Stealth Governance: Shareholder Agreements and Private Ordering

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Abstract

Corporate law has embraced private ordering -- tailoring a firm's corporate governance to meet its individual needs. Firms are increasingly adopting firm-specific governance through dual-class voting structures, forum selection provisions and tailored limitations on the duty of loyalty. Courts have accepted these provisions as consistent with the contractual theory of the firm, and statutes, in many cases, explicitly endorse their use. Commentators too support private ordering for its capacity to facilitate innovation and enhance efficiency. Private ordering typically occurs through firm-specific charter and bylaw provisions. VC-funded startups, however, frequently use an alternative tool – shareholder agreements. These agreements, which have largely escaped both judicial and academic scrutiny, highlight the extent to which rights and responsibilities in the corporation should be the subject of private contract. This Article offers the first broad-based analysis of shareholder agreements, detailing the scope of issues to which they are addressed and identifying the challenges that they pose for corporate governance. Focusing on the use of shareholder agreements by VC-funded startups, the Article recognizes the broad role played by shareholder agreements in structuring and coordinating investors' economic rights, but it argues that using shareholder agreements for corporate governance, what this Article terms "stealth governance," sacrifices critical corporate law values. These concerns are particularly problematic for the growing number of unicorns that have substantial economic impact but whose governance structures are shielded from the transparency and price discipline of the public capital markets. This Article argues that stealth governance is inappropriate for corporations and instead advocates a uniform structural approach to corporate law that would limit private ordering to the charter and bylaws. It further critiques the use of shareholder agreements to evade statutory limits on charter and bylaw provisions, arguing that, to the extent existing limits are undesirable, they should be the subject of legislative reform. A prior draft of this Article was posted with the working title of "Private Ordering and the Role of Shareholder Agreements."

Keywords: Corporations, private ordering, corporate governance, shareholder agreements, mandatory corporate law, contractual corporate law, theory of the firm, start-up governance, venture capital

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STEALTH GOVERNANCE: SHAREHOLDER AGREEMENTS AND PRIVATE ORDERING

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ABSTRACT

Corporate law has embraced private ordering—tailoring a firm's corporate governance to meet its individual needs. Firms are increasingly adopting firm-specific governance through dual-class voting structures, forum selection provisions, and tailored limitations on the duty of loyalty. Courts have accepted these provisions as consistent with the contractual theory of the firm, and statutes, in many cases, explicitly endorse their use. Commentators too support private ordering for its capacity to facilitate innovation and enhance efficiency.

Private ordering typically occurs through firm-specific charter and bylaw provisions. VC-funded startups, however, frequently use an alternative tool—shareholder agreements. These agreements, which have largely escaped both judicial and academic scrutiny, highlight the extent to which rights and responsibilities in the corporation should be the subject of private contract.

This Article offers the first broad-based analysis of shareholder agreements, detailing the scope of issues to which they are addressed and identifying the challenges that they pose for corporate governance. Focusing on the use of shareholder agreements by VC-funded startups, the Article recognizes the broad role played by shareholder agreements in structuring and coordinating investors' economic rights, but it argues that using shareholder agreements for corporate governance, what this Article terms "stealth governance," sacrifices critical corporate law values including standardization, transparency, and accountability. These concerns are particularly problematic for the growing number of unicorns that have substantial economic impact but whose governance structures are

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This Article argues that stealth governance is inappropriate for corporations and instead advocates a uniform structural approach to corporate law that would limit private ordering to the charter and bylaws. It further critiques the use of shareholder agreements to evade statutory limits on charter and bylaw provisions, arguing that, to the extent existing limits are undesirable, they should be the subject of legislative reform.

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INTRODUCTION

Startups[1] are used to breaking things.[2] Among the things they break are traditional corporate governance norms. Dual class stock is one high-profile example. Google went public in 2004 with dual-class stock,[3] shattering the norm of one share/one vote, and a host of other startups followed its example.[4] Snap went public in 2017 and broke the norm that publicly traded shares possess at least some voting rights.[5]

The tools used by startups to engage in private ordering offer a less visible example.[6] The allocation of rights and power in the corporation is subject to a variety of statutory default rules, but corporations can and do modify those rules through firm-specific charter and bylaw provisions. This

1. This Article uses the term startup to describe the growing category of innovative venture-funded companies that defy the traditional categories of public and private companies. For a more detailed definition and an explanation of why startups warrant distinctive treatment from a governance perspective, see Elizabeth Pollman, *Startup Governance*, 168 U. PA. L. REV. 155, 163–64 (2019).

2. *See* THE QUANTIFIED VC, *Move Fast and Break Things is Not Dead*, MEDIUM (Sept. 14, 2018), https://medium.com/swlh/move-fast-and-break-things-is-not-dead-8260b0718d90 ("'Moving fast and breaking things' is at the heart of the startup philosophy of being scrappy.").

3. Google Inc., Prospectus, at 1 (Aug. 18, 2004), https://www.sec.gov/Archives/edgar/data/1288776/000119312504143377/d424b4.htm.

4. *See* Jill E. Fisch & Steven Davidoff Solomon, *The Problem of Sunsets*, 99 B.U. L. REV. 1057, 1067 (2019) ("Google opened the floodgates, and thereafter, dual class stock has become a norm for technology companies.").

5. *See* Ken Bertsch, Council of Institutional Invs., *Snap and the Rise of No-Vote Common Shares*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (May 26, 2017), https://corpgov.law.harvard.edu/2017/05/26/snap-and-the-rise-of-no-vote-common-shares/ [https://perma.cc/P6Q4-QKTJ] ("With NYSE-listed Snap's arrival with 'zero' rights for public shareholders, perhaps the bottom has been reached.").

6. *See* Jill E. Fisch, *The New Governance and the Challenge of Litigation Bylaws*, 81 BROOK. L. REV. 1637, 1638 (2016) (defining private ordering as "the adoption of issuer-specific rules that are contractual in nature (as opposed to statutes, agency rules, or decisional law)").

tailoring is known as private ordering, and common examples include forum selection provisions, proxy access bylaws, and indemnification provisions.[7] Where startups depart from this governance norm is their use of shareholder agreements rather than the charter and bylaws as a governance tool.[8] Although startups widely use investor contracts to navigate financing issues, adopting structures designed to control risk and mitigate moral hazard,[9] the scope of these contracts has expanded to governance issues such as inspection rights, appraisal rights, and fiduciary duties, as well as the allocation of control and the composition of the board of directors. The use of shareholder agreements—rather than charter and bylaw provisions—as governance tools raises a variety of issues but has largely escaped attention.[10]

This Article addresses that oversight and argues that the use of shareholder agreements as governance tools, what this Article terms "stealth governance," is troubling. Using shareholder agreements for corporate governance instead of the charter and bylaws sacrifices important corporate law values including transparency, predictability, and standardization. Shareholder agreements facilitate unequal treatment of shareholders and pose a particular risk when they are used to limit the rights of minority shareholders in private companies.

Perhaps most problematically, corporations appear to be using shareholder agreements, at least in part, to avoid mandatory elements of corporate law that would constrain analogous charter or bylaw provisions.

7. Private ordering is not limited to startups. Corporate law affords firms extensive flexibility to modify statutory default rules with respect to the structure of the corporation, the rights of shareholders, and the scope of director liability. *See generally* Jill E. Fisch, *Governance by Contract: The Implications for Corporate Bylaws*, 106 CALIF. L. REV. 373, 379 (2018) (describing the scope of private ordering permitted by corporate law); Megan Wischmeier Shaner, *Interpreting Organizational "Contracts" and the Private Ordering of Public Company Governance*, 60 WM. & MARY L. REV. 985, 988 (2019) ("With increasing frequency and creativity, the certificate of incorporation and bylaws of public corporations are being used as tools for restructuring key aspects of corporate governance.").

8. The term "shareholder agreement" encompasses several types of contracts by and among shareholders including voting agreements, stock purchase agreements, and investors' rights agreements. *See* NVCA, *Model Legal Documents* (Sept. 2, 2021), https://nvca.org/model-legal-documents/ [https://perma.cc/VDZ2-4EHW]. This Article will refer to these documents collectively as shareholder agreements.

9. *See, e.g.*, Susheng Wang & Hailan Zhou, *Staged Financing in Venture Capital: Moral Hazard and Risks*, 10 J. CORP. FIN. 131 (2004) (modeling how staged financing can control agency problems); Manuel A. Utset, *High-Powered (Mis)Incentives and Venture-Capital Contracts*, 7 OHIO ST. ENTREPRENEURIAL BUS. L.J. 45 (2012) (exploring how venture capital financing contracts address entrepreneurial opportunism).

10. As of the date of this Article, only one other article has broadly considered the role of shareholder agreements in corporate governance. *See* Gabriel Rauterberg, *The Separation of Voting and Control: The Role of Contract in Corporate Governance*, 38 YALE J. REGUL. 1124 (2021) (analyzing the use of shareholder agreements to allocate control rights contractually).

Two recent decisions are illustrative. In *Manti Holdings LLC v. Authentix Acquisition Co*.,[11] the Delaware Supreme Court upheld a provision in a shareholder agreement waiving the appraisal rights of common stockholders. And in *Juul Labs, Inc. v. Grove*, the Delaware chancery court considered but did not resolve the validity of a provision purporting to waive shareholders' statutory inspection rights.[12] Notably, despite questions about their validity,[13] the use of both provisions appears to be common.[14]

These concerns are heightened by the context in which shareholder agreements are used—venture-backed startup companies for which problematic governance practices are already a growing concern.[15] Because shareholder agreements are largely, albeit not exclusively, a private company phenomenon,[16] their legal analysis has drawn from principles of contract law rather than corporate law, an approach that is consistent with the nature of the traditional close corporation but that makes little sense for today's technology startups. In addition, their use creates an anomalous

11. Manti Holdings, LLC v. Authentix Acquisition Co., C.A. No. 354, 2020, 2021 Del. LEXIS 286 (Del. Sept. 13, 2021).

12. Juul Labs, Inc. v. Grove, 238 A.3d 904, 919 (Del. Ch. 2020).

13. *See id.* at 919–20 (summarizing arguments for and against the validity of inspection rights waivers).

14. Both appraisal waivers and inspection rights waivers are part of the most recent versions of the National Venture Capital Association's model documents. *See* NVCA, *Voting Agreement* (updated July 2020), at 7, https://nvca.org/recommends/nvca-2020-voting-agreement-2/ (last visited Oct. 2, 2021) (including waiver of appraisal rights and the right to bring fiduciary duty litigation); NVCA, *Investors' Rights Agreement* (updated Sept. 2020), at 24–25, https://nvca.org/recommends/nvca-2020-investors-rights-agreement-2/ (last visited Oct. 2, 2021) (waiver of statutory inspection rights). For an explanation of the model documents and the process by which they are developed, see Dror Futter, N*VCA Updates Its Series A Model Legal Documents*, VC EXPERTS: BLOG (Sept. 18, 2018), https://blog.vcexperts.com/2018/09/18/nvca-updates-its-series-a-model-legal-documents/ [https://perma.cc/LC26-YZPC]. *See also* Roy Shapira, *Corporate Law, Retooled: How Books and Records Revamped Judicial Oversight*, 42 CARDOZO L. REV. 101, 151 (2021) (describing efforts by startup companies to limit employee use of inspection rights through shareholder agreements); Anat Alon-Beck, Bargaining Inequality: Employee Golden Handcuffs and Asymmetric Information (June 6, 2021) (unpublished manuscript), https://www.lawfin.uni-frankfurt.de/fileadmin/user_upload/ABeck_Bargaining_Inequality_-_6.6.2021_.pdf (reporting that startup companies increasingly require employees to waive inspection rights in order to receive stock options).

15. *See, e.g.*, Renee M. Jones, *The Unicorn Governance Trap*, 166 U. PA. L. REV. ONLINE 165, 167–168 (2017) (observing that "in the absence of an impending IPO, Unicorn managers and investors lack sufficient incentives to develop governance structures and practices appropriate for enterprises of their scale"); Amy Deen Westbrook, *What to Do About Poor Corporate Governance at Unicorns*, CLS BLUE SKY BLOG (Jan. 18, 2021), https://clsbluesky.law.columbia.edu/2021/01/18/what-to-do-about-poor-corporate-governance-at-unicorns/ [https://perma.cc/H5RK-YFA4] ("Uber, Theranos, Zenefits, and a host of other companies struggled with bad governance while unicorns.").

16. *See* Rauterberg, *supra* note 10 (detailing frequency with which shareholder agreements continue in effect after an issuer's initial public offering).

dichotomy in the scope of corporate law in an era in which the line between public and private corporations has become increasingly blurred.[17]

This Article argues that contract based private ordering is inappropriate for corporations and instead advocates a uniform structural approach to corporate law. Corporate law provides a set of substantive and procedural rules that define the corporation and govern the rights and powers of its constituencies. The use of the corporate form signals the application of these rules both to corporate participants such as officers, directors, and shareholders and to third parties that deal with the corporation. These rules provide predictability with respect to the corporation's operations, enhance the accuracy of investment pricing, and facilitate the use of contracts.

Within these rules, a corporation's charter and bylaws are key. Together they form the corporation's governing documents; they set out the rights and responsibilities of officers, directors, and shareholders. Corporate law incorporates the concept of implicit consent—the terms of the governing documents are binding on all corporate participants, regardless of their individual sophistication, knowledge, and consent. Corporate law provides the procedures by which these documents may be altered and the features they can contain. Moving from the implicit contract of corporate law to the explicit contract of common law sacrifices fundamental values of the corporate form.

As a result, the Article argues that corporations should engage in private ordering exclusively through their charter and bylaws, and that courts should invalidate shareholder agreements that attempt to substitute for the corporation's constitutive documents.[18] Critically, it maintains that shareholder agreements should not be used to restructure the scope of officer, director, and controlling shareholder accountability. In addition, the Article argues that shareholder agreements should be subject to the traditional hierarchy of governance tools, meaning that a shareholder

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17. *See* Donald C. Langevoort & Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation After the JOBS Act*, 101 GEO. L.J. 337, 384 (2013) (explaining that the "boundary issues along the public-private divide are under theorized and, up until recently, left to resolution by reference to regulatory legacies from a time far different from today's trading markets").

18. This Article focuses specifically on the use of shareholder agreements to address corporate governance issues such as inspection rights, appraisal rights, control rights, and the selection and removal of directors. It is not addressed to issues such as the number and price of shares being sold and the future capital commitments by investors. *See, e.g.*, NVCA, *Stock Purchase Agreement* (updated Sept. 2020), at 1, https://nvca.org/recommends/nvca-2020-stock-purchase-agreement-2/ (last visited Oct. 2, 2021) (indicating that the model agreement does not include characteristics of the shares sold or the rights of the parties post-closing in recognition of the fact that these issues are typically addressed in the charter and may implicate the rights of third parties).

agreement that is inconsistent with the statute, charter, or bylaws should not be enforceable.[19]

This approach would have the effect of limiting certain innovations in private ordering—specifically it would invalidate corporate efforts to impose waivers of appraisal rights, inspection rights, and fiduciary duties, as well as certain allocations of shareholder control, through shareholder agreements. The Article argues that the case for the permissible scope of private ordering is context specific and should not depend on whether the instrument used is a shareholder agreement or a charter provision but on the policy implications of allowing firm-specific variation with respect to a particular legal rule or shareholder right. To the extent that private ordering is normatively desirable, the appropriate solution is explicit legislation authorizing variation in the charter or bylaws, an approach that the Delaware legislature has consistently taken in response to evolving business needs.[20]

The Article proceeds as follows. Part I explains the role of private ordering in corporate governance and identifies the limits corporate law imposes on such private ordering through mandatory rules. Part II describes stealth governance—the development of shareholder agreements as a governance tool. Part III identifies concerns over the use of shareholder agreements for private ordering as an alternative to charter and bylaw provisions. Part IV concludes that, based on these concerns, private ordering should take place through the charter and bylaws and existing limitations on the availability of such tools should be the subject of legislative reform.

I. PRIVATE ORDERING AND CORPORATE GOVERNANCE

A. The Role of Private Ordering

Private ordering—tailoring a corporation's structure and governance mechanisms to meet firm-specific needs—is an important feature of corporate law. New IPO companies like Facebook and Snap use dual or multiclass voting structures to protect a founder's ability to pursue his or her idiosyncratic vision while enabling public shareholders to share in the

19. *See, e.g.*, Andrew K. Jennings, *Firm Value and Intracorporate Arbitration*, 38 REV. LITIG. 1, 11 (2018) (explaining that corporations are governed by a hierarchy of public and private law headed by "the substantive corporate law of the firm's chartering jurisdiction, followed by the firm's charter and then its bylaws").

20. For an assessment of the policy considerations relevant to whether the legislature should explicitly authorize private ordering with respect to shareholder appraisal rights, see Jill E. Fisch, *A Lesson from Startups: Contracting Out of Shareholder Appraisal*, IOWA L. REV. (forthcoming 2022).

economic growth of the firm.[21] VC-funded firms like Trados implement negotiated board structures that balance control rights and veto power among shareholders with different incentives and skill sets.[22] A growing number of corporations are adopting provisions to increase board accountability to shareholders such as majority voting[23] and proxy access.[24]

The standard tools by which corporations engage in private ordering are the certificate of incorporation or charter and the bylaws.[25] State corporation statutes allow corporations to tailor their charter and bylaws to meet their individual needs. Most statutory provisions are structured as default rules that explicitly authorize individual corporations to modify the statutory default through a charter provision, a bylaw, or, in some cases, a board resolution. For example, section 141 of the Delaware statute provides that, as a default rule, corporations shall elect the board of directors on an annual basis.[26] The statute explicitly authorizes corporations to depart from this default and to adopt a staggered board.[27] The statute further instructs corporations that, if they choose to modify the statutory default and engage in private ordering, they must do so "by the certificate of incorporation or by an initial bylaw, or by a bylaw adopted by a vote of the stockholders."[28] As section 141 illustrates, in many cases, the statutory text explicitly contemplates private ordering. The scope of private ordering is not, however, limited to topics for which there is specific statutory authorization. State statutes afford corporate participants broad authority to use the charter and bylaws to adopt firm-specific governance terms. For example, section

21. *See, e.g.*, Dave Michaels, *Facebook, Snap and Other Firms Targeted by SEC Regulator's Attack on Dual-Class Shares*, WALL ST. J. (Feb. 15, 2018, 4:30 PM), https://www.wsj.com/articles/facebook-to-viacom-targeted-by-sec-regulators-attack-on-dual-class-shares-1518730229 [https://perma.cc/7ELK-Y74C] (describing Facebook and Snap as using multiclass voting structures to preserve founder control).

22. *See In re* Trados Inc. S'holder Litig., C.A. No. 1512-CC, 2009 Del. Ch. LEXIS 128, at *3 (Del. Ch. July 24, 2009) (describing composition of Trados board of directors which included four representatives of venture capital firms, two Trados executives and one outside director).

23. *See* Stephen J. Choi, Jill E. Fisch, Marcel Kahan & Edward B. Rock, *Does Majority Voting Improve Board Accountability?*, 83 U. CHI. L. REV. 1119, 1144 (2016) (empirically analyzing adoption of majority voting at S&P 1500 companies).

24. *See, e.g.*, Holly J. Gregory, Rebecca Grapsas & Claire Holland, *The Latest on Proxy Access*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 1, 2019), https://corpgov.law.harvard.edu/2019/02/01/the-latest-on-proxy-access/ [https://perma.cc/MU3H-9Y6J] (reporting that 71% of S&P 500 companies had adopted a proxy access bylaw by the end of 2018, up from 1% in 2014).

25. *See, e.g.*, Shaner, *supra* note 7, at 988 ("With increasing frequency and creativity, the certificate of incorporation and bylaws of public corporations are being used as tools for restructuring key aspects of corporate governance.").

26. DEL. CODE ANN. tit. 8, § 141(d) (2021).

27. *Id.*

28. *Id.*

102(b)(1) of the Delaware statute allows the charter to contain "[a]ny provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders, or any class of the stockholders, . . . if such provisions are not contrary to the laws of this State."[29] Section 109(b) provides that the bylaws may address any subject, "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."[30]

The courts have upheld the power of corporations to address a variety of novel issues through bylaw and charter provisions. For example, in *Boilermakers*, the Delaware Supreme Court upheld the validity of forum-selection bylaws.[31] In *ATP*, the court found fee-shifting bylaws to be facially valid.[32] Most recently, in *Salzberg*, the Delaware Supreme Court made national headlines[33] when it upheld a charter provision requiring certain federal securities claims to be filed in federal court.[34]

The rationale for these decisions is the contractual theory of the corporation.[35] As then-Chancellor 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 [Delaware General Corporation Law]."[36] Strine's reasoning in *Boilermakers* explains the rationale behind the contractual approach. As Strine explained, shareholders implicitly consent to the terms of the charter and bylaws when they make the voluntary decision to invest in a corporation.[37] Moreover, shareholders have the power

29. § 102(b)(1). *See* Salzberg v. Sciabacucchi, 227 A.3d 102, 115 (Del. 2020) (describing section 102(b)(1)'s scope as "broadly enabling").

30. § 109(b).

31. Boilermakers Local 154 Ret. Fund v. Chevron Corp., 73 A.3d 934, 939 (Del. Ch. 2013).

32. ATP Tour, Inc. v. Deutscher Tennis Bund, 91 A.3d 554 (Del. 2014). Subsequently, the legislature amended the statute to prohibit fee-shifting charter and bylaw provisions.

33. Alison Frankel, *Dela. Supreme Court: Companies Can Pick Forum for Shareholders' Section 11 Claims*, REUTERS (Mar. 18, 2020, 6:08 PM), https://www.reuters.com/article/legal-us-otc-blueapron/dela-supreme-court-companies-can-pick-forum-for-shareholders-section-11-claims-idUSKBN21540M [https://perma.cc/Q28D-N6U3].

34. *Salzberg*, 227 A.3d. at 137.

35. *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").

36. *Boilermakers*, 73 A.3d at 939. The Delaware legislature validated the former when, in 2015, it adopted legislation expressly authorizing issuers to adopt forum selection provisions in their charters and bylaws. 8 DEL. CODE ANN. tit. 8, § 115 (2015).

37. *Boilermakers*, 73 A.3d at 939. Strine further observed that shareholders also consent to the possibility that the board will unilaterally amend the bylaws when they invest in a corporation in which the board has been given the authority to do so. *Id.* at 958.

to modify contract terms with which they disagree, either by amending the bylaws or removing and replacing the directors.[38] In addition to providing a justification for upholding charter and bylaw provisions that adopt firm-specific governance terms, the contractual approach also offers a methodology for interpreting those provisions—they are to be interpreted using contract principles.[39]

The contractual approach supports broad flexibility in firm-specific private ordering. Commentators defend this approach on variety of efficiency grounds.[40] Private ordering allows efficient customization in corporate structures by enabling rules to vary with firm-specific differences.[41] It allows innovation and experimentation and reduces the risk of regulatory error associated with mandatory regulation.[42] A firm's governance choices are also constrained by market discipline.[43]

Not only do firms engage in extensive private ordering, they continue to innovate by adopting new governance provisions. One example is forum selection bylaws, which corporations have adopted in an effort to reduce the incidence of multi-forum litigation.[44] Many corporations have increased shareholder power over the process of electing directors through the

38. *Id.* at 956–57.

39. *See* BlackRock Credit Allocation Income Tr. v. Saba Cap. Master Fund, Ltd., 224 A.3d 964, 977 (Del. 2020) ("'Because corporate charters and bylaws are contracts, our rules of contract interpretation apply.'" (quoting Hill Int'l, Inc. v. Opportunity Partners L.P., 119 A.3d 30, 38 (Del. 2015))).

40. *See* Fisch, *supra* note 6, at 1639 (describing the advantages of private ordering). Notably, not all commentators agree with this position. *See, e.g.*, Michal Barzuza, *Inefficient Tailoring: The Private Ordering Paradox in Corporate Law*, 8 HARV. BUS. L. REV. 131 (2018) (identifying efficiency costs associated with allowing firms to engage in private ordering instead of subjecting them to mandatory rules).

41. *See, e.g.*, Roberta Romano, THE GENIUS OF AMERICAN CORPORATE LAW 1 (1993) ("The genius of American corporate law . . . [is that firms] can particularize their charters under a state code, as well as seek the state whose code best matches their needs so as to minimize their cost of doing business."); Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1418 (1989) ("No one set of terms will be best for all; hence the 'enabling' structure of corporate law.").

42. *See id.* (citing bylaws responding to board adoption and use of poison pills as an example of innovation through private ordering); D. Gordon Smith, Matthew Wright & Marcus Kai Hintze, *Private Ordering with Shareholder Bylaws*, 80 FORD. L. REV. 125, 174 (2011) (explaining that private ordering enables "each corporation to become a laboratory of corporate governance, experimenting with different models of shareholder participation and ultimately producing a diversity of governance forms and practices").

43. Barry D. Baysinger & Henry N. Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. 179, 182 (1985) ("Markets lead managers to adopt the optimal mix of legal and market governance structures for their own firm.").

44. Roberta Romano & Sarath Sanga, *The Private Ordering Solution to Multiforum Shareholder Litigation*, 14 J. EMPIRICAL LEGAL STUD. 31, 32–33 (2017) (documenting the spread of forum-selection provisions after the *Boilermakers* decision).

adoption of majority voting[45] and proxy access provisions.[46] And Gabriel Rauterberg and Eric Talley report widespread adoption of corporate opportunity doctrine waivers in response to the Delaware legislature's 2000 statutory authorization of such waivers in section 122(17).[47]

B. The Limits of Private Ordering

The contract analogy as a basis for private ordering in corporate law is imperfect, however.[48] Although corporate law provides broad authority for firm-specific tailoring, certain elements of corporate law are generally understood to be mandatory and therefore beyond the scope of permissible private ordering.[49] Commentators term these elements "mandatory corporate law."[50] As Chancellor Allen explained, "[corporate law] is not, however, bereft of mandatory terms . . . . Generally, these mandatory provisions may not be varied by the terms of the certificate of incorporation *or otherwise*."[51]

One limit on private ordering is the statutory text. For example, DGCL section 102(f) prohibits fee-shifting charter provisions in connection with internal corporate claims, and section 109(b) does the same for bylaws.[52]

45. Choi et al., *supra* note 23 (analyzing the adoption of firm specific majority voting provisions).

46. *See, e.g.*, CII RSCH. AND EDUC. FUND, PROXY ACCESS BY PRIVATE ORDERING (2017), https://www.cii.org/files/publications/misc/02_02_17_proxy_access_private_ordering_final.pdf [https://perma.cc/8U7L-Z4QK] (reporting on firms' adoption of proxy access bylaws through private ordering).

47. Gabriel Rauterberg & Eric Talley, *Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers*, 117 COLUM. L. REV. 1075, 1079 (2017) (stating that "hundreds of public corporations in our sample—and well over one thousand in the population—have disclosed or executed waivers").

48. *See* Fisch, *supra* note 7, at 377 (challenging the contract metaphor because shareholders' power to adopt and amend bylaws is more limited than that of the board).

49. *See, e.g.*, John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989); Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549 (1989). Jurisdictions outside the United States rely more heavily on mandatory corporate law. *See, e.g.*, Jens Dammann, *The Mandatory Law Puzzle: Redefining American Exceptionalism in Corporate Law*, 65 HASTINGS L.J. 441 (2014) (distinguishing U.S. law, which is primarily enabling, from European law, which involves more mandatory terms); *see also* Katharina Pistor, Yoram Keinan, Jan Kleinheisterkamp & Mark D. West, *Innovation in Corporate Law*, 31 J. COMP. ECON. 676, 689 (2003) (comparing the corporate law of ten jurisdictions and describing Delaware as an "outlier[] . . . on the flexible end of the spectrum").

50. *See* Bernard S. Black, *Is Corporate Law Trivial? A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 543 (1990) (using term "mandatory corporate law" to refer to corporate law rules that are not "waivable by contract among the relevant parties").

51. *In re* Appraisal of Ford Holdings, Inc. Preferred Stock, 698 A.2d 973, 976 (Del. Ch. 1997) (emphasis added).

52. *See* DEL. CODE ANN. tit. 8, § 102(f) (2021) ("The certificate of incorporation may not contain any provision that would impose liability on a stockholder for the attorneys' fees or expenses of the

Similarly, section 102(b)(7) authorizes contractual limitations on the scope of director fiduciary duties but does not permit a waiver of the duty of loyalty or the obligation to adhere to the statutory limits on the payment of dividends.[53]

The second limit is implicit. The language of statutes that authorize firm-specific charter and bylaw provisions forbid such provisions that are "contrary to the laws of this state."[54] As then-Vice Chancellor Strine stated in *Jones Apparel*, "contrary to the laws of this State" means charter provisions that "'transgress a statutory enactment or a public policy settled by the common law or implicit in the General Corporation [Law] itself.'"[55] Courts have generally interpreted this language to mean that some provisions in the corporation code are mandatory and cannot be modified through private ordering.[56] Chancellor Allen identified several mandatory aspects of corporate law in his decision in *Ford Holdings*:

> Under Delaware law, for example, a corporation is required to have an annual meeting for the election of directors; is required to have shareholder approval for amendments to the certificate of incorporation; must have appropriate shareholder concurrence in the authorization of a merger; and is required to have shareholder approval in order to dissolve. Generally, these mandatory provisions may not be varied by terms of the certificate of incorporation or otherwise.[57]

The basis by which courts determine which aspects of corporate law are mandatory is not entirely clear. Courts have been guided in part by the statutory text. For example, some courts have read a statute as mandatory if it contains the word "shall." Thus the court in *H-M Wexford* held that the requirements of section 228(c) concerning the validity of written consents were mandatory because "[t]he word 'shall' is a mandatory term."[58]

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corporation or any other party in connection with an internal corporate claim, as defined in § 115 of this title."); § 109(b) ("The bylaws may not contain any provision that would impose liability on a stockholder for the attorneys' fees or expenses of the corporation or any other party in connection with an internal corporate claim, as defined in § 115 of this title.").

53. *See* Siegman v. Tri-Star Pictures, Inc., C.A. No. 9477, 1989 Del. Ch. LEXIS 56, at *25 (Del Ch. May 30, 1989) (denying motion to dismiss a claim alleging that such a charter provision was invalid).

54. DEL. CODE ANN. tit. 8, § 102(b)(1).

55. Jones Apparel Grp. v. Maxwell Shoe Co., 883 A.2d 837, 843 (Del. Ch. 2004) (quoting Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 118 (Del. 1952)).

56. *See id.* at 846 (explaining that the court will "invalidate a certificate provision . . . [that] vitiates or contravenes a mandatory rule of our corporate code").

57. *In re* Appraisal of Ford Holdings, Inc. Preferred Stock, 698 A.2d 973, 976 (Del. Ch. 1997) (citations omitted).

58. H-M Wexford LLC v. Encorp, Inc., 832 A.2d 129, 152 (Del. Ch. 2003).

Similarly, the court in *Speiser v. Baker* emphasized the language of section 211 which states that a corporation "shall" hold an annual meeting.[59]

Courts have also looked to the policy behind the statute, reasoning that the statute sets up certain core components of the rights and responsibilities of directors and shareholders that are not subject to firm-specific modification. One of the areas in which courts have applied this reasoning is with respect to shareholders' rights to remove directors. Accordingly, the *Rohe* court concluded that a corporate charter could not restrict the right of shareholders to remove directors of a nonclassified board without cause because the removal right was a "fundamental element of stockholder authority" that could not be eliminated by the charter."[60] The court in *Frechter v. Zier* applied a similar rationale to invalidate a bylaw providing that shareholder could only remove directors by a two-thirds vote.[61] Notably, the court in *Frechter* explicitly rejected the argument that, in order to qualify as a mandatory provision, a statute section must contain the words shall or must.[62] It seems likely that courts would take a similar view with respect to a charter or bylaw that attempted to divest shareholders of their power to amend the bylaws, although provisions that require such a supermajority vote to do so have been upheld.[63]

A similar rationale applies in other areas. The court in *Kurz* concluded that directors could not adopt a bylaw that would have the effect of enabling them to remove a fellow director.[64] Although the text of the Delaware statute does not explicitly define or impose fiduciary duties on corporate officers and directors, commentators have widely reasoned that public policy reasons bar charter or bylaw provisions that limit or eliminate the duty of loyalty.[65] Thus, the court in *Siegman v. Tri-Star Pictures* held that the

59. Speiser v. Baker, 525 A.2d 1001, 1005 (Del. Ch. 1987).

60. Rohe v. Reliance Training Network, Inc., C.A. No. 17992, 2000 Del. Ch. LEXIS 108, at *37 (July 21, 2000). *See also* Oral Argument on Cross Motions for Summary Judgment and Rulings of the Court at 18, *In re* VAALCO Energy, Inc. S'holder Litig., C.A. No. 11775, 2015 WL 13631027 (Del. Ch. Dec. 21, 2015) (reaching the same conclusion).

61. Frechter v. Zier, C.A. No. 12038, 2017 Del. Ch. LEXIS 14, at *5–6 (Jan. 24, 2017) ("Under the plain language of the statute, I find that the Removal provision is inconsistent with Section 141(k).").

62. *See id.* at *7. *But see* Siegman v. Tri-Star Pictures, Inc., C.A. No. 9477, 1989 Del. Ch. LEXIS 56, at *21 (May 30, 1989) (rejecting challenge to charter provision providing the board with the exclusive authority to fill vacancies on the board and newly-created directorships, based on the permissive character of § 223).

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

64. Kurz v. Holbrook, 989 A.2d 140, 157 (Del. Ch. 2010) ("For 89 years, Delaware law has barred directors from removing other directors.") (citations omitted).

65. The extent to which corporate law permits the waiver of fiduciary duties has been debated extensively. *See* Rauterberg & Talley, *supra* note 47, at 1077 n.8 (citing commentators arguing that duty of loyalty is a mandatory component of corporate law). This conclusion has support in the statutory text. *See* DEL. CODE ANN. tit. 8, § 102(b)(7). *Accord* Neubauer v. Goldfarb, 133 Cal. Rptr. 2d 218, 225 (Ct.

Delaware statute barred a charter provision purporting to limit director liability under the corporate opportunity doctrine.[66] In *Jones Apparel*, the court recognized that Delaware law affords shareholders and managers broad power to engage in private ordering through charter provisions but nonetheless questioned whether a charter provision that divested the board of its statutory power to approve a merger or amend the charter would be valid.[67]

To the extent that mandatory provisions in corporate law are viewed as undesirable, one potential response is that alternative business forms, such as the limited partnership and limited liability company, allow greater contractual freedom.[68] In Delaware, the statutes for both these alternative entity forms explicitly state that they are intended to give the maximum possible effect to principles of freedom of contract.[69] Similarly, Delaware and other states allow statutory close corporations in which the participants are explicitly granted greater contractual freedom than in the traditional corporation.[70] Accordingly, business participants that desire greater contractual freedom than is available under corporate law can choose a different business form. Indeed, a number have chosen to do so, and courts have upheld provisions in LLCs and LPs that broadly eliminate managers' fiduciary duties.[71]

App. 2003) (holding that "waiver of corporate directors' and majority shareholders' fiduciary duties to minority shareholders in private close corporations is against public policy"). Amir Licht has argued that transaction costs and information asymmetries provide a justification for precluding fiduciary duties from being fully contractable and suggests that permitting fiduciary duty waivers would "lead to suboptimal 'market for lemons' equilibrium at the societal level." Amir N. Licht, *Motivation, Information, Negotiation: Why Fiduciary Accountability Cannot be Negotiable*, *in* RESEARCH HANDBOOK ON FIDUCIARY LAW 159, 179 (2018). *But see* Rauterberg & Talley, *supra* note 47, at 1077 (arguing that the perception that the duty of loyalty is mandatory is no longer true in light of the adoption by Delaware and other states of statutory provisions permitting corporations to waive the corporate opportunity doctrine).

66. *Siegman*, 1989 Del. Ch. LEXIS 56, at *24–25. The Delaware legislature subsequently overturned *Siegman* by statute. *See* DEL. CODE ANN. tit. 8, § 122(17).

67. Jones Apparel Grp., Inc. v. Maxwell Shoe Co., 883 A.2d 837, 849 n.30 (Del. Ch. 2004).

68. *But see* Leo E. Strine, Jr. & J. Travis Laster, *The Siren Song of Unlimited Contractual Freedom*, *in* RESEARCH HANDBOOK ON PARTNERSHIPS, LLCS AND ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS 11 (Robert W. Hillman & Mark J. Loewenstein eds., 2015) (questioning the value of unlimited contractual freedom for noncorporate business forms).

69. *See, e.g.*, tit. 6, § 18-1101(b) ("It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability agreements It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability agreements.").

70. *See* Harwell Wells, *The Rise of the Close Corporation and the Making of Corporation Law*, 5 BERKELEY BUS. L.J. 263, 286, 295 (2008) (explaining why corporate law's "statutory norms" were a poor fit for close corporations and describing the body of common and statutory law specific to the close corporation as a response to this problem).

71. *See* Peter Molk, *Protecting LLC Owners While Preserving LLC Flexibility*, 51 U.C. DAVIS L. REV. 2129 (2018).

II. PRIVATE ORDERING THROUGH SHAREHOLDER AGREEMENTS

The mandatory features in corporate law limit the scope of private ordering available through charter and bylaw provisions. As noted in Part I, the charter and bylaws must be consistent with the governing statute and, although statutes do not impose many limits on private ordering, courts will invalidate provisions that transgress those limits. This Part considers an alternative tool for implementing private ordering—the shareholder agreement.

Shareholder agreements have their origin in close corporations, small family businesses that are run, in many cases, as incorporated partnerships.[72] Close corporations typically have a small number of shareholders, substantial shareholder participation in the management of the corporation and little or no market for the corporation's stock.[73] In close corporations, shareholder agreements are used to provide predictability and stability,[74] and their use dates back many years.[75] Participants in close corporations frequently use shareholder agreements to designate specific individuals to serve as directors or officers, to limit the authority of directors, and to increase shareholder control over operational decisions.[76] Close corporations' use of shareholder agreements in these ways were in tension with the statutory authority of the board of directors, a tension that led early courts to view them with skepticism.[77] As a result, a number of state legislatures enacted close corporation statutes that explicitly authorized greater contractual freedom among the participants in corporations that elected to be governed under their terms.[78]

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72. George D. Hornstein, *Judicial Tolerance of the Incorporated Partnership*, 18 L. & CONTEMP. PROBS. 435, 435 (1953).

73. *See, e.g.*, Kaplan v. First Hartford Corp., 484 F. Supp. 2d 131, 132 n.2 (D. Maine 2007). Close corporations are typically defined "by a blending of the roles of shareholder, officer, and director; the close personal relationships between the players; and the lack of market for reselling shares." Martin Edwards, *The Big Crowd and the Small Enterprise: Intracorporate Disputes in the Close-But-Crowdfunded Firm*, 122 PENN ST. L. REV. 411, 414 (2018).

74. *See, e.g.*, Galler v. Galler, 203 N.E.2d 577, 584 (Ill. 1964) (explaining that in a close corporation, "often the only sound basis for protection is afforded by a lengthy, detailed shareholder agreement securing the rights and obligations of all concerned").

75. *See, e.g.*, Faulds v. Yates, 57 Ill. 416, 420 (1870) (upholding shareholder agreement to choose the company's officers and directors).

76. Wells, *supra* note 70, at 298.

77. *See, e.g.*, Manson v. Curtis, 119 N.E. 559 (N.Y. 1918) (invalidating shareholder agreement that violated statutory requirement that corporation be managed by the board of directors); McQuade v. Stoneham, 189 N.E. 234 (N.Y. 1934) (invalidating shareholder agreement that selected corporate officers and determined their salaries as stripping the board of its power to do so).

78. *See, e.g.*, DEL. CODE ANN. tit. 8, § 350 (2021) ("A written agreement among the stockholders of a close corporation holding a majority of the outstanding stock entitled to vote, whether solely among

VC-funded startups differ substantially from the prototypical close corporation.[79] They have centralized management, hundreds of shareholders—many of whom are passive investors—and shares that are frequently traded, albeit not in the public markets.[80] Market and regulatory developments have allowed startups to stay private for an extended period of time, and many have grown to substantial size.[81] The most visible are the Silicon Valley unicorns, private corporations with a valuation of $1 billion or more.[82] As of September 30, 2021, there were almost unicorns.[83]

Although they often remain private for many years, VC-funded startups raise money from a wide range of investors through increasingly complex capital structures.[84] Early-stage investors are predominantly venture capital funds, but, as a startup grows, its investor base is likely to expand to a broader range of shareholders, including employees,[85] mutual funds, and pension funds.[86] The interests of these investors may differ substantially from those of the founders and the early-stage investors.[87] In addition, early-

themselves or with a party not a stockholder, is not invalid, as between the parties to the agreement, on the ground that it so relates to the conduct of the business and affairs of the corporation as to restrict or interfere with the discretion or powers of the board of directors.").

79. *See* Carol Goforth, *Too Many Cooks Spoil the Cake, and Too Many Statutes Spoil the LLC: A Plea for Uniformity*, 46 SW. L. REV. 63 (2016) (describing these as companies that have not yet gone public); Elizabeth Pollman, *Startup Governance*, 168 U. PA. L. REV. 155, 159 (2019) (explaining that venture capital-funded "startups are different from both public corporations and traditional closely held corporations").

80. *See, e.g.*, Langevoort & Thompson, *supra* note 17, at 349–50 (describing the growth of platforms that facilitate the trading of private company stock).

81. *See* Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 HASTINGS L.J. 445 (2017) (describing regulatory factors leading to the growth of large private companies).

82. Jennifer S. Fan, *Regulating Unicorns: Disclosure and the New Private Economy*, 57 B.C. L. REV. 583, 584 (2016).

83. Gené Teare, *Crunchbase Unicorn Board Leaps to Just Under 1,000 Companies, Reaches $3.4T in Value*, CRUNCHBASE NEWS (Sept. 30, 2021), https://news.crunchbase.com/news/crunchbase-unicorn-board-1000-companies/ [https://perma.cc/M82N-6C58]. As Fan notes, the growing number of unicorns has led commentators to coin a new term, the "decacorn," which refers to a company with a valuation of $10 billion or more. Fan, *supra* note 82, at 588.

84. *See* Fan, *supra* note 82 (detailing the structure of five well-known unicorns).

85. *See* Yifat Aran, *Making Disclosure Work for Start-up Employees*, 2019 COLUM. BUS. L. REV. 867, 880–881 ("[A] growing number of employees have started accepting compensation agreements in which equity grants represent a significant proportion of their pay."); Anat Alon-Beck, *Unicorn Stock Options—Golden Goose or Trojan Horse?* 2019 COLUM. BUS. L. REV. 107 (describing historical practice by startups of compensating their employees largely with stock options).

86. *See, e.g.*, Michael Ewens & Joan Farre-Mensa, *The Deregulation of the Private Equity Markets and the Decline in IPOs*, 33 REV. FIN. STUD. 5463, 5497 (2020) ("[N]on-traditional startup investors, such as PE, mutual, and hedge funds, have greatly increased their investments in late-stage startups.").

87. *See, e.g.*, Sergey Chernenko, Josh Lerner & Yao Zeng, *Mutual Funds as Venture Capitalists? Evidence from Unicorns*, 34 REV. FIN. STUD. 2362 (2021) (identifying agency problems between early and late-stage investors resulting, in part, by the need by mutual funds to focus on liquidity rights).

stage investors may sell their shares through privately negotiated transactions or on developing secondary markets without the discipline and regulatory scrutiny associated with the public offering process.[88]

Both the financial condition and the governance structure of startups are opaque. As commentators have observed, private companies are not subject to mandatory disclosure requirements limiting the ability of both shareholders and regulators to exercise oversight.[89] Startup valuations are notoriously unreliable and, in many cases, a startup's value is revised sharply downward once its financial statements are subject to the public disclosure associated with the IPO process.[90] Lack of disclosure may hide a host of governance problems ranging from conflicts of interest to outright fraud.[91] Later stage investors may lack both the bargaining power and the sophistication necessary to protect themselves from exploitation.[92]

There are reasons to believe that large private companies systematically have poor governance practices relative to their publicly traded peers, a problem Renee Jones terms the "Unicorn Governance Trap."[93] Hillary Sale and Donald Langevoort describe technology startups as engaged in "corporate adolescence" and warn that the absence of adult supervision through effective governance leads to a variety of problems including excessive risk-taking and rule-breaking.[94] Unicorns also expose both their investors and the public to significant risk.[95]

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88. A variety of secondary markets have developed to enable trading in the stock of private companies. *See, e.g.*, Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 VAND. L. REV. 1 (2012) (describing legal issues presented by VC secondary markets).

89. *See* Rauterberg, *supra* note 10, at 1129 (terming private companies "the dark matter of the corporate universe").

90. *See* Yves Smith, *Fake "Unicorns" Are Running Roughshod Over the Venture Capital Industry*, N.Y. MAG. (Nov. 14, 2018), https://nymag.com/intelligencer/2018/11/fake-unicorns-are-running-over-the-venture-capital-industry.html [https://perma.cc/YQ2F-6FSJ] (describing "pervasive overvaluation" of startups); Donald C. Langevoort & Hillary A. Sale, *Corporate Adolescence: Why Did "We" Not Work?*, 99 TEX. L.REV. 1347, 1357 (2021) (noting the incentives among startup participants to inflate valuations and observing that Uber's public offering price was "well below the company's private valuations").

91. *See* Langevoort & Sale, *supra* note 90 (detailing the conflicts of interest at WeWork); JOHN CARREYROU, BAD BLOOD: SECRETS AND LIES IN A SILICON VALLEY STARTUP (2018) (describing the Theranos fraud).

92. *See* Langevoort & Sale, *supra* note 90, at 1366 (identifying the potential vulnerability of late-stage investors in VC-funded firms).

93. Jones, *supra* note 15. *See also* Amy Deen Westbrook, *We('re) Working on Corporate Governance: Stakeholder Vulnerability in Unicorn Companies*, 23 U. PA. J. BUS. L. 505, 521 (2021) (detailing governance problems at startups including lack of board independence and diversity, dual class stock and a "lack of internal discipline").

94. Langevoort & Sale, *supra* note 90.

95. *See, e.g.*, Gary Spencer, Comment, *Financial Beasts: How Breeding Unicorns May Bring Big Consequences*, 35 REV. BANKING & FIN. L. 47, 55 (2015) (identifying the problems of unicorns as including overvaluation, excessive risk, and possibility of becoming a "[u]nicorpse") (citation omitted).

Shareholder agreements play an important role in VC-funded startups.[96] Their primary role is to allocate the economic rights of shareholders, rights that become complex as the startup proceeds through multiple rounds of financing.[97] As in the close corporation, startups use shareholder agreements to allocate the right to board representation among investors.[98] A shareholder agreement may provide VC investors with a degree of operational contract such as the power to veto certain corporate transactions. Depending on the relative bargaining strength of the founder and the VC funds, the agreement may grant investors control rights disproportionate to their economic interest in the company.[99]

Importantly, shareholder agreements are not just used to allocate control and cash flow rights between the founder and the VC funds. They are also used to address a variety of additional issues and often extend to other investors.[100] Shareholder agreements may provide shareholders with preemptive rights or registration rights. They may limit how shareholders can exercise their voting power.[101] They typically describe the scope of shareholders' inspection rights and designate those shareholders who can exercise such rights.[102] They often include detailed provisions that apply in the context of a merger such as drag-along rights and appraisal waivers. Shareholder agreements may specify a forum for litigation of shareholder

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96. Common shareholder agreements in the startup context include voting agreements, stock purchase agreements, and investors' rights agreements. *See* NVCA, *supra* note 8. *See generally* Corp. L. Comm. of the Ass'n of the Bar of N.Y.C., *The Enforceability and Effectiveness of Typical Shareholders Agreement Provisions*, 65 BUS. LAW. 1153 (2010) (describing common types of issues addressed by shareholder agreements and evaluating their enforceability).

97. *See generally* Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281 (2003) (describing the sophisticated terms in these contracts addressing cash flow rights, board rights, voting rights, and liquidation rights).

98. *Id.*; Rauterberg, *supra* note 10.

99. *See, e.g.*, Daniel T. Janis, *Venture Capital Shareholder Agreements—More Attention Now, Less Heartache Later*, ABA: BUS. L. TODAY (May 18, 2017), https://www.americanbar.org/groups/business_law/publications/blt/2017/05/03_janis/ [https://perma.cc/SW5W-BBAV] ("The ultimate purpose of a shareholder agreement is to provide a VC with rights above and beyond what it would have simply by virtue of its overall percentage ownership of the company.").

100. *See, e.g.*, DOUGLAS YOUNG, BAKER & MCKENZIE, IBA GUIDE ON SHAREHOLDERS' AGREEMENTS, https://nanopdf.com/download/shareholders-agreements_pdf [https://perma.cc/P3Z3-MSV2] (detailing common provisions in California shareholder agreements).

101. *See* John F. Coyle, *Altering Rules, Cumulative Voting, and Venture Capital*, 2016 UTAH L. REV. 595, 606–08 (explaining how participants in California corporations can use shareholder agreements to eliminate the statutorily required cumulative voting).

102. *See generally* Corp. L. Comm. of the Ass'n of the Bar of N.Y.C., *supra* note 96, at 1182–85; Fan, *supra* note 82, at 598. *See also* Shapira, *supra* note 14, at 150–51 (describing efforts by startup companies to limit employee use of inspection rights through shareholder agreements).

disputes or select arbitration in lieu of litigation.[103] In some cases, they include limitations on or waivers of the right to bring litigation, including litigation alleging breaches of fiduciary duties.[104] As the National Venture Capital Association website demonstrates, it is common practice for a single corporation to use a number of different shareholder agreements, each of which addresses different elements of the shareholders' relationship with his or her fellow shareholders and the corporation.[105]

Shareholder agreements operate as governance devices in two ways. First, they serve as contractual mechanisms for allocating control and determining board representation.[106] Corporate law provides shareholders with the power to vote on a variety of issues including the election of directors, the amendment of the charter and bylaws, and the approval of certain corporate transactions. Shareholders can commit, pursuant to a shareholder agreement, to vote their stock together or in a designated manner, forming a control coalition. Shareholders can also designate officers or directors pursuant to a shareholder agreement, taking those decisions outside the standard process.[107]

Second, shareholder agreements allocate shareholder rights and, as a result, the extent to which minority shareholders can hold officers, directors and controlling shareholders accountable. Corporate governance is addressed, in large part, to the agency problems that arise from the separation of ownership and control. As noted above, these agency problems are particularly pervasive in startups. A variety of governance mechanisms—from independent directors to shareholder voting, inspection and litigation rights—are designed to mitigate these agency problems, and shareholder agreements are used, in startups, to reduce shareholder power to use these mechanisms. Notably, shareholder benefit not only from their individual rights but from the power to act collectively to identify and respond to problems. As a result, shareholders may be damaged not just by

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103. *See, e.g.*, Corp. L. Comm. of the Ass'n of the Bar of N.Y.C., *supra* note 96, at 1201–02 (discussing considerations in drafting arbitration provisions); Pinto Tech. Ventures, L.P. v. Sheldon, 526 S.W.3d 428, 443 (Tex. 2017) (upholding forum-selection provision in shareholder agreement).

104. *Cf.* Neubauer v. Goldfarb, 133 Cal. Rptr. 2d 218, 225 (Ct. App. 2003) (holding that, under California law, shareholder agreement purporting to waive shareholders' right to sue for breach of fiduciary duty was void).

105. NVCA, *supra* note 8.

106. Gabriel Rauterberg focuses on this use of shareholder agreements. *See* Rauterberg, *supra* note 10.

107. The use of shareholder agreements to allocate decisional rights raises additional concerns about the extent to which shareholders that exercise those rights are subject to fiduciary duties. *See id.* at 1168 (observing that shareholders acting collectively raises the issue of "[w]hen . . . do the signatories to a shareholder agreement owe other shareholders fiduciary duties?").

contractual limitations on their own rights but by agreements entered into by their fellow shareholders.[108]

Why do startups use shareholder agreements for private ordering rather than the charter and bylaws? There are at least three reasons. First, shareholder agreements are more flexible. They can be implemented and amended without the formalities associated with amending the charter and bylaws. In particular, charter provisions require board approval, and the board's fiduciary duties to all shareholders may create a "bargaining friction."[109] Shareholder agreements require no formal action by the corporation or the board and can be implemented and amended by shareholders acting in their individual capacity.

Second, shareholder agreements are opaque.[110] Corporate charters, even for private corporations, are public documents.[111] Similarly, shareholders have a near-absolute right to inspect the current bylaws of the corporation without relying on any statutory inspection rights.[112] By contrast, shareholder agreements have the legal status of contracts, and, as such, they do not need to be disclosed to nonsignatories or filed with the state, qualifying them as a type of stealth corporate governance.[113] Significantly, shareholder agreements allow some shareholders to obtain economic or

108. *See, e.g.*, Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 936–39 (Del. 2003) (concluding that voting agreement entered into by controlling stockholders had preclusive effect on merger to the detriment of minority stockholders).

109. *See* Rauterberg, *supra* note 10, at 1147 (identifying this concern).

110. *See id.* at 21 ("Firms with a secrecy interest in their governance may thus prefer a shareholder agreement.").

111. *See* Fan, *supra* note 82, at 611 (observing that "[a]lthough anyone can obtain a corporation's certificate of incorporation from the Secretary of State of Delaware, there is a fee, and the certificate of incorporation does not include significant information about the company") (footnotes omitted).

112. *See, e.g.*, 13 PENNSYLVANIA LAW ENCYCLOPEDIA *Corporations* § 110, Lexis (database updated Sept. 2021) ("explaining that "[t]he statute does not refer expressly to the bylaws because the shareholders have an absolute right to be supplied with a copy of the currently effective text of the bylaws without going through this statutory procedure regarding inspection"); *Articles of Incorporation and Shareholder Agreements: What's the Difference?*, LEGALNATURE, https://www.legalnature.com/guides/articles-of-incorporation-and-shareholder-agreements-whats-the-difference [https://perma.cc/W5B5-DCV2] ("[Corporate charter and bylaw provisions] are available for the public to inspect while the shareholder agreement is typically private, shared only by the parties involved . . . ."); 14 N.Y. JUR. 2D *Business Relationships* § 386 ("While the right of a stockholder to examine the bylaws of the company is not absolute but rests in the discretion of the court, a strong case will be required to deny an inspection since the bylaws constitute a part of the contract between the stockholder and the corporation, and the stockholder should be permitted to know the extent and terms of the stockholder's and the corporation's obligation to each other."). *But see* Rauterberg, *supra* note 10, at 1129 (observing that private companies "are not required to publicly disclose any instrument of governance beyond filing their charter with the Secretary of State").

113. A public corporation may be required to disclose a material shareholder agreement to which it is a party under the federal securities laws. *See* Rauterberg, *supra* note 10, at 1148 (describing disclosure requirement).

control rights well beyond those that they appear to possess based on the corporation's charter provisions.[114]

Third, shareholder agreements have at least the potential to go further than the charter and bylaws in modifying the rights and powers established by corporate statutes. Although the law is not clear, there is some support for the proposition that shareholder agreements can be used to modify what would otherwise be mandatory provisions of corporate law. As a result, commentators have argued that corporations have broader power to engage in private ordering by using shareholder agreements.[115] For startups that are seeking to depart from governance best practices and, in particular, for founders and VC funds seeking to limit their accountability to other shareholders, shareholder agreements are particularly attractive.

Private corporations are not required to file shareholder agreements with state or federal regulators.[116] As a result, it is not possible to ascertain the full range of shareholder agreements in existence or their terms. Some guidance on their use is available, however. The National Venture Capital Association posts a variety of model forms of shareholder agreements.[117] The Corporation Law Committee of the Association of the Bar of the City of New York published a report in 2010 summarizing typical provisions in shareholder agreements.[118] Many provisions are commonplace in such agreements despite a paucity of case law on their enforceability.[119] Gabriel Rauterberg collected data from shareholder agreements filed in connection with the IPO process and estimates and reports, based on this data, that roughly 55% of pre-IPO companies were governed by a shareholder agreement.[120] Notably, although shareholder agreements are used primarily in private corporations, Rauterberg finds a significant number of shareholder agreements that continue in effect even after a company goes public.[121]

As noted above, although corporate law historically treated shareholder agreements with suspicion,[122] their legal treatment, by both statutes and courts, has evolved. Today, corporate statutes expressly authorize some

114. *See, e.g.*, Janis, *supra* note 99 ("Shareholder agreements give VCs extensive rights, far beyond the economics reflected in a company's charter.").

115. *See* Rauterberg, *supra* note 10, at 1167 ("Certain rules are mandatory, but only for the charter and bylaws, not shareholder agreements; some rules bind all three.").

116. *Id.* at 4.

117. NVCA, *supra* note 8.

118. Corp. L. Comm. of the Ass'n of the Bar of N.Y.C., *supra* note 96, at 1172–94.

119. *See, e.g.*, *id.* at 1182 (explaining that "case law concerning the enforceability of drag-along rights is scarce").

120. Rauterberg, *supra* note 10, at 1149.

121. *Id.*

122. *See supra* note 77.

types of shareholder agreements. For example, the Delaware statute and the MBCA provide that voting agreements among shareholders are specifically enforceable.[123] The statutes do not limit voting agreements to close corporations. Although at one time the statutes imposed various procedural requirements for voting agreements to be valid—such as requiring that they be publicly disclosed and limiting their duration to ten years—subsequent amendments removed these requirements.[124] Courts have relied on these statutes[125] to uphold shareholder voting agreements as long as their terms are sufficiently clear.[126]

MBCA section 7.32 authorizes shareholder agreements that address a variety of issues beyond voting, including agreements that limit the discretion of the board of directors, govern corporate distributions, and establish who shall serve as directors or officers.[127] Notably, the statute expressly authorizes shareholder agreements that conflict with other provisions in the statute, stating that an agreement that complies with section 7.32 is valid "even though it is inconsistent with one or more other provisions of this Act."[128] To be valid under the MBCA, a voting agreement must be set forth in the charter or bylaws and approved by all shareholders or in a written agreement signed by all the shareholders. The existence of an agreement must also be noted on the share certificates.[129]

Although section 7.32 is not part of a separate close corporation statute, the drafters of the MBCA appear to have intended it to play an analogous role because the provision originally provided that shareholder agreements authorized by its terms would cease to be effective if the corporation went

123. MODEL BUS. CORP. ACT § 7.31 (AM. BAR ASS'N 2020); DEL. CODE ANN. tit. 8, § 218 (2021).

124. *See, e.g.*, DOUGLAS K. MOLL & ROBERT A. RAGAZZO, CLOSELY HELD CORPORATIONS § 3.02 (2020) (explaining that limitations on the duration of voting agreements and requirement that they be publicly disclosed have disappeared in most states).

125. *See, e.g.*, Salamone v. Gorman, 106 A.3d 354, 383 (Del. 2014) (explaining that a "Voting Agreement acts as a contractual overlay [of section 212(a)] pursuant to 8 *Del. C.* § 218(c)").

126. *See, e.g.*, Rohe v. Reliance Training Network, Inc., C.A. No. 17992, 2000 Del. Ch. LEXIS 108, at *57 ("[A]lthough Delaware law provides stockholders with a great deal of flexibility to enter into voting agreements, our courts rightly hesitate to construe a contract as disabling a majority of a corporate electorate from changing the board of directors unless that reading of the contract is certain and unambiguous.") (footnote omitted).

127. MODEL BUSINESS CORP. ACT § 7.32 (AM. BAR ASS'N 2020). Delaware law contains no similar provision.

128. MODEL BUSINESS CORP. ACT § 7.32(a) (AM. BAR ASS'N 2020). Some commentary suggests public policy limits in the statute would preclude a shareholder agreement under the Act that purported to eliminate director fiduciary duties. *See* William F. Griffin, Jr., *Fiduciary Duties of Officers, Directors, and Business Owners*, DAVIS, MALM & D'AGOSTINE, PC 38–39 (Jan. 2011), https://www.davismalm.com/wp-content/uploads/2019/08/Griffin_CH8_Fiduciary_Duties.pdf [https://perma.cc/KQ4T-Y5AX].

129. MODEL BUSINESS CORP. ACT § 7.32(c) (AM. BAR ASS'N 2020). Rauterberg, *supra* note 10, at 26 n.99.

public.[130] In 2017, the ABA eliminated this restriction, however, and the current form of the provision is not limited to private companies.[131] A number of state statutes, retain the restriction limiting shareholder agreements to private companies.[132] The Delaware statute does not explicitly authorize shareholder agreements other than voting agreements, although various sections of the statute refer to shareholder agreements, implicitly recognizing their potential validity.[133]

Judicial treatment of shareholder agreements is limited, particularly outside the close corporation context.[134] The enforceability of such agreements raises several issues. The first issue is whether the agreement complies with the necessary formalities.[135] The second issue is whether it complies with the standard requirements of contract law.[136] The third issue is the one relevant to this Article—whether enforcement of the agreement is consistent with principles of corporate law; specifically, the degree to which participants in a corporation can modify corporate law requirements by private contract.

Two potentially conflicting principles apply. On the one hand, corporate law imposes a hierarchy of authority. Under corporate law, the statute is supreme, the terms of the charter must comply with the statute, and the terms of the bylaws are limited by the charter. One way of understanding this hierarchy is to conclude that a shareholder agreement is not valid if it

130. *See* MODEL BUSINESS CORP. ACT § 7.32(d) (AM. BAR ASS'N 2003) (providing that "[a]n agreement authorized by this section shall cease to be effective when shares of the corporation are listed on a national securities exchange or regularly traded in a market maintained by one or more members of a national or affiliated securities association").

131. Rauterberg, *supra* note 10, at 1153 n.102; MODEL BUSINESS CORP. ACT § 7.32 (AM. BAR ASS'N 2020).

132. *See, e.g.*, ARIZ. REV. STAT. ANN. § 10-732(D) (2021); FLA. STAT. § 607.0732(4) (2020); *cf.* Ramos v. Estrada, 10 Cal. Rptr. 2d 833, 836 (Ct. App. 1992) (upholding enforcement of shareholder agreement even though corporation was not technically a close corporation).

133. *See, e.g.*, Bonanno v. VTB Holdings, Inc., C.A. No. 10681, 2016 Del. Ch. LEXIS 24, at *47 (Feb. 8, 2016) (describing the statute's "distinct itemization of shareholder agreements as a class of documents that, in addition to corporate charters and bylaws, fall within the given regulatory ambit").

134. *See, e.g.*, Abregov v. Lawrence, No. G056629, 2020 Cal. App. Unpub. LEXIS 1826, at *7 (2020) (holding that the rules governing the enforceability of shareholder agreements are different for statutory close corporations than for other corporations). One likely reason is the limited extent to which participants in startups engage in litigation. *See infra* notes 220–221 and accompanying text.

135. *See, e.g.*, Booker v. Humphreys, 73 Va. Cir. 543, 551 (2007) (refusing to enforce shareholder agreement that did not comply with the Virginia statutory requirements that it be in writing and signed by all the shareholders).

136. *See, e.g.*, Dick v. Koski Pro. Grp., P.C., 95 N.W.2d 321, 354 (Neb. 2020), *opinion modified on denial of reh'g*, 953 N.W.2d 257 (Neb. 2021) ("Shareholder agreements are construed according to the principles of the law of contracts.").

conflicts with any of the foregoing instruments.[137] Specifically, a shareholder agreement cannot be used to override a statutory requirement.[138] This approach finds support in the language of MBCA section 7.32 and similar statutory provisions that expressly authorize certain shareholder agreements even if they conflict with other sections of the statute. If a contract were sufficient to override a mandatory statute, this language would be unnecessary.

On the other hand, shareholder agreements (unlike corporate charters and bylaws) are contracts, and outside corporate law courts generally accept the premise that private parties may, by contract, waive statutory, and even constitutional rights.[139] Several courts suggest that the same analysis applies to shareholder agreements,[140] at least so long as the waiver of statutory rights in a shareholder agreement is "clear and unmistakable."[141] Under this analysis, a shareholder agreement could implement private ordering provisions that would not be permitted in the charter or bylaws.[142] This analysis is further supported by recent cases identifying freedom of contract as consistent with the objectives of corporate law.[143]

137. As the Delaware Chancery Court explained in *Gaskill*, "The by-laws must succumb to the superior authority of the charter; the charter if it conflicts with the statute must give way; and the statute, if it conflicts with the constitution, is void." Gaskill v. Gladys Belle Oil Co., 16 Del. Ch. 289, 296 (1929). *But see* Manti Holdings, LLC v. Authentix Acquisition Co., C.A. No. 354, 2020, 2021 Del. LEXIS 286, at *28–29 (Del. Sept. 13, 2021) (describing and rejecting petitioners' argument that "[b]ecause the charter is higher up in the corporate hierarchy than a stockholders agreement, . . . Authentix cannot use the Stockholders Agreement to impose a limitation that could not be included in the corporation's charter.").

138. *See* Schroeder v. Buhannic, C.A. No. 2017-0746, 2018 Del. Ch. LEXIS 1444 (Jan. 10, 2018), at *10 (explaining that a shareholder agreement is invalid if it conflicts with the statute).

139. *See* G. Richard Shell, *Contracts in the Modern Supreme Court*, 81 CAL. L. REV. 431, 475–80 (1993) (describing U.S. Supreme Court's analysis of private parties' power to waive various statutory and constitutional protections).

140. *See* Bonanno v. VTB Holdings, Inc., C.A. No. 10681, 2016 Del. Ch. LEXIS 24, at *43–49 (Feb. 8, 2016) (allowing enforcement of provision in shareholder agreement waiving shareholders' right to litigate in Delaware courts, despite explicit statutory language prohibiting such a waiver in a corporate charter or bylaw).

141. *See, e.g.*, Windmill Inns of Am., Inc. v. Cauvin, 450 P.3d 1013, 1019 (Or. Ct. App. 2019) (citation omitted); *accord* Kortüm v. Webasto Sunroofs Inc., 769 A.2d 113, 125 (Del. Ch. 2000) (footnote omitted) ("There can be no waiver of a statutory right unless that waiver is clearly and affirmatively expressed in the relevant document.");); *see also Manti*, 2021 Del. LEXIS 286, at *47 (concluding that waiver is permissible where stockholders "freely and knowingly consented to waive their appraisal rights in exchange for valuable consideration").

142. *See* Rohe v. Reliance Training Network, Inc., C.A. No. 17992, 2000 Del. Ch. LEXIS 108, at *58 n.49 (Del. Ch. July 21, 2000) ("[S]tockholders can bind themselves contractually in a stockholders agreement in a manner that cannot be permissibly accomplished through a certificate of incorporation.").

143. *See, e.g.*, EV3, Inc. v. Lesh, 114 A.3d 527, 529 n.3 (Del. 2014) (quoting Libeau v. Fox, 880 A.2d 1049, 1056-57 (Del. Ch. 2005), *aff'd in pertinent part*, 892 A.2d 1068 (Del. 2006)) ("When parties have ordered their affairs voluntarily through a binding contract, Delaware law is strongly inclined to respect their agreement, and will only interfere upon a strong showing that dishonoring the contract is

An additional consideration is that, in several cases, the shareholder agreements address the rights of preferred stockholders. In upholding the validity of these agreements, the courts have reasoned that preferred stockholders' rights are primarily contractual rather than statutory. Thus the court in *Ford Holdings* observed that that DGCL section 262, providing shareholders with statutory appraisal rights, is a mandatory provision of Delaware corporate law.[144] The court concluded that the appraisal rights of preferred stockholders could nonetheless be modified by contract.[145] The court expressly conditioned its holding on the fact that "preferred stock is a very special case."[146] Similarly, the court in *Metromedia* explained that the "proposition of contract interpretation for preferred stock is interwoven with a stockholder's statutory right of appraisal."[147] As a result, the court concluded that a contractual provision establishing the fair value of the preferred stock was not inconsistent with either the language or the policy of section 262.[148] In *Fletcher International Ltd. v. ION Geophysical Corp.*, the court applied similar reasoning to conclude that the contractual duties owed to preferred stockholders in the case supplanted any fiduciary duty claims that might result in additional remedies.[149]

When the cases addressing the rights of preferred stockholders and those involving close corporations are excluded, the number of decisions evaluating the permissible scope of shareholder agreements is tiny.[150]

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required to vindicate a public policy interest even stronger than freedom of contract."); *see also What's the Purpose of a Shareholders' Agreement*, BELLAS & WACHOWSKI https://www.bellas-wachowski.com/whats-the-purpose-of-a-shareholders-agreement.html [https://perma.cc/3XVT-T76Q] ("Illinois has a strong history of upholding shareholders' agreements pursuant to the underlying policy regarding freedom of contract."); Galler v. Galler, 203 N.E.2d 577 (Ill. 1964).

144. *In re* Appraisal of Ford Holdings, Inc. Preferred Stock, 698 A.2d 973, 976 (Del. Ch. 1997) (explaining that "[a]mong the[] mandatory provisions of Delaware law is Section 262").

145. *Id.* at 975 ("[I]nsofar as preferred stock is concerned, the provisions of Section 262 may be modified by provisions of the certificate of rights . . . ."). *See* Hintmann v. Fred Weber, Inc., C.A. No. 12839, 1998 Del. Ch. LEXIS 26, at *36 (Feb. 17, 1998) (questioning whether the reasoning in *Ford Holdings* could be used to limit the rights of "common, as opposed to preferred," stockholders).

146. *Ford Holdings*, 698 A.2d at 977 (footnote omitted).

147. *In re* Appraisal of Metromedia Int'l Grp., Inc., 971 A.2d 893, 899 (Del. Ch. 2009).

148. *Id.* at 900.

149. Fletcher Int'l, Ltd. v. ION Geophysical Corp., C.A. No. 5109, 2010 Del. Ch. LEXIS 125, *27 (May 28, 2010) (footnote omitted) (holding that asserted fiduciary duty claims "arise out of and are superfluous to the breach of contract claims").

150. The absence of case law does not appear to limit the use of these provisions. *See, e.g.*, Shapira, *supra* note 14, at 151 (explaining that "a burgeoning practice among growing start-ups is to sign employees on an inspection rights waiver before granting said employees stock options"); George S. Geis, *Information Litigation in Corporate Law*, 71 ALA. L. REV. 407, 427 (2019) (footnote omitted) ("Corporations are even starting to include conditions in employee stock grants that require workers to waive future shareholder inspection rights."); Rolfe Winkler, *Startup Employees Invoke Obscure Law to Open Up Books*, WALL ST. J. (May 24, 2016, 1:48 PM), https://www.wsj.com/articles/startup-

Nonetheless, the cases provide some support for the proposition that shareholder agreements can be used more expansively than charter or bylaw provisions to tailor a corporation's governance structure. For example, courts have generally held that shareholder inspection rights comprise a mandatory provision of corporate law such that charter or bylaw provisions purporting to limit or eliminate inspection rights are invalid.[151] Nonetheless, dicta in several cases suggests that courts may uphold waivers of shareholder inspection rights in shareholder agreements.[152] In *Juul Labs, Inc. v. Grove*, the Delaware Chancery court failed to reach the issue of whether a shareholder agreement purporting to waive statutory inspection rights was valid under Delaware law.[153] The court specifically noted the competing claims as to the provision's validity, but observed that there were "arguments for distinguishing between provisions that appear in those documents and waivers in private agreements."[154]

In *Bonanno*, the court considered the validity of a forum selection in a shareholder agreement.[155] Notably, the Delaware statute authorizes forum selection provisions in the charter and bylaws but provides that such provisions cannot select an exclusive non-Delaware forum for the litigation of internal corporate claims.[156] Nonetheless, the *Bonanno* court concluded that a shareholder agreement providing for exclusive litigation in New York did not contravene public policy.[157] The court relied in part on a synopsis included with the bill that stated "Section 115 is not intended, however, to prevent the application of any such provision in a stockholders agreement

employees-invoke-obscure-law-to-open-up-books-1464082202 (quoting executive compensation attorney Richard Grimm as stating that "[s]ome companies are now pushing employees to waive their right to inspect the books as a condition for receiving stock awards").

151. *See e.g.*, State *ex rel.* Cochran v. Penn-Beaver Oil Co., 143 A. 257, 260 (Del. 1926) (holding that a charter provision that "permits the directors to deny any examination of the company's records by a stockholder is unauthorized and ineffective"); Rainbow Navigation, Inc. v. Pan Ocean Navigation, Inc., 535 A.2d 1357, 1359 (Del. 1987) (citations omitted) ("[The shareholders' right of inspection] can only be taken away by statutory enactment."); BBC Acquisition Corp. v. Durr-Fillauer Medical, Inc., 623 A.2d 85, 90 (Del. 1992) ("[A shareholder's inspection rights] cannot be abridged or abrogated by an act of the corporation.").

152. *See e.g.*, Kortüm v. Webasto Sunroofs Inc., 769 A.2d 113, 125 (Del. Ch. 2000) (observing that the shareholders agreement "does not expressly provide for a waiver of statutory inspection rights [and] there can be no waiver of a statutory right unless that waiver is clearly and affirmatively expressed . . .."); Schoon v. Troy Corp., C.A. No. 1677-N, 2006 Del. Ch. LEXIS 123, at *7 (rejecting argument that shareholder's section 220 rights were defined by the stock purchase agreement where "[t]he agreement did not in any way, explicitly or implicitly, contractually limit the information that must be provided to Steel in the exercise of its statutorily protected inspection rights under Section 220").

153. Juul Labs, Inc. v. Grove, 238 A.3d 904 (Del. Ch. 2020).

154. *Id.* at 902 (footnote omitted).

155. Bonanno v. VTB Holdings, Inc., C.A. No. 10681, 2016 Del. Ch. LEXIS 24, at *47 (Feb. 8, 2016).

156. *See* DEL. CODE ANN. tit. 8, § 115 (2021).

157. *Bonanno*, 2016 Del. Ch. LEXIS 24, at *48.

or other writing signed by the stockholder against whom the provision is to be enforced."[158] The court also noted, however, that, unlike some other provisions of the Delaware statute, section 115 did not explicitly prohibit such provisions in a shareholder agreement.[159] Notably, the two provisions to which the court referred affirmatively authorize shareholder action by written agreement, in contrast to the overwhelming majority of statute sections that only address the extent to which private ordering may be effected through the charter, the bylaws, or both and which are silent as to shareholder agreements.

Another example is appraisal rights. In *Manti Holdings LLC v. Authentix Acquisition Co.*, the Delaware Supreme Court held that shareholders could waive their appraisal rights through a shareholder agreement.[160] The court concluded that, because the parties were sophisticated, represented by counsel, and received valuable consideration, the shareholder agreement was a valid contract.[161] Although the petitioners argued that the Delaware appraisal statute was a mandatory component of Delaware law, the court rejected this argument, concluding that nothing in the statute precluded petitioners from waiving their appraisal rights.[162] Critically the court reasoned that the shareholder agreement was a personal waiver, holding that it "did not restrict the appraisal rights of the classes of stock held by the Petitioners."[163] Instead the court concluded that the petitioners had simply agreed by contract "to forbear from exercising that right."[164]

The problem with analyzing shareholder agreements as personal waivers, as the *Manti* court did, is that a shareholder's corporate governance rights affect the interests of other shareholders as well as the rights and responsibilities of the corporation's officers, directors, and nonshareholder stakeholders. This is particularly true when the shareholder agreement limits the use of governance mechanisms designed to promote corporate accountability. A shareholder's agreement limiting the authority of shareholders to remove sitting directors reduces the potential accountability of the board. An agreement to waive inspection rights prevents shareholders from overseeing the corporation's financial condition and responding to

158. *Id.* at *46 n.131 (citing Del. S.B. 75 syn., 148th Gen. Assem. (2015)).

159. *Id.* at *47 (referring to "other DGCL provisions' distinct itemization of shareholder agreements as a class of documents that, in addition to corporate charters and bylaws, fall within the given regulatory ambit").

160. Manti Holdings, LLC v. Authentix Acquisition Co., C.A. No. 354, 2020, 2021 Del. LEXIS 286, at *4 (Sept. 13, 2021).

161. *Id.*

162. *Id.* at *33–34. Nor did the court view the waiver as inconsistent with public policy. *Id.* at *38–39.

163. *Id.* at *25.

164. *Id.* at *26.

potential problems. An agreement to forsake appraisal rights affects the terms of future transactions.

It is also misleading to characterize shareholder agreements as purely personal if they contain terms to which all shareholders must agree. As noted above, many statutes including the MBCA require that shareholders unanimously approve a shareholder agreement. Similarly, corporations may require that shareholders agree to the terms of a shareholder agreement as a condition of acquiring stock. If, however, all shareholders waive their inspection rights, their appraisal rights, or their rights to pursue fiduciary duty litigation, then no shareholder is capable of exercising those rights and, as a practical matter, the corporation has eliminated them. Thus, in *Manti*, if all shareholders waive their appraisal rights, the common stock has no appraisal rights. To the extent the elimination of statutory appraisal rights is inconsistent with public policy, the prospect of obtaining this result through a contractual waiver is problematic.[165]

To be sure, some shareholder agreements are more limited in scope. In *In re Altor Bioscience Corp.*, the court considered a covenant in a shareholder agreement waiving the plaintiffs' right to sue.[166] The plaintiffs argued that enforcement of the covenants would essentially insulate the defendants from claims of breach of fiduciary duty and were therefore invalid.[167] In evaluating and rejecting this claim, the court observed that, in the case before it, the agreements only bound the plaintiffs; other shareholders were able to sue and were, in fact, asserting similar claims to those the plaintiffs sought to assert.[168] Consequently, the court concluded that enforcement of the agreements against the plaintiffs was not contrary to public policy.[169] Even this analysis may fall short, however. If shareholder agreements are used to eliminate the rights of minority or disempowered

165. For arguments that statutory appraisal rights serve a valuable role in disciplining deal price and quality, see Audra Boone, Brian Broughman & Antonio J. Macias, *Merger Negotiations in the Shadow of Judicial Appraisal*, 62 J.L. & ECON. 281, 285 (2019) (finding that "a strong appraisal regime increases returns to target shareholders"); Scott Callahan, Darius Palia & Eric Talley, *Appraisal Arbitrage and Shareholder Value*, 3 J.L. FIN. & ACCT. 147 (2018) (shareholders tend to receive higher premia as the strength of the appraisal remedy increases).

166. Telephonic Rulings of the Court on Defendants' Motions for Summary Judgment and Motions to Dismiss, *In re* Altor Bioscience Corp., 2019 Del. Ch. LEXIS 1103 (2019) (No. 2017-0466).

167. Katherine Henderson, Amy Simmerman & Brad Sorrels, *Appraisal Claim Waivers and Deal Covenants*, HARV. L. SCH. F. ON CORP. GOVERNANCE, Aug. 26, 2019, https://www.wsgr.com/publications/PDFSearch/harvard-082619.pdf [https://perma.cc/3Y4N-FVSK].

168. Katherine L. Henderson, Amy L. Simmerman, Brad Sorrels, Ryan J. Greecher & Toni Wormald, *Delaware Court Addresses Private Company Deal Issues*, WILSON SONSINI (Aug. 13, 2019), https://www.wsgr.com/en/insights/delaware-court-of-chancery-addresses-significant-issues-regarding-private-company-deal-litigation.html [https://perma.cc/5JBE-3JLR].

169. *Id.*

shareholders, the fact that other shareholders have the technical ability to assert these claims does not ensure accountability.

III. SHAREHOLDER AGREEMENTS AS CORPORATE GOVERNANCE

A. The Corporate/Contract Paradigm

As noted above, courts and commentators increasingly describe corporate law as "contractual." The contract analogy is imperfect, however. As William Bratton and Michael Wachter recognize, the law has struggled to reconcile "two great private law paradigms, corporate law and contract law."[170] Shareholder agreements sit uneasily between these two paradigms. On the one hand, they purport to function as contracts and courts have analyzed them according to principles of contract law. On the other hand, the powers and rights that they address are the product of corporate law.[171]

There are fundamental differences between the two paradigms. Contracts generally affect only the rights of the contracting parties; contract law explicitly disavows, in most cases, the proposition that a contract creates rights or obligations with respect to third parties.[172] Contracts provide the primary source of rights and responsibilities between the parties thereto, and the terms to which the parties can agree are infinitely customizable.[173] To the extent that statutory provisions and public policy considerations limit the permissible scope of contract terms, those limitations are minimal.[174] Contracts are self-defining in terms of their scope—they determine the duration of the obligations they impose, the manner in which the contract can be modified,[175] and the circumstances under which the contract may be terminated.[176]

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170. William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, 161 U. PA. L. REV. 1815, 1820 (2013).

171. *See also* David Ciepley, *Beyond Public and Private: Toward a Political Theory of the Corporation*, 107 AM. POL. SCI. REV. 139, 152 (2013) (describing corporations as neither public nor private but "corporate").

172. *See, e.g.*, Pinto Tech. Ventures, L.P. v. Sheldon, 526 S.W.3d 428, 445 (Tex. 2017) (concluding that nonsignatories to a shareholder agreement lacked the power to enforce its terms).

173. *See, e.g.*, Thomas W. Merrill & Henry E. Smith, *Optimal Standardization in the Law of Property: The* Numerus Clausus *Principle*, 110 YALE L.J. 1, 3 (2000) ("The parties to a contract are free to be as whimsical or fanciful as they like in describing the promise to be performed, the consideration to be given in return for the promise, and the duration of the agreement.").

174. *See id.* (observing that legal constraints on permissible types of contracts—such as promises to commit a crime—are "relatively narrow areas of proscription").

175. *See, e.g.*, *Pinto Tech*, 526 S.W.3d at 443 (holding that signatory to a shareholder agreement was bound by changes to that agreement pursuant to its terms).

176. The potential for termination is a key distinction between shareholder agreements and charter and bylaw provisions. A charter or bylaw continues in effect unless and until it is amended or removed.

Consent is a central component of contract law.[177] Contract law "requires that the parties have an understanding of the terms to which they have agreed."[178] A binding contract requires affirmative assent; silence or inaction is not generally sufficient.[179] The requirement of consent limits the ability of one party unilaterally to modify the contract.[180] And, where a contract purports to waive a party's statutory or constitutional rights, that waiver must be explicit.

Corporate law, by contrast, is structural.[181] Statutes prescribe the necessary formalities to form a corporation and, once those formalities are complied with, establish the corporation as a distinct legal entity.[182] Corporate law also specifies the entity's critical features.[183] It identifies the key participants in a corporation—the officers, directors, and shareholders—and allocates rights and responsibilities among those parties based on status, not agreement. The board of directors, for example, has primary authority to operate the corporation. Shareholders have the right to elect directors, the economic right to the corporation's residual value, and the right to vote on certain structural changes. The board and the shareholders must act jointly to undertake actions such as amending the charter or approving a merger.

Shareholder agreements may provide for formal termination of the contract or revocation of an individual shareholders' agreement to its terms. Contractual silence on these points need not eliminate the potential for revocation. Thus in *Roam-Tel Partners*, the Chancery court held that, in a short-form merger, absent prejudice to the company, a stockholder could revoke his prior waiver of appraisal rights in a shareholder agreement so long as the revocation occurred within the statutory period prescribed for perfecting those rights. Roam-Tel Partners v. AT&T Mobility Wireless Holdings Operations, Inc., C.A. 5745-VCS, 2010 WL 5276991 (Del. Ch. Dec. 17, 2010).

177. *See, e.g.*, Blake D. Morant, *Law, Literature, and Contract: An Essay in Realism*, 4 MICH. J. OF RACE & L. 1, 10 (1998) (footnote omitted) (consent is "a mandatory requisite of any valid agreement"); Randy E. Barnett, *The Sound of Silence: Default Rules and Contractual Consent*, 78 VA. L. REV. 821 (1992) (describing importance of consent in contract theory and identifying circumstances under which parties may be understood to consent to contractual default rules); Orit Gan, *The Many Faces of Contractual Consent*, 65 DRAKE L. REV. 615, 616 (2017) ("The concept of consent lies at the heart of contract law.").

178. Atalese v. U.S. Legal Servs. Grp., L.P., 99 A.3d 306, 313 (N.J. 2014).

179. *See, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS § 69 CMT. A (AM. L. INST. 1981) ("Acceptance by silence is exceptional.").

180. *See, e.g.*, Badie v. Bank of Am., 79 Cal. Rptr. 2d 273, 280 (Ct. App. 1998); Discover Bank v. Shea, 827 A.2d 358, 361–63 (N.J. Super. Ct. Law. Div. 2001).

181. An alternative characterization is that "the corporation is not exclusively contractual but instead a mix of contract and property." Robert Anderson IV, *A Property Theory of Corporate Law*, 2020 COLUM. BUS. L. REV. 1, 102 (2020) (footnote omitted).

182. *See* Ciepley, *supra* note 171, at 141 (explaining that a corporation relates to outside parties "as an independent contracting individual, with property and liability wholly separate from its members"); *Id.* at 144 (identifying "asset lock-in, entity-shielding, and limited liability" as features that "preserv[e] the corporation as a separate contracting individual").

183. *Id.* at 141.

Corporate law, unlike contract law, is not susceptible to near-infinite customization.[184] Although many features of the relationship among a corporation's participants can be modified by contract, some cannot. A corporation must have a charter and bylaws. Unless it is a close corporation, it must be operated under the direction of a board of directors. It must have the power to issue stock, to amend its governing documents, to enter into mergers, and to dissolve.

The mechanics of corporate law also differ from those of contract law. Corporate law supplies default rules that govern the rights and responsibilities of corporate participants and specify whether those default rules can be modified and, if so, the required mechanism for doing so. Most corporation statutes, for example, explicitly provide that statutory amendments apply to existing corporations.[185] Statutes typically require the joint agreement of the board of directors and the shareholders to approve charter amendments and, in some cases, require the vote even of a class of shareholders that does not otherwise have voting rights to approve amendments that would adversely affect the rights of that class. Statutes typically provide default rules regarding the power to amend the bylaws and specify how a corporation can modify that default rule.[186]

Unlike contract law, corporate law explicitly addresses the rights of third parties—most importantly through the principle of limited liability, which provides entity-level treatment for corporate obligations in tort and contract. Limited liability means that corporate participants—including officers, directors, and shareholders—are not personally liable for the corporation's obligations to third parties such as tort victims. Other aspects of corporate law also affect third party interests such as statutory provisions that limit the conditions under which a corporation may pay dividends. Commentators increasingly argue that corporate law includes responsibilities to

184. *See, e.g.*, Merrill & Smith, *supra* note 173 (identifying this as a feature, the *numerus clausus* principle, that distinguishes property law from contract law).

185. *See* Nelson Ferebee Taylor, *Evolution of Corporate Combination Law: Policy Issues and Constitutional Questions*, 76 N.C. L. REV. 687, 724–30 (1998) (describing such provisions as standard). For example, DGCL section 394 reserves to the legislature the right to amend the statute and provides that such amendments shall be part of the charter of every corporation so long as they do not take away a remedy or liability that has "been previously incurred." DEL. CODE ANN. tit. 8, § 394 (2021).

186. *See, e.g.*, TEX. BUS. ORGS. CODE ANN. § 21.057(c) (West 2021) ("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 . . . ."); Boilermakers Local 154 Ret. Fund v. Chevron Corp., 73 A.3d 934, at 955–56 (Del. Ch. 2013) (describing the shareholders' power to amend the bylaws under Delaware law as "indefeasible" and "sacrosanct").

stakeholders such as employees, customers, and suppliers,[187] and a majority of states have adopted constituency statutes that explicitly authorize directors to consider stakeholder interests in making corporate decisions.[188]

Finally, corporate law operates under the principle of implied consent rather than explicit consent.[189] Shareholders invest in a corporation with the constructive knowledge of the rules of the game—the binding effect of the statute, charter, and bylaws.[190] They invest with the knowledge that those rules can be changed. By investing, they consent to changes that conform to the corporate law mechanisms for changing these rules, including the adoption of new statutes, and amendments to the charter and bylaws.[191]

This consent is necessarily implicit, but it is nonetheless binding. As then-Chancellor Strine explained in *Boilermakers*, shareholders cannot be heard to complain about the board's unilateral adoption of a bylaw pursuant to a charter that gives the board the power to amend the bylaws, even if the shareholder lacked knowledge of the relevant charter provision.[192] Bylaws are not like contracts; shareholders need not approve them to be bound. Strine explicitly distinguished the basis on which the shareholders were bound from traditional contract law, concluding that "the bylaws are not contractually invalid simply because the board-adopted bylaw lacks the contemporaneous assent of the stockholders."[193]

The role of implied consent highlights "the tension between corporate law principles—which generally impute to members of the corporation knowledge and acceptance of corporate bylaws—and the law of contracts,

187. *See, e.g.*, *Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans'*, BUS. ROUNDTABLE (Aug. 19, 2019), https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans [https://perma.cc/56YA-AFLK] (stating that corporations should be run for the benefit of all stakeholders—customers, employees, suppliers, communities, and shareholders).

188. Christopher Geczy, Jessica S. Jeffers, David K. Musto & Anne M. Tucker, *Institutional Investing When Shareholders Are Not Supreme*, 5 HARV. BUS. L. REV. 73, 95 (2015) (reporting that, as of publication date, thirty-three states had constituency statutes).

189. *See, e.g.*, Memorandum in Support of Motion to Dismiss of Proposed Intervenors California Public Employees' Retirement System and Colorado Public Employees' Retirement Ass'n, Doris Behr 2012 Irrevocable Tr. v. Johnson & Johnson at 22, 2021 WL 2722569 (D.N.J. May 31, 2019) (No. 19-cv-08828) (citation omitted) (explaining that corporate law does not involve the "mutual manifestation of assent" that is a required component of contract law).

190. *See, e.g.*, *Boilermakers*, 73 A.3d at 939–40 (reasoning that shareholders invested with constructive notice that state law and a company's "certificates of incorporation gave the boards the power to adopt and amend bylaws unilaterally" and that such bylaws "are binding on the stockholders").

191. *See* Verity Winship, *Shareholder Litigation by Contract*, 96 B.U. L. REV. 485, 497–498 (2016) ("Unlike in other contracting contexts, the rationale is not that shareholders have consented to the terms, but rather that they have consented to the corporate governance structure that gave rise to them.").

192. *Boilermakers*, 73 A.3d at 955.

193. *Id.* at 956 (footnote omitted).

which requires consent to be bound."[194] Implied consent is an efficient component of corporate law because it means both that shareholders implicitly consent to the authority delegated to the board of directors to make operational decisions and that shareholder decisions can be made by majority vote. Minority interests neither have the power to block a decision with which they disagree nor the right to exit the corporation as a result of that disagreement. Limitations on shareholders' veto and exit rights are a distinguishing feature of the corporate form and are critical to its capacity to organize large-scale businesses.[195] These features allow passive investors to finance corporations in a manner that would not be possible through formal multilateral contracts.

In sum, corporate law is not contract law. Moreover, the structure of corporate law is directly in tension with the proposition that corporate participants have unlimited freedom to customize the corporate form to their particularized needs. This proposition is not in tension with the contractual theory of corporate law in that corporate law creates specific instruments for customization, identifies how those instruments can be used, and sets out limits on the scope of their use. The use of shareholder agreements to extend customization beyond these limits is not justified by contract principles. In this next Part, the Article moves from corporate law theory to practice and considers the practical implications of stealth governance.

B. Problems with Stealth Governance

The preceding sections have described a scope of shareholder agreements far broader than suggested by the limited number of judicial decisions analyzing their validity. As Rauterberg and others have observed, the use of shareholder agreements in VC-funded startups is ubiquitous. Moreover, these agreements are not limited to future financing commitments and the allocation of cash flow rights but extend to quintessential governance matters such as inspection rights, appraisal rights, and control rights. In short, startups are using shareholder agreements to disrupt corporate governance.

194. Kirleis v. Dickie, McCamey & Chilcote, P.C., 560 F.3d 156, 162–163 (3d Cir. 2009).

195. *See, e.g.*, Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387, 388–95 (2003) (defining capital lock-in and the separation of ownership from control as the "features of corporations that made the corporate form so useful in the development of modern industrial economies").

But disruption is what startups are known for, and it is not necessarily problematic.[196] This subpart addresses the normative questions of whether shareholder agreements are a desirable tool for private ordering and, if not, why not. It identifies three key governance values sacrificed by the use of shareholder agreements: transparency, standardization, and oversight.[197]

As the title of this Article suggests, the first problem with shareholder agreements is their lack of transparency.[198] To the extent that shareholder agreements address governance issues, those issues would normally be addressed in the charter or bylaws and would be visible to the public or, at a minimum, the corporation's participants. Similarly, when shareholder agreements address control or voting rights, they modify the power dynamic set forth in the publicly available corporate charter. In contrast, shareholder agreements are typically only disclosed to their signatories, making them tools of stealth governance. Notably, the ownership, valuation, and governance structures of startup companies are already opaque. As private companies, startups raise capital without the disclosure requirements applicable to publicly traded corporations,[199] and the only information that is available to investors, regulators, and the general public is the information

196. *See* Elizabeth Pollman & Jordan M. Barry, *Regulatory Entrepreneurship*, 90 S. CALIF. L. REV. 383, 427 (2017) ("Culturally, startups often pride themselves on being disruptive and changing the world . . ..").

197. Notably, these governance values are independent of the substantive issue to which the shareholder agreement is addressed. Accordingly, this section does not consider the merits of particular governance features such as inspection rights or the limitations on shareholder power to remove directors. That shareholder agreements identify these features as candidates for private ordering may be evidence that corporate law should facilitate such private ordering but, as the next Part explains, that tailoring can and should be done through the charter or bylaws.

198. *See, e.g.*, Manti Holdings, LLC v. Authentix Acquisition Co., C.A. No. 354, 2020, 2021 Del. LEXIS 286, at *79 (Sept. 13, 2021) (Valihura, J., dissenting) (observing that "unlike charters, [shareholder agreements] are not public documents filed with the Secretary of State").

199. Exemptions also limit the information received by secondary investors and employees. Shareholders of private companies can freely resell their stock if they comply with the requirements of Rule 144. 17 C.F.R. § 230.144 (2020). Similarly, under Rule 701 startup employees who purchase stock typically do not receive any disclosure other than a copy of the compensation plan. Aran, *supra* note 85, at 892–95.

in the corporate charter[200] and on any Form Ds filed with the SEC.[201] Shareholder agreements exacerbate that opacity.

The result is problematic for several reasons. The rationale for requiring public filing of the corporate charter is to make certain basic information about the corporation available to both investors and third parties who deal with the corporation. Corporate charters therefore contain information on the corporation's key features including its legal purpose, its control dynamics, and its capital structure. One should be able to determine from the charter both what a corporation has the power to do and who can exercise that power. As Gabriel Rauterberg demonstrates, however, shareholder agreements may create substantial deviations from the terms set forth in the charter.[202] A major investor's capacity to monitor may be limited by an agreement to support director candidates chosen by another investor. An ownership structure that appears to involve shared power may be undermined by the contractual formation of a control group.

In addition, because investors cannot readily determine the rights and responsibilities of their fellow investors, they cannot determine who is responsible for making critical firm decisions.[203] The importance of this determination is heightened because a startup's complex capital structure creates "significant divergences in preferences among shareholders."[204] Although the board is "one of the key arenas in which conflicts are resolved and investments are protected,"[205] shareholder agreements can designate

200. As noted above, corporate charters are filed with the state and are publicly available. Bylaws are not. Concededly a substantial component of private ordering takes place through bylaw provisions. *See, e.g.*, Boilermakers Local 154 Ret. Fund v. Chevron Corp., 73 A.3d 934, 939 (Del. Ch. 2013) (upholding private ordering through board-adopted bylaw). Notably, however, statutes require a variety of private ordering provisions to be implemented through charter provisions, a requirement that has the effect of ensuring their transparency to both investors and third parties. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (2021) (requiring director exculpation provisions to be in the charter); § 122(17) (requiring corporate opportunity doctrine waivers to be in the charter or by action of the board of directors); MODEL BUSINESS CORP. ACT § 13.02(c) (AM. BAR ASS'N 2020) (requiring appraisal waivers to be in the charter). I have argued elsewhere that, in some cases, the charter may be a more appropriate tool for private ordering. *See* Fisch, *supra* note 20.

201. Any corporation that raises capital in a private placement pursuant to Regulation D must file a Form D with the Securities and Exchange Commission. *See* U.S. SEC. & EXCH. COMM'N, FORM D, NOTICE OF EXEMPT OFFERING OF SECURITIES, https://www.sec.gov/about/forms/formd.pdf [https://perma.cc/55JN-CCWW].

202. Rauterberg, *supra* note 10.

203. The importance to startups of vesting control in a visionary founder has been identified as a rationale for differential voting rights such as dual class stock. *See, e.g.*, Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560, 590 (2016) (defending dual-class stock structures as supporting ability of entrepreneurs to realize their idiosyncratic vision). The voting rights of each class of stock must be set forth in the charter. Yet shareholder agreements can cause control rights to differ from those disclosed in the charter.

204. Pollman, *supra* note 1, at 160. As Pollman notes, contract terms can create conflicts not just between common and preferred shareholders but between common shareholders. *Id.*

205. *Id.* at 183.

individual directors or grant investors the power to designate or remove directors irrespective of their stated voting rights. The opacity of shareholder agreements also prevents investors from identifying conflicts of interest and accurately ascertaining the risk associated with the company. As Gornall and Strebulaev demonstrate empirically, contractual rights that are "virtually invisible to employees under the current disclosure regime, have a dramatic influence on the value of the common stock."[206] Nonetheless, existing law does not require the disclosure of such rights if they are based on shareholder agreements.[207]

The value of transparency is not limited to protecting investors. It also protects the public by providing a level of oversight over a corporation and its practices. One explanation for problematic business practices among startups, including illegal and unethical practices, and even outright fraud, is the insulation provided by the absence of disclosure.[208] As Ann Lipton explains, transparency plays a role in "protecting both employees and surrounding communities from corporate antisocial activity."[209]

Shareholder agreements also sacrifice the standardization of corporate governance provisions. As noted above, there is limited case law on the validity of specific provisions in shareholder agreements.[210] Because they are not public, they do not provide similar network effects as charter and bylaw provisions which enable firms to see and copy each other's governance provisions and allow private ordering innovations to disseminate among firms.[211] These efforts are aided by judicial decisions such as *Boilermakers* and *ATP* which provide firms with clear guidance on the validity of such innovations.[212]

206. Aran, *supra* note 85, at 911–12 (citing William Gornall & Ilya A. Strebulaev, *Squaring Venture Capital Valuations with Reality*, 135 J. FIN. ECON. 120 (2020)).

207. Aran, *supra* note 85.

208. On the role of disclosure in policy private company fraud, see Elizabeth Pollman, *Private Company Lies*, 109 GEO. L.J. 353 (2020).

209. Ann M. Lipton, *Not Everything Is About Investors: The Case for Mandatory Stakeholder Disclosure*, 37 YALE J. ON REG. 499, 510 (2020).

210. Transcript at 27, Mathieson v. Digital Ocean, 2015 WL 4076395, (Del. Ch. Aug. 27, 2015) (No. 11185-VCP) (observing, in trying to assess the validity of a provision in a shareholder agreement waiving inspection rights, "what's holding me up on that issue to some regard, No. 1 is we don't have any case that quite deals with it squarely. We've had some that have recognized the principle, but then for some reason or another have held that it wasn't clear and affirmative or they have not found a waiver.").

211. *See, e.g.*, Smith et al., *supra* note 42, at 188 (explaining how private ordering through shareholder-adopted bylaws can "create laboratories of corporate governance that benefit the entire corporate governance system").

212. Romano & Sanga, *supra* note 44, at 32–33 (documenting diffusion of forum selection bylaws).

In contrast, the particularized governance provisions in shareholder agreements vary substantially, creating interpretive uncertainty. As the cases interpreting these provisions caution, their analysis must therefore be context specific, meaning that other corporate participants cannot readily rely on those decisions as to the validity of their own contracts. In addition to the complexity associated with their validity, shareholder agreements make it necessary to create, interpret, and integrate multiple documents to ascertain the scope of various corporate participants' rights and authority. As the National Venture Capital Association website demonstrates, it is common practice for a single corporation to use a number of different shareholder agreements, each of which addresses different elements of the shareholders' relationship with his or her fellow shareholders and the corporation.[213] Separate agreements may address voting issues, rights associated with share ownership including preemptive rights, redemption rights and registration rights, and rights and responsibilities in connection with a merger.

Drag-along rights, which are a common term in shareholder agreements, illustrate this lack of predictability. Drag-along rights compel shareholders, under specified conditions, to vote their stock in favor of a merger. Technically, a drag-along provision is a form of voting agreement, and voting agreements are explicitly authorized by most corporate statutes. But corporate law is increasingly looking to shareholder votes in mergers as an indication of transactional fairness and, in some cases, to reduce the level of judicial scrutiny.[214] In such cases, the approval of the transaction by minority stockholders can have the effect of cleansing the merger process. Such cases then raise the question whether shares voted pursuant to a drag-along have this same legal effect or, alternatively, in a corporation with a drag-along provision, whether this cleansing procedure is legally unavailable. Moreover, because the terms of drag-along provisions vary, it is not clear that all such provisions should be treated the same way. A drag-along that requires a process for determining fair price or the approval of disinterested directors, for example, might be evaluated differently from a provision that is simply triggered by votes cast by a controlling stockholder or group of stockholders.

213. NVCA, *supra* note 8.

214. *See, e.g.,* Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304, 312–13 (Del. 2015) (applying business judgment rule to postclosing challenge to transaction approved by a majority of the shareholders); Kahn v. M & F Worldwide Corp., 88 A.3d 635, 654 (Del. 2014) (applying business judgment rule to controlling stockholder freeze-out merger that was approved by special committee and fully informed uncoerced vote of minority stockholders).

The lack of standardization reduces the predictability of stealth governance provisions and increases their cost.[215] As property law scholars explain, standardization reduces transaction costs,[216] facilitates the conveyance of ownership interests,[217] and can operate as a tool of constraint, promoting ethical values and normative commitments.[218] In corporate law, predictability is particularly important, and commentators have observed that it is more important for business participants that the law be predictable than that it be correct.[219]

Lack of standardization also creates the potential for opportunism. VC funds and controlling stockholders may view legal uncertainty as a basis for overreaching, choosing to include aggressive provisions in shareholder agreements despite the absence of any legal authority, in the hope or expectation that the inclusion of these terms will deter counterparties from asserting their rights.[220] The potential for unequal bargaining power, coupled with the general obstacles to shareholder rights litigation in private companies, compounds this problem.[221] These factors may explain the

215. The values of standardization differ for startups relative to traditional close corporations both because of the number and type of investors and because the eventual goal of a startup is a market-based exit transaction such as an initial public offering or a merger. *See* Pollman, *supra* note 1, at 164 ("Unlike traditional closely held corporations, startups are aimed at eventually being acquired by another corporation or transforming to a public corporation—their existence in startup form is understood to be ephemeral like a caterpillar in its chrysalis.").

216. Merrill & Smith, *supra* note 173, at 8.

217. Henry Hansmann & Reinier Kraakman, *Property, Contract, and Verification: The* Numerus Clausus *Problem and the Divisibility of Rights*, 31 J. LEGAL STUD. 373 (2002).

218. Shyamkrishna Balganesh, *Codifying the Common Law of Property in India: Crystallization and Standardization as Strategies of Constraint*, 63 AM. J. COMPAR. L. 33, 76 (2015). *See also* Manuel A. Utset, *A Theory of Self-Control Problems and Incomplete Contracting: The Case of Shareholder Contracts*, 2003 UTAH L. REV. 1329, 1405–06 (arguing that corporate formalities can serve as important self-regulation mechanisms).

219. *See, e.g.*, Stephen J. Massey, *Chancellor Allen's Jurisprudence and the Theory of Corporate Law*, 17 DEL. J. CORP. L. 683, 688 (1992) (footnote omitted) (describing "the necessity that corporate law provide a sufficient level of stability and predictability to allow corporate planners to have a high level of confidence as to the law that courts will apply to their transactions"); Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 227 (1985) (explaining that efficient corporate law reduces the transaction costs of organizing and operating a business).

220. *See* James D. Cox, *Corporate Law and the Limits of Private Ordering*, 93 WASH. U. L. REV. 257, 269 (2015) (noting that those in control of a corporation "enjoy important, and likely unerodable, strategic advantages" in a system of private ordering). Aggressive efforts to limit shareholder rights through shareholder agreements may be similar to the aggressive use of contractual waivers in other instances of unequal bargaining power such as employer/employee and business/consumer. *See, e.g.*, Heather Bromfield, Comment, *The Denial of Relief: The Enforcement of Class Action Waivers in Arbitration Agreements*, 43 U. CAL. DAVIS L. REV. 315, 333 (2009) (footnote omitted) ("Lack of contractual mutuality runs rampant in situations of unequal bargaining power, such as consumer contracts and employee agreements.").

221. Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 1001 (2006) (describing the potential reputational costs of litigating against VCs,

widespread use of certain provisions in shareholder agreements despite their uncertain legal status.

Shareholder agreements also frustrate standardization in the treatment of individual shareholders.[222] Although corporate law does not mandate that all shareholders be treated equally in all circumstances,[223] that corporations should generally provide equal treatment of shareholders with the same economic interest is a foundational principle of corporate law.[224] Unlike a charter or bylaw provision, however, a shareholder agreement may cause shareholders with the same economic interest to have different rights.[225] For example, not every shareholder is a signatory to every shareholder agreement. If shareholder agreements are governed by contract law, only signatories to that agreement are bound.

Nor do shareholder agreements need to provide all shareholders, even shareholders holding the same class of stock, with equal rights. Substantial shareholders and those with significant bargaining power typically contract for rights that are not shared by other shareholders rights that may include detailed inspection rights, the opportunity to observe board meetings or participate in operational decisions, or rights with respect to the sale or liquidity of their shares.[226] By contrast, small shareholders may be forced to give up significant rights in order to invest. Some of these shareholders may lack the sophistication to understand the implications of the contracts that they are forced to sign or be unaware of the terms of those contracts.

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including future limits on the ability to obtain funding from VCs or work at a VC-funded firm). *Cf.* Jeffrey M. Leavitt, *Burned Angels: The Coming Wave of Minority Shareholder Oppression Claims in Venture Capital Start-up Companies*, 6 N.C. J.L. & TECH. 223, 228 (2005) (predicting future wave of litigation by "burned" angel investors, but observing that filed cases were limited and none survived pre-trial settlement).

222. Shareholders may also differ in their ability to enforce a shareholder agreement, depending on whether they are a party to it. *See, e.g.*, Pinto Tech. Ventures, L.P. v. Sheldon, 526 S.W.3d 428, 443–44 (Tex. Sup. 2017) (refusing to allow enforcement of forum selection provision in shareholders' agreement by nonsignatories).

223. *See, e.g.*, Roger J. Dennis, *Two-Tiered Tender Offers and Greenmail: Is New Legislation Needed?*, 19 GA. L. REV. 281, 307 (1985) (observing that "[t]here is no requirement of equal treatment in negotiated share repurchases").

224. *See, e.g.*, Victor Brudney, *Equal Treatment of Shareholders in Corporate Distributions and Reorganizations*, 71 CAL. L. REV. 1072, 1074 (1983) (terming the proposition of equal treatment of shareholders as "part of the received learning about publicly held corporations"); *see also Dual-Class Stock*, COUNCIL OF INSTITUTIONAL INVS., https://www.cii.org/dualclass_stock [https://perma.cc/277G-WZ6W] ("CII's policies endorse the principle of 'one share, one vote': every share of a public company's common stock should have equal voting rights.").

225. *See, e.g.*, Henry v. Phixios Holdings, Inc., C.A. No. 12504, 2017 WL 2928034 (Del. Ch. July 10, 2017) (finding that shareholder was not bound by a shareholder agreement when he acquired stock without knowledge of transfer restrictions contained in that agreement).

226. *See, e.g.*, Cox, *supra* note 220, at 269 (observing that the board, officers and controlling stockholders "enjoy important, and likely unerodable, strategic advantages" in a system of private ordering).

Employees who receive stock or options as a substantial component of their compensation are likely to be particularly vulnerable.

Moreover, even those shareholders who sign a shareholder agreement may not all be bound. Startups involve a range of investors. There are substantial differences in the knowledge, sophistication, and bargaining power of a venture capital fund, a sovereign wealth fund, and a former employee—yet all may be shareholders. If the validity of a shareholder's consent to a waiver of his or her rights requires that the consent be knowing, voluntary, and uncoerced, a court's analysis of consent may depend on individual circumstances. For example, a shareholder agreement between a VC fund and the entrepreneur that purports to waive certain shareholder rights might be enforced while the same provision in an employment agreement or option agreement over which a prospective shareholder has limited bargaining power may not. At oral argument of a motion to dismiss in *Matheson v. Digital Ocean*,[227] VC Parsons expressed some concern about the validity of such a contractual waiver of shareholder rights in an employee stock option agreement. Describing the agreement as potentially a contract of adhesion, VC Parsons questioned whether the employee's assent to the terms of that agreement constituted a knowing and voluntary waiver of his statutory rights.[228] Similarly, the Delaware Supreme Court in *Manti* expressly conditioned its holding that the shareholder agreement was enforceable on the fact that the petitioners were "sophisticated and informed investors."[229]

Finally, shareholder agreements may limit shareholders' ability to exercise oversight. The governance rights that startups seek to eliminate through shareholder agreements—inspection rights, appraisal rights, and the right to bring fiduciary duty litigation—are specifically designed to enhance the ability of minority shareholders to oversee corporate operations. As noted above, exemptions from federal disclosure requirements insulate startups from both investor and regulatory oversight. Whether the extent of that insulation is efficient or not, shareholder rights partially fill the gap by affording shareholders both some level of access to corporate information and the potential to hold managers, directors, and controlling shareholders accountable.

227. Matheson v. Digital Ocean, Inc., C.A. No. 11185-VCP (Aug. 27, 2015) (on file with author).

228. *See id.*, Transcript at 29 ("I don't know where on that spectrum it is, and it seems conceivable to me that it might make a difference in the enforceability of this waiver.").

229. *See* Manti Holdings, LLC v. Authentix Acquisition Co., C.A. No. 354, 2020, 2021 Del. LEXIS 286, at *46 (Sept. 13, 2021) (noting that "if Authentix attempted to enforce the Refrain Obligation against a retail investor that was not involved in negotiating the Stockholders Agreement—or against outsiders that lack material knowledge of Authentix's corporate governance dynamics—concerns about information asymmetry might justify excusing enforcement").

Moreover, these waivers are most likely to limit the rights of small investors—current and former employees and those to whom they transfer their shares—investors who otherwise lack the ability to exercise any kind of oversight. Daniel Grove, the plaintiff in *Juul Inc. v. Grove*, for example, was a former employee who received his stock pursuant to an employee stock option plan.[230] Grove sought to exercise his inspection rights in order to obtain information in connection with his pursuit of litigation against Juul's directors alleging various breaches of fiduciary duty.[231] Given the importance of statutory inspection rights in enabling a plaintiff to overcome the procedural barriers to such litigation, a valid inspection rights waiver would substantially undermine Grove's ability to exercise such oversight.[232]

IV. IMPLICATIONS

In addition to these problems discussed in Part III, stealth governance creates an illogical disparity between the corporate law that applies to startups and that which applies to publicly traded corporations. Public corporations cannot readily use shareholder agreements for private ordering.[233] Unlike startups then, they cannot evade statutory limits on the permissible scope of private ordering available through the charter and bylaws. Similarly, they cannot modify the voting rights and control dynamics associated with their share class structure or afford differential rights to similarly situated shareholders.

There is a public value in having a single version of corporate law apply to all corporations—public and private. The need for managerial accountability, the mechanisms for addressing shareholder collective action problems, concerns about conflicts of interest, and the challenges of ensuring that shareholders enter and exit the business on fair terms, are not categorically different depending on whether a corporation's securities are

230. Hailey Konnath, *Juul Says Investor Waived His Right to Inspect Its Books*, LAW360, Jan. 9, 2020.

231. Complaint at 27, Grove v. Bowen, No. CGC-20-582059 (Cal. Super. Ct. filed Jan. 7, 2020), https://www.bloomberglaw.com/product/blaw/document/X2DHAOPV58K9EU98UFDA50UR7DJ/download?fmt=pdf.

232. *See, e.g.*, Alejandro E. Moreno & Kristin P. Housh, *Delaware Supreme Court Provides Important Guidance Regarding Section 220 Demands, Rejecting Several Limiting Principles Frequently Offered by Corporations Resisting Stockholder Inspection Demands*, NAT'L L. REV.: SHEPPARDMULLIN CORP. & SEC. LAW BLOG (Dec. 23, 2020), https://www.natlawreview.com/printpdf/143110 [https://perma.cc/9T9B-8GFB] ("By stressing the importance of stockholder inspection rights in instances of alleged corporate wrongdoing, the Delaware courts are channeling putative stockholder plaintiffs through this process before those plaintiffs initiate a potentially meritless derivative suit to the detriment of the corporation in whose benefit the derivative action is allegedly brought.").

233. Public trading, by its nature, makes it impossible for all shareholders to be signatories to a shareholder agreement and therefore bound by its terms.

traded in the public capital markets. The value of a single body of corporate law is increased by the freedom that business entities possess to choose a more contract-based alternative legal structure such as a statutory close corporation or LLC. To the extent that an entity has chosen corporate law, its choice should reflect a willingness to be bound by the rules of the corporate form, including its mandatory features.

If anything, the poor quality of startup governance suggests that private companies should be given less flexibility than public corporations to depart from the structure and formalities of general corporate law. Shielding venture capital funds and idiosyncratic founders, who are already shielded from capital market discipline, from internal monitoring by other investors contributes to their ability to prolong their adolescent behavior until they decide to enter the public capital markets.[234]

The way to maintain a single version of corporate law is to require that all corporations, public and private, play by the same rules. Private ordering should take place through a corporation's constitutive documents, the charter and bylaws, and those documents should be subject in scope to the statutory and common law on the permissible scope of private ordering.[235] This approach would reinforce the corporation's status as an independent legal entity that operates not by means of multilateral contracts but according to a set of legal principles that include both substantive rules and the procedures by which those rules are tailored or modified.

This is not to suggest that all shareholder agreements in the startup context or otherwise should be invalid. The VC-funded startup is largely a creature of contract, and shareholder agreements play a valuable rule in tailoring cash flow and control rights and facilitating a flexible financing structure. Where this Article weighs in is with respect to shareholder agreements that go further and address governance issues—those rights or powers that are typically addressed in corporate charters or bylaws or where

234. *See* Jones, *supra* note 15, at 167–68 (footnote omitted) ("[I]n the absence of an impending IPO, Unicorn managers and investors lack sufficient incentives to develop governance structures and practices appropriate for enterprises of their scale."); David F. Larcker & Brian Tayan, *Governance Gone Wild: Epic Misbehavior at Uber Technologies* (Rock Ctr. for Corp. Governance at Stanford Univ., Closer Look Series: Topics, Issues and Controversies in Corp. Governance, No. CGRP-70; Stanford Univ. Graduate Sch. of Bus. Rsch., Research Paper No. 18-3, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3087371 [https://perma.cc/3S5L-BTMG] (describing governance failures at Uber prior to its IPO).

235. While this Article was in the editorial process, Justice Valihura articulated a similar analysis in her dissent in *Manti*. Manti Holdings, LLC v. Authentix Acquisition Co., C.A. No. 354, 2020, 2021 Del. LEXIS 286, at *79 (Sept. 13, 2021) (Valihura, J., dissenting) (arguing that private ordering provisions that alter the "delicate balance of power . . . among a Delaware corporation's constituencies" belong "in the charter or bylaws").

the shareholder agreement expressly deviates from the governance structure set forth in the corporation's constitutive documents.

Existing statutes provide ample guidance on the distinction. Statutes provide default rules with respect to matters such as the selection and removal of directors, the allocation of shareholder and director voting rights, and the scope of inspection and appraisal rights. Statutes also provide explicit guidance for modifying both default rules and common law rights and liabilities, including the permissible instruments for doing so and the limits, if any, on the scope of such modifications. Using shareholder agreements instead of these instruments, particularly to evade such statutory limits, should not be allowed. In contrast, the charter and bylaws typically do not address how and when investors pay for stock, commitments to provide additional capital, or individual rights against the corporate entity such as the right to compel registration.

The scope of this proposal is limited to startups, and this Article does not propose to apply this standard to traditional close corporations. As the legislative provisions concerning such entities reflect, close corporations operate quite differently from other corporations. Indeed, the premise behind close corporation statutes is both to recognize that difference and to afford close corporations the option of being governed by a different set of rules than those applicable to other corporations.[236]

The Article's proposed limitation on stealth governance should not be understood as a condemnation of innovative corporate governance by startups. Corporations have identified new solutions to market and legal developments and tailored those solutions to their individual needs through private ordering. Situating private ordering within the corporation's constitutive documents rather than in shareholder agreements, however, provides three advantages over stealth governance.

First, the proposal restores the legislative and judicial roles in determining the permissible scope of private ordering. The debate over the extent to which corporate law should incorporate mandatory features as opposed to being subject to complete freedom of contract is beyond the scope of this Article. Assuming, however, that some constraints on private ordering are desirable as a matter of efficiency or public policy, courts and

236. The question of whether a close corporation should be compelled to register under state close corporation statutes in order to use shareholder agreements more expansively is beyond the scope of this Article. Only a small percentage of the corporations that are eligible for statutory close corporation status choose to register under these statutes. *See, e.g.*, Tara J. Wortman, Note, *Unlocking Lock-in: Limited Liability Companies and the Key to Underutilization of Close Corporation Statutes*, 70 N.Y.U. L. REV. 1362, 1362 (1995) (estimating that only five percent of eligible firms elect statutory close corporation status); *id.* at 1365 (examining "the possible reasons for the systematic underutilization of close corporation statutes by firms eligible for that status").

legislatures, not individual corporations, should determine the scope of those constraints.

Second, the proposal allows lawmakers to determine the appropriate mechanism by which private ordering is to be implemented. In particular, the proposal recognizes the substantial differences between the charter and the bylaws as governance instruments. As noted above, the greater visibility of charter provisions—particularly in private corporations—enhances the transparency of private ordering, enabling investors, scholars, regulators, and those who deal with the corporation to understand and evaluate its governance structure. This visibility creates network externalities and fosters standardization. In addition, as I have argued elsewhere, charter provisions require bilateral action by the board and the shareholders, and this requirement offers greater protection against potential self-dealing.[237]

Finally, by requiring private ordering to take place through charter and bylaw provisions, which can be implemented by public corporations as well as startups, this Article's proposal would allow all corporations to benefit from innovation.[238] The extension of new governance provisions to public companies allows their effects to be broadly evaluated. Commentators can analyze the policy implications of a bylaw that purports to limit the scope of managerial fiduciary duties.[239] The capital markets can price the impact of a forum selection bylaw. These benefits lower transaction costs and increase the likely efficiency of firm specific private ordering.

Significantly, when they engage in private ordering, corporate participants need not limit themselves to the status quo. This Article's proposal enables private ordering innovation through a tripartite process. In the first instance, corporate participants identify a potentially beneficial issue that can potentially be addressed through firm specific private ordering. To the extent they believe that the innovation is permitted under existing law, they can implement it through a charter or bylaw provision. To the extent that they believe existing law does not currently permit the provision, they can seek legislation. If a corporation implements a new type of charter or bylaw provision and that provision is subsequently challenged, courts can evaluate the degree to which it is in tension with the statute and public policy. Judicial approval of the provision is likely to lead to broader

237. Fisch, *supra* note 20.

238. As noted above, corporate charter and bylaw provisions "are available for the public to inspect while the shareholder agreement is typically private, shared only by the parties involved." *Articles of Incorporation and Shareholder Agreements: What's the Difference?*, LEGAL NATURE, https://www.legalnature.com/guides/articles-of-incorporation-and-shareholder-agreements-whats-the-difference [https://perma.cc/HR5W-MUDV].

239. *See* Rauterberg & Talley, *supra* note 47.

adoption, but even then, the provision will be subject to the discipline of market forces, and some innovative provisions will not be successful.[240] Finally, state legislatures can evaluate the courts' analysis and ratify or overturn the courts' conclusions by statute.

Formal legislative action operates as a safety valve with respect to this process. State legislatures can evaluate the policy rationale for taking a mandatory versus enabling approach. From a comparative institutional perspective, they are particularly well-suited to engage in this analysis.[241] Legislatures can readily access the information necessary to determine the potential costs and benefits of innovation.[242] Unlike courts, legislatures control their agendas and need not wait for litigation to evaluate the validity of a provision. Finally, legislatures can assess the interests of those likely to be affected by an opt-out or waiver, interests that may not be represented in the litigation context. As a result, they can identify the private ordering approach most protective of those interests. For example, the legislature might determine that corporations should be allowed to limit director liability for breaches of the duty of care through private ordering, but that the risk that directors will act out of self-interest if permitted to adopt such limitations unilaterally means that they should be limited to charter provisions that require shareholder approval.[243]

Corporate law contains numerous examples of this process in action. Corporations adopted innovative charter and bylaw forum selection provisions in response to the explosion in multi-forum litigation challenging mergers. The validity of these provisions was uncertain until the Delaware court's *Boilermakers* decision, after which their adoption increased dramatically.[244] The Delaware legislature subsequently endorsed forum

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240. *See, e.g.*, 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, 695 (2016) (detailing the power of both Institutional Shareholder Services and the Wachtell Lipton law firm in influencing firm behavior with respect to the adoption of an innovative corporate governance bylaw).

241. *See generally* Neil K. Komesar, IMPERFECT ALTERNATIVES: CHOOSING INSTITUTIONS IN LAW, ECONOMICS, AND PUBLIC POLICY (1994) (developing analysis of comparative institutional advantage).

242. Roberta Romano explains, for example, the variety of legislative responses in the late 1980s to the crisis in the market for D&O insurance as "an excellent case study of the successful operation of federalism as a laboratory for legal reform." Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 YALE J. ON REG. 209, 221 (2006). *See also* Edward P. Welch & Robert S. Saunders, *Freedom and Its Limits in the Delaware Corporation Law*, 33 DEL. J. CORP. L. 845, 854 (2008) (describing Delaware legislature's adoption of section 102(b)(7) in response to the D&O insurance crisis).

243. This analysis likely explains the structure of DGCL section 102(b)(7), which permits director exculpation provisions but requires that they be in the corporate charter. DEL. CODE ANN. tit. 8, § 102(b)(7) (2021).

244. *See* Romano & Sanga, *supra* note 44 (documenting the spread of forum selection provisions after the *Boilermakers* decision).

selection provisions and provided clarification as to their permissible scope.[245]

The corporate opportunity doctrine is a component of the common law duty of loyalty.[246] Courts adopted various tests to determine when the doctrine had been breached, and the variety and complexity of the tests led the doctrine to become "unpredictable and over complicated."[247] To reduce possible corporate opportunity doctrine litigation, Tri-Star Pictures amended its charter to limit the liability of its directors for potential breaches. The court in *Siegman v. Tri-Star Pictures, Inc.* held that, because the charter provision was potentially invalid in that it conflicted with the duty of loyalty, a mandatory corporate law rule.[248] The Delaware legislature responded by adopting DGCL section 122(17), which authorizes corporations to adopt corporate opportunity doctrine waivers in their charters.[249] The legislation responded to a broad-based market demand and, subsequent to its enactment, corporations broadly adopted such waivers.[250] Many states followed Delaware's lead and adopted similar legislation.[251] Moreover, at least one empirical study has found market reactions to the adoption of such waivers to be favorable.[252]

Finally, as institutional investors became more active in corporate governance, they sought ways to overcome collective action problems and increase shareholder access to the corporate proxy machinery. One of the tools for doing so was proxy reimbursement bylaws—bylaws that entitled

245. *See* Fisch, *supra* note 6, at 1669–71 (describing legislation authorizing forum selection charter and bylaw provisions).

246. Eric Talley & Mira Hashmall, The Corporate Opportunity Doctrine (Feb. 2001) (unpublished manuscript), https://weblaw.usc.edu/why/academics/cle/icc/assets/docs/ articles/iccfinal.pdf [https://perma.cc/983C-FUAY].

247. Martha M. Effinger, Comment, *A New Corporate Statute: Adding Explicit Procedures to Maryland's Corporate Opportunity Waiver Provision*, 48 U. BALT. L. REV. 293, 300 (2019).

248. Siegman v. Tri-Star Pictures, Inc., C.A. No. 9477, 1989 Del. Ch. LEXIS 56, at *26 (May 5, 1989) ("Thus, at least one scenario (and perhaps others) could plausibly be constructed where Article Sixth would eliminate or limit the liability of Tri-Star directors for breach of their fiduciary duty of loyalty—a result proscribed by § 102(b)(7).").

249. DEL. CODE ANN. tit. 8, § 122(17). The statute also authorizes such waivers "by action of [the] board of directors." *Id.*

250. *See* Rauterberg & Talley, *supra* note 47, at 1079 (stating that "hundreds of public corporations in our sample—and well over one thousand in the population—have disclosed or executed waivers").

251. *See* Effinger, *supra* note 247, at 305 ("[M]any states have followed by adopting corporate opportunity waivers."). Notably, not every state's approach is identical to Delaware's. For example, Georgia allows corporate opportunity doctrine waivers in both the charter and the bylaws. *See* GA. CODE ANN. § 14-2-870 (2021).

252. Rauterberg & Talley, *supra* note 47, at 1081 (reporting results of an event study finding that "market reactions [to the adoption of a waiver] appear to be favorable, resulting in an average positive abnormal stock return hovering around one percent in the days immediately surrounding the announcement date").

shareholders to reimbursement of their expenses in conducting a proxy contest if the context was successful. In *CA, Inc. v. AFSCME Employees Pension Plan*, the Delaware Supreme Court struck down a proxy reimbursement bylaw on the basis that it interfered with the board's statutory authority to determine how corporate money should be spent.[253] The legislature overturned the decision, adopting a statutory provision that explicitly authorized proxy reimbursement bylaws.[254]

These examples suggest that requiring corporations to use their charters and bylaws to implement private ordering will not stifle innovation. To the contrary, the use of formal governance tools facilitates the transparency of governance innovation, leads to clarification of the law, and permits the spread of provisions that have the potential to enhance corporate value. Channeling innovation through charter and bylaw provisions, provisions that can be adopted by public companies and whose validity can be clarified through litigation and legislation, has led to their widespread use. At the same time, waivers and innovations that have been implemented through shareholder agreements—such as appraisal waivers and limits on shareholder inspection rights—have not been standardized and remain of uncertain validity.

CONCLUSION

This Article has explored the role of stealth governance—the use by startups of shareholder agreements as substitutes for the corporate charter and bylaws in adopting firm-specific private ordering. It has argued that the expansive use of shareholder agreements is premised on confusion between the contract law and corporate law paradigms and that allowing corporate participants to evade existing limitations on the scope and structure of private ordering sacrifices important corporate law values.

As the number and size of private companies continue to grow, stealth governance raises increasing concerns. Because private companies are not subject to federally mandated disclosure requirements or capital market discipline, they are particularly vulnerable to poor corporate governance practices that reduce the accountability of officers, directors and controlling shareholders and potentially sacrifice the interests of minority shareholders and other stakeholders. The opacity and uncertainty associated with shareholder agreements increase this potential. Stealth governance also

253. CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 239–40 (Del. 2008).

254. DEL. CODE ANN. tit. 8, § 113 (2021). *See* Jill E. Fisch, *Leave It to Delaware: Why Congress Should Stay Out of Corporate Governance*, 37 DEL. J. CORP. L. 731, 763 (2013) (describing legislation authorizing both proxy reimbursement and proxy access bylaws).

frustrates innovation by limiting the standardization and dispersion of new governance terms, impeding the market's ability to evaluate them, and frustrating the growth of judicial precedent.

This Article therefore argues against applying principles of freedom of contract to uphold and enforce stealth governance. Instead, it proposes that private ordering should be limited to a corporation's traditional constitutive instruments—the charter and bylaws. It highlights the superiority of these instruments in providing both predictability and a mechanism for continued evolution of governance norms.

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