws, in particular, sought to limit the need for a corporation to defend itself against lawsuits in multiple courts based on a single transaction.²⁰⁸

Because the vast majority of forum selection bylaws were adopted unilaterally and not subjected to a shareholder vote,²⁰⁹ the analysis proposed in this Article should apply. A board's adoption of a forum selection bylaw would be analyzed under a Unocal-type approach as follows. First, the increase in M&A litigation generally and multi-forum litigation in particular should qualify as a sufficient threat to corporate value. Commentators have noted the costs of defending against litigation in multiple forums as well as the risk of conflicting judgments and reverse auctions by plaintiffs' counsel.²¹⁰ In addition, managing litigation and litigation risk is a core managerial function of the board.²¹¹ Second, adoption of a forum selection bylaw is a reasonable response to the threat – it addresses the problems associated with multi-foum litigation without reducing shareholders' litigation rights.

²⁰⁷ See Matthew D. Cain & Steven Davidoff Solomon, *A Great Game: The Dynamics of State Competition and Litigation*, 100 Iowa L. Rev. 465 (2015) (detailing the rise in merger litigation); Fisch, *supra* note __ (Brooklyn) (describing litigation bylaws as a response to that rise).

²⁰⁸ Joseph Grundfest was one of the first to suggest this approach. See Joseph Grundfest, *Choice of Forum Provisions in Intra-Corporate Litigation: Mandatory and Elective Approaches* (2010) (unpublished manuscript), available at <http://ssrn.com/abstract=1690561>.

²⁰⁹ Roberta Romano & Sarath Sanga, *The Private Ordering Solution to Multiforum Shareholder Litigation* 27 (June 2015), avail. at <http://ssrn.com/abstract=2624951> (reporting that, in the sample studied, “Only 12 percent of midstream adoptions were put to a shareholder vote.”).

²¹⁰ See, e.g. MUKESH BAJAJ ET AL., U.S. CHAMBER INST. FOR LEGAL REFORM, *ECONOMIC CONSEQUENCES: THE REAL COSTS OF U.S. SECURITIES CLASS ACTION LITIGATION* 1, 3 (Feb. 2014), http://www.instituteforlegalreform.com/uploads/sites/1/EconomicConsequences_Web.pdf (describing the costs of shareholder suits).

²¹¹ See, e.g., Michael P. Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 *Bus. Law.* 503 (1989) (observing that “no principled distinction can be drawn between a board's decisions relating to corporate litigation generally and those relating to other business matters”).

Fee-shifting bylaws might be analyzed differently. Although the problem of excessive or frivolous litigation is closely related to the concern over multi-forum litigation, it is somewhat less clear that a board would have a reasonable basis for concluding that current levels of litigation are too high. Nonetheless, the frequency with which mergers are challenged through litigation coupled with the infrequency with which this litigation results in a monetary recovery for the plaintiff class has led many to conclude that a substantial percentage of lawsuits are without merit.²¹² A reviewing court should therefore conclude that the potential for excessive and frivolous litigation constitutes a threat.

Whether the *ATP* bylaw represents a reasonable response to that threat is, however, highly questionable. As critics have observed, the specific bylaw in *ATP* would likely discourage both good and bad lawsuits from being brought.²¹³ On the other hand, fee-shifting bylaws can be more narrowly tailored so that they discourage frivolous litigation while allowing meritorious suits to proceed.²¹⁴ More rigorous judicial scrutiny would thus bring a more nuanced approach to the validity of fee shifting bylaws than either the broad acceptance of the *ATP* decision or the Delaware legislature subsequent rejection of all charter and bylaw provisions that impose liability on a shareholder in connection with the litigation of an internal corporate claim.²¹⁵

²¹² See Jill E. Fisch, Sean J. Griffith & Steven Davidoff Solomon Confronting the Peppercorn Settlement in Merger Litigation: An Empirical Analysis and a Proposal for Reform, 93 Tex. L. Rev. 557, 559-560 (2015) (summarizing this debate); Delaware State Bar Council, Explanation of Council Legislative Proposal, 3 (2015)

<http://www.corporatedefensedisputes.com/files/2015/03/COUNCIL-SECOND-PROPOSAL-EXPLANATORY-PAPER-3-6-15-U0124513.pdf> (observing that “Some officers and directors and their advocates assert, on the other hand, that stockholder litigation causes corporations expense without producing commensurate benefits”).

²¹³ See.e.g., Sean J. Griffith, Correcting Corporate Benefit: How to Fix Shareholder Litigation by Shifting the Doctrine on Fees, 56 B.C. L. Rev. 1, 30 (2015) (terming such a bylaw “extreme”); Delaware State Bar Council, Explanation of Council Legislative Proposal, 3 (2015)

<http://www.corporatedefensedisputes.com/files/2015/03/COUNCIL-SECOND-PROPOSAL-EXPLANATORY-PAPER-3-6-15-U0124513.pdf> (arguing that fee-shifting bylaws like the one in *ATP* would make shareholder litigation “untenable” and “eliminate the only extant regulation of substantive corporate law.”)

²¹⁴ See.e.g, Albert Choi, Optimal Fee-Shifting Bylaws (working paper dated 2016) (developing a model for optimal fee-shifting bylaws).

²¹⁵ DEL. CODE ANN. tit. 8, § 115 (2016).

A final example is advance notice bylaws. Advance notice bylaws, which require shareholders to provide the issuer with advance notice of their intent to nominate a director candidate, and to disclose various information relating to that nomination, are almost ubiquitous among public issuers.²¹⁶ The Delaware courts have observed that “[a]dvance notice requirements are 'commonplace' and 'are often construed and frequently upheld as valid by Delaware courts.’”²¹⁷ The scope of advance notice bylaws varies tremendously, however, both with respect to the amount of advance notice required and the mandated disclosure.²¹⁸ The courts’ approach to advance notice bylaws has been characterized as “judicial schizophrenia.”²¹⁹ In particular, the effort to determine when the requirements of a specific bylaw excessively burden shareholders’ voting rights appears somewhat unprincipled.²²⁰

The test proposed in this Article would add clarity. Advance notice bylaws are generally defended by issuers as allowing shareholders sufficient time and information to vote intelligently.²²¹ A bylaw for which the notice period and required information appear reasonably related to these objectives should survive judicial scrutiny.²²² To the extent that an

²¹⁶ See fn __ supra.

²¹⁷ *Goggin v. Vermillion, Inc.*, No. 6465-VCN, 2011 WL 2347704, at *4 (Del. Ch. June 3, 2011) (quoting *Openwave Sys. Inc. v. Harbinger Capital Partners Master Fund I, Ltd.*, 924 A.2d 228, 238-39 (Del. Ch. 2007)).

²¹⁸ See, e.g., Elina Khasina, Note, Disclosure of “Beneficial Ownership” of Synthetic Positions in Takeover Campaigns, 2009 Colum. Bus. L. Rev. 904 (proposing that issuers adopt an advance notice bylaw that requires shareholders to disclose their ownership of derivative securities).

²¹⁹ Dale A. Oesterle & Alan R. Palmiter, Judicial Schizophrenia in Shareholder Voting Cases, 79 Iowa L. Rev. 485, 570 (1994).

²²⁰ See, e.g., Morgan N. Neuwirth, Shareholder Franchise – No Compromise: Why the Delaware Courts Must Proscribe All Managerial Interference with Corporate Voting, 145 U. Pa. L. Rev. 423, 467 (1996) (describing *Stroud v. Grace*, a case involving the validity of an advance notice bylaw, as “[o]ne of the more confusing cases in recent Delaware law”).

²²¹ See *Mentor Graphics Corp. v. Quickturn Design Sys.*, 728 A.2d 25, 39 (Del. Ch. 1998).

²²² See *id.* at 40-43 (concluding that the specific bylaw at issue was a reasonable response to the identified concerns); *In re Gaylord Container Corp. S’holders Litig.*, 753 A.2d 462 (Del. Ch. 2000). (stating that a 60 day advance notice bylaw “merely lengthens the electoral contest in a way that appears to strike a reasonable balance between the electorate’s need to hear out all participants in the debate and the acquiror’s need for an adequate opportunity to line up a slate before the meeting.”); but see *Chesapeake Corp. v. Shore*, 771 A.2d 293 (Del. Ch. 2000) (applying the

advance notice bylaw has the effect of precluding shareholders from exercising their voting rights, however, this test would provide the court with a basis for invalidating it as disproportionate.²²³

A similar analysis, applied to other board-adopted bylaws that limit the effectiveness of shareholders' voting rights, would clarify the scope of the board's authority.²²⁴ For example, in the recent *Frechter v. Zier* decision, the board adopted a bylaw requiring a two-thirds shareholder vote to remove a director.²²⁵ The court held that the bylaw was invalid because it conflicted with section 141(k).²²⁶ The decision is in tension, however, with section 216, which seems explicitly to authorize supermajority bylaws,²²⁷ as well as earlier cases that have not viewed such bylaws as invalid.²²⁸ Rather than relying on the statute, the court's analysis could have focused on the board's rationale for the bylaw and the extent to which a supermajority requirement, in the context of the specific corporation, materially limited shareholders' voting rights, recognizing that a supermajority requirement does not, by itself, prevent shareholders from achieving their desired outcome.

Finally, the rationale for greater judicial scrutiny of board-adopted bylaws that interfere with shareholder election power can be applied to the

"compelling justification" standard to strike down a board-adopted supermajority bylaw, where the board's "primary purpose" was to impair stockholders).

²²³ See, e.g., Fisch, *supra* note __, Brooklyn L. Rev. at 1655-56 (describing characterization of bylaws adopted by Allergan board as unduly restrictive of shareholder voting rights).

²²⁴ See, e.g., J.W. Verret, *Defending Against Shareholder Proxy Access: Delaware's Future Reviewing Company Defenses in the Era of Dodd-Frank*, 36 J. Corp. Law 391, 404-06 (2011) (discussing potential board adoption of director qualification bylaws or bylaws that limit the powers of dissident-nomianted directors).

²²⁵ *Frechter v. Zier*, C.A. No. 12038-VCG (Del. Ch. Jan. 24, 2017).

²²⁶ As the Court noted, section 141(k) is subject to two exceptions – for corporations that have classified boards and those that have cumulative voting. Neither exception was applicable in *Frechter*. The court further noted that its decision was limited to the validity of a supermajority bylaw, observing that section 102(b)(4) of the statute provides that a certificate of incorporation may require "for any corporate action . . . a larger portion of the stock . . . than is required by this chapter." 8 Del. C. § 102(b)(4).

²²⁷ See DGCL § 216 ("[s]ubject to this chapter in respect of the vote that shall be required for a specified action, the certificate of incorporation or bylaws of any corporation authorized to issue stock may specify . . . the votes that shall be necessary for, the transaction of any business . . .").

²²⁸ See, e.g., *Chesapeake Corp. v. Shore*, 771 A.2d 293 (Del. Ch. 2000) (rejecting board-adopted supermajority bylaw based on the board's purpose in adopting it)..

permissible scope of shareholder-adopted bylaws to produce a more principled analysis than that reflected in *AFSCME*. In light of the critical importance of shareholders' right to elect directors, courts should view shareholder power to adopt bylaws that focus on the election and structure of the board more expansively. The touchstone for the validity of such bylaws should be the subject matter – the election process – rather than whether the bylaws are properly characterized as substantive or procedural. Indeed, this approach appears to be consistent with legislative intent as reflected in the amendments subsequent to the *AFSCME* decision that explicitly authorized shareholders to adopt bylaws implementing proxy access. The same principle should be applied to similar bylaws, however, rather than requiring explicit statutory authorization for each.

Conclusion

The contractual approach to corporate law – which has been widely defended in legal scholarship for more than twenty-five years -- has received strong judicial support in two recent Delaware decisions.²²⁹ The courts' broad endorsement of freedom of contract in these cases opens the door to broad-based experimentation and implementation of new governance provisions tailored to issuer-specific needs. The Delaware courts have explicitly relied on contractual principles to justify broad deference to this experimentation.

At the same time, these decisions may stretch the contract analogy too far. In particular, several aspects of existing law limit the ability of shareholder to participate on an equal footing with boards in the private ordering process. This asymmetry undermines the justification for the broad judicial deference. In the absence of true shareholder power to limit the board's adoption of unwanted governance provisions, the characterization of new governance provisions in terms of contract is overstated.

One solution is for the courts or the legislature to overturn existing limits on shareholder power so as to warrant reliance on the contractual analogy. Although this approach may be desirable, increased shareholder empowerment raises a number of potential concerns. An alternative is for courts to rethink the existing level of deference and

²²⁹ *Boilermakers Local 154 Retir. Fund v. Chevron Corp.*, 73 A.3d 934 (Del. Ch. 2013); *ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554 (Del. 2014).

instead to exercise greater judicial scrutiny over board-adopted bylaws, recognizing the existing legal and practical limitations on shareholder power to constrain their adoption.

about ECGI

The European Corporate Governance Institute has been established to improve *corporate governance through fostering independent scientific research and related activities*.

The ECGI produces and disseminates high quality research while remaining close to the concerns and interests of corporate, financial and public policy makers. It draws on the expertise of scholars from numerous countries and bring together a critical mass of expertise and interest to bear on this important subject.

The views expressed in this working paper are those of the authors, not those of the ECGI or its members.

ECGI Working Paper Series in Law

Editorial Board

Editor	Luca Enriques, Allen & Overy Professor of Corporate Law, Faculty of Law, University of Oxford
Consulting Editors	John Coates, John F. Cogan, Jr. Professor of Law and Economics, Harvard Law School Paul Davies, Senior Research Fellow, Centre for Commercial Law, Harris Manchester College, University of Oxford Horst Eidenmüller, Freshfields Professor of Commercial Law, University of Oxford Amir Licht, Professor of Law, Radzyner Law School, Interdisciplinary Center Herzliya Roberta Romano, Sterling Professor of Law and Director, Yale Law School Center for the Study of Corporate Law, Yale Law School
Editorial Assistants :	Tamas Barko, University of Mannheim Ulrich Keesen, University of Mannheim Mengqiao Du, University of Mannheim

Electronic Access to the Working Paper Series

The full set of ECGI working papers can be accessed through the Institute's Web-site (www.ecgi.org/wp) or SSRN:

Finance Paper Series	http://www.ssrn.com/link/ECGI-Finance.html
-----------------------------	---

Law Paper Series	http://www.ssrn.com/link/ECGI-Law.html
-------------------------	---