

## **The Emerging Role of Bylaws in Corporate Governance**

The Honorable Henry duPont Ridgely, Justice, Supreme Court of Delaware\*

Essay

### *Introduction*

It is a pleasure for me to be with you today at SMU's Corporate Counsel Symposium. I bring you greetings on behalf of Chief Justice Leo Strine and on behalf of the entire Delaware Supreme Court. I also want to thank Professor Steinberg and the SMU Law Review for inviting me back to speak.

Today my topic is about the emerging role and use of bylaws as a tool for corporate governance. I will start by touching upon the historical origins of organizational bylaws and their limits. Then I will talk about the framework and case law governing bylaws in Delaware, three recent decisions involving the facial validity of corporate bylaws—the Delaware Court of Chancery's decisions in *Boilermakers Local 154 Retirement Fund v. Chevron Corp.* and *City of Providence v. First Citizens Bancshares, Inc.*, as well as the Delaware Supreme Court's

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opinion in *ATP Tour, Inc. v. Deutscher Tennis Bund*. And finally, I will provide my view on the questions you should ask on the road ahead before adopting any of the more controversial bylaws being discussed after these cases. Before I begin, I need to say that the views I give you are my own and do not necessarily reflect the views of my colleagues or the Delaware Supreme Court.

### *Historical Background*

Throughout history, organizations have been created to continue beyond the life of one person. These organizations were often groups of skilled labors or guilds, English municipalities, and businesses, which have become the modern corporation. In each organization, there needed to be rules defining the organization's membership, purpose, and means of selecting its leaders. Out of this need grew the need to create and adopt bylaws.

The use of bylaws in an organization can be traced to ancient Rome.<sup>2</sup> One Roman statute from the 5<sup>th</sup> century B.C.E. provided that “guild members shall have the power . . . to make for themselves any rule that they may wish provided that they impair no part of the public law.”<sup>3</sup> Just as today, ancient Roman professional guilds, veterans' organizations, and social clubs needed rules to establish who could join and how the organization would function.

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<sup>2</sup> See Mary Sarah Bilder, *The Corporate Origins of Judicial Review*, 116 YALE L.J. 502, 515 n.51 (2006) (discussing the Twelve Tables in Roman Law and other ancient Roman statutes).

<sup>3</sup> The Twelve Tables VIII.27 (c. 450 B.C.E.), in *Ancient Roman Statutes* 12.

In medieval England, “[c]orporations were a particular type of delegated jurisdiction within the ‘King’s exclusive prerogative.’”<sup>4</sup> These often included “municipal corporations . . . , ecclesiastical bodies, universities and colleges, guilds and fraternities, and livery and trading companies.”<sup>5</sup> During this time and into the sixteenth and early seventeenth centuries, the ability to issue bylaws was considered to be part of a corporation’s inherent power.<sup>6</sup>

The power to create and pass bylaws was never considered to be limitless. In 1388, King Richard II required guilds and fraternities to have written rules and ordinances, which had to be delivered to the Mayor of London for approval.<sup>7</sup> And later, citizens complained to King Henry VI that guilds, fraternities, and other “companies incorporate” had enacted “unlawful and unreasonable ordinances” which were contrary to the King’s prerogative and in violation of the common law.<sup>8</sup> This ultimately resulted in an Act of Parliament prohibiting the “unlawful orders made by masters of guilds, fraternities, and other companies” and

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<sup>4</sup> Builder, *supra* note 2, at 516 (quoting Janet McLean, *The Transnational Corporation in History: Lessons for Today?*, 79 IND. L.J. 363, 364 (2004)).

<sup>5</sup> *Id.*

<sup>6</sup> *Id.* at 517–18.

<sup>7</sup> *Id.* at 520.

<sup>8</sup> *Id.* (quoting, ENGLISH GILDS : THE ORIGINAL ORDINANCES OF MORE THAN ONE HUNDRED EARLY ENGLISH GILDS : TOGETHER WITH THE OLDE USAGES OF THE CITE OF WYNCHESTRE; THE ORDINANCES OF WORCESTER; THE OFFICE OF THE MAYOR OF BRISTOL; AND THE COSTOMARY OF THE MANOR OF TETTENHALL-REGIS : FROM MANUSCRIPTS OF THE FOURTEENTH AND FIFTEENTH CENTURIES 23, 30, 39 (Smith, Joshua Toulmin ed., 1870)).

invalidating any ordinance in derision or diminution of the King’s franchise or “against the common profit to the people.”<sup>9</sup>

In the late-sixteenth century, English common law courts issued a number of rulings finding that corporate bylaws could not be repugnant to the “Laws of the Nation.”<sup>10</sup> And later, Sir William Blackstone noted in his *Commentaries on the Laws of England* that “in the very act of incorporation” corporations have the power “[t]o make by-laws or private statutes for the better government of the corporation; which are binding upon themselves, unless contrary to the laws of the land.”<sup>11</sup>

As this early corporate history demonstrates, bylaws have long been needed to govern the manner in which an organization operates. But these rules could not violate the law or impair public policy.

### *Modern Bylaws*

The requirement that an organization’s rules and bylaws comply with the law and policy of its state of incorporation continues to this day. Section 109(b) of the DGCL, which deals generally with bylaws and what they must or may contain, provides that:

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<sup>9</sup> A Restraint of Unlawful Orders Made by Masters of Guilds, Fraternities, and Other Companies, 1437, 15 Hen. 6, c. 6, in 3 STATUTES AT LARGE 215, 215–16 (Danby Pickering ed., 1762).

<sup>10</sup> Builder, *supra* note 2, at 526.

<sup>11</sup> 1 BLACKSTONE, *Commentaries* 463.

The bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees.<sup>12</sup>

The Delaware Supreme Court explained in *CA, Inc. v. AFSCME* that “[i]t is well-established Delaware law that a proper function of bylaws is not to mandate how the board should decide specific substantive business decisions, but rather, to define the process and procedures by which those decisions are made.”<sup>13</sup> By way of example, “[DGCL Section] 141(b) authorizes bylaws that fix the number of directors on the board, the number of directors required for a quorum (with certain limitations), and the vote requirements for board action. [DGCL Section] 141(f) authorizes bylaws that preclude board action without a meeting.”<sup>14</sup> Additionally, DGCL Section 141(b) expressly allows a corporation’s bylaws to provide for reasonable qualifications for directors to serve as board members.<sup>15</sup>

### *Bylaws as Contracts*

In *Airgas, Inc. v. Air Products & Chemicals, Inc.*, the Delaware Supreme Court reiterated that modern bylaws are “contracts among a corporation’s

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<sup>12</sup> See 8 *Del. C.* § 109(b); *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227, 233 (Del. 2008).

<sup>13</sup> *CA, Inc.*, 953 A.2d at 234–35.

<sup>14</sup> *Id.* at 235.

<sup>15</sup> 8 *Del. C.* § 141(b) (“The certificate of incorporation or bylaws may prescribe other qualifications for directors.”).

shareholders.”<sup>16</sup> Therefore, “the general rules of contract interpretation are held to apply.”<sup>17</sup> That means that the rules that “govern the construction of statutes, contracts and other written instruments” are used to construe bylaw provisions and determine “the meaning of charters and grants of corporate powers and privileges.”<sup>18</sup> And so long as the language is not ambiguous, the meaning of a bylaw provision will be determined solely according to the plain language used.<sup>19</sup>

### *The Bylaw Adoption Process*

The DGCL specifically allows for corporations to add to, and amend, their bylaws. Section 109(a) endows stockholders entitled to vote with “the power to adopt, amend or repeal bylaws.”<sup>20</sup> But this same provision also allows corporations to give the board of directors the power to add and amend the bylaws.<sup>21</sup>

The directors’ authority to adopt, amend, or repeal the company’s bylaws, however, does not restrict the stockholders’ ability to change the bylaws. Section 109(a) specifically provides: “The fact that such power has been so conferred upon the directors or governing body [to modify the bylaws] . . . shall not divest the stockholders or members of the power, nor limit their power to adopt, amend or

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<sup>16</sup> *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)).

<sup>17</sup> *Centaur Partners, IV v. Nat’l Intergroup, Inc.*, 582 A.2d 923, 928 (Del. 1990)

<sup>18</sup> *Lawson v. Household Fin. Corp.*, 17 Del. Ch. 343, 348, 152 A. 723, 726 (1930)

<sup>19</sup> *Harrah’s Entm’t, Inc. v. JCC Holding Co.*, 802 A.2d 294, 309 (Del. Ch. 2002).

<sup>20</sup> 8 Del. C. § 109(a).

<sup>21</sup> *Id.*

repeal bylaws.”<sup>22</sup> This means that the stockholders may repeal or amend bylaws that the directors adopted. Stockholders may also adopt bylaws of their own to aid in the governance of a corporation. Correlative with this, stockholders may vote or not vote for directors who adopt, amend, or repeal bylaws.

For public companies, a shareholder vote to approve a bylaw requires proxy access. Many Delaware corporations also have advance-notice bylaw provisions, which require “advance notice of various shareholder propositions be provided to a public company, including the nomination of directors.”<sup>23</sup> But for the corporation and shareholders alike, the proxy process can be complex and involve the U.S. Securities and Exchange Commission.

In *CA, Inc. v. AFSCME Employees Pension Plan*, the SEC certified a question of law to the Delaware Supreme Court arising from a shareholder effort to enact a bylaw proposal that would require that CA reimburse shareholders for all reasonable expenses incurred in a proxy challenge to management’s slate of directors, so long as at least one nominee from the dissident slate won.<sup>24</sup> Ultimately, the Court held that the shareholder proposal was a proper subject but

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<sup>22</sup> *Id.*

<sup>23</sup> Paul D. Davis & Stephen Gentner, *Advance Notice By-Laws – A Tool to Prevent a Stealth Proxy Contest or Ambush*, MCMILLAN (March 2012), <http://www.mcmillan.ca/advance-notice-by-laws--a-tool-to-prevent-a-stealth-proxy-contest-or-ambush>.

<sup>24</sup> *CA, Inc.* 953 A.2d at 229–31. In its filings with the SEC, CA argued that the AFSCME’s bylaws violated Delaware law, which AFSCME disputed. Because this was a unique question of Delaware law, the SEC presented a certified question to the Delaware Supreme Court.

invalid under Delaware law because “[t]he Bylaw mandate[d] reimbursement of election expenses in circumstances that a proper application of fiduciary principles could preclude.”<sup>25</sup>

### *Public Policy Limitations*

The DGCL stipulates that “bylaws may contain any provision, not *inconsistent with* law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees.”<sup>26</sup> If a bylaw provision conflicts with a provision of a corporation’s charter, then the bylaw provision is a “nullity.”<sup>27</sup>

The same is true if a bylaw provision violates Delaware law. For example, stockholders “may not directly manage the business and affairs of the corporation, at least without specific authorization in either the statute or the certificate of incorporation.”<sup>28</sup> As we explained in *CA, Inc. v. AFSCME*, “the shareholders’ statutory power to adopt, amend or repeal bylaws *is not coextensive* with the board’s concurrent power and is limited by the board’s management prerogatives

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<sup>25</sup> *Id.* at 240.

<sup>26</sup> 8 *Del. C.* § 109(b) (emphasis added); see *In re Appraisal of Metromedia Int’l Grp., Inc.*, 971 A.2d 893, 900 (Del. Ch. 2009).

<sup>27</sup> *Centaur Partners, IV v. Nat’l Intergroup, Inc.*, 582 A.2d 923, 929 (Del. 1990) (quoting *Burr v. Burr Corp.*, 291 A.2d 409, 410 (Del. Ch. 1972)).

<sup>28</sup> *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227, 232 (Del. 2008).

under Section 141(a).”<sup>29</sup> This is because “the board’s managerial authority under Section 141(a) is a cardinal precept of the DGCL,” and a shareholder-adopted bylaw that undermines this basic tenet of Delaware corporate law would be inconsistent with the law.<sup>30</sup> Similarly, stockholders may not enact a bylaw that would force a director to violate his or her fiduciary duties.<sup>31</sup> As a contract between the corporation and the shareholders, a bylaw may govern any topic or arrangement, so long as it relates to the business of the corporation, its affairs, or the rights or powers of the stockholders, directors, officers or employees.

An example of how bylaws have been used in corporate governance relates to director qualifications. Delaware General Corporation Law Section 141(b) expressly permits either the certificate of incorporation or bylaws to provide reasonable qualifications for service on a board of directors.<sup>32</sup> Thus, directors may be required to be stockholders of the corporation. Director qualification bylaws will be struck down only when they are enacted for an inequitable purpose, in violation of Delaware law, or are unreasonable or arbitrary.<sup>33</sup> And while ISS views

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<sup>29</sup> *Id.*

<sup>30</sup> *Id.* at 232 n.7.

<sup>31</sup> *See, e.g., id.* at 238 (invalidating a bylaw that “would violate the prohibition . . . against contractual arrangements that commit the board of directors to a course of action that would preclude them from fully discharging their fiduciary duties to the corporation and its shareholders”).

<sup>32</sup> *See* 8 *Del. C.* 141(b) (“The certificate of incorporation or bylaws may prescribe other qualifications for directors.”)

<sup>33</sup> *See* 8 *Del. C.* 109(b) (“[B]ylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of

such bylaws on a case-by-case analytical framework because of its view that shareholders have the right to vote on otherwise qualified candidates, it notes that requiring disclosure of third-party compensation payments provides “greater transparency for shareholders, and allows better-informed voting decisions.”<sup>34</sup>

### *Recent Decisions in Delaware*

Three recent Delaware decisions have spurred much of the discussion over the use of bylaws in corporate governance in ways that are new. In *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*, the Court of Chancery considered the facial validity of a board-adopted bylaw that would limit to a Delaware forum a derivative suit, a suit alleging a breach of a director’s fiduciary duty, and any other suit arising under the DGCL or involving the internal affairs of the corporation.<sup>35</sup>

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its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees.”); *Triplex Shoe Co. v. Rice & Hutchins, Inc.*, 152 A. 342, 351 (Del.1930) (holding that bylaw requiring a director to be a stockholder mandated stock ownership prior to entering office); see also *Stroud v. Milliken Enters.*, 585 A.2d 1306, 1308–09 (Del. Ch. 1988) *appeal dismissed*, 552 A.2d 476 (Del. 1989); *Klaassen v. Allegro Development Corporation*, 2013 WL 5739680, at \*23 (Del. Ch. 2013); see also *J.S. Alberici Const. Co., Inc. v. Mid-W. Conveyor Co., Inc.*, 750 A.2d 518, 520 (Del. 2000) (refusing to enforce a contract that violated Delaware public policy).

<sup>34</sup> ISS, *Director Qualification/Compensation Bylaw FAQs* (Jan. 23, 2014), available at <http://www.issgovernance.com/file/files/directorqualificationcompensationbylaws.pdf>.

<sup>35</sup> As an illustration, the text of Chevron’s bylaw provides:

Unless the Corporation consents in writing to the selection of an alternative forum, the Court of Chancery of the State of Delaware shall be the sole and exclusive forum for (i) any derivative action or proceeding brought on behalf of the Corporation, (ii) any action asserting a claim of breach of a fiduciary duty owed by any director, officer or other employee of the Corporation to the Corporation or the Corporation’s stockholders, (iii) any action asserting a claim arising pursuant to any provision of the Delaware General Corporation Law, or (iv) any action asserting a claim governed by the internal affairs doctrine. Any person or entity purchasing or otherwise acquiring any interest

More recently, in *City of Providence v. First Citizens BancShares, Inc.*, the Court of Chancery considered a similar board-adopted bylaw that would limit the forum in which a stockholder could bring suit solely to North Carolina. In *ATP Tour, Inc. v. Deutscher Tennis Bund*, the Delaware Supreme Court considered the facial validity of an attorney’s fee-shifting bylaw in a non-stock corporation.

### *The Boilermakers Case*

Turning first to *Boilermakers*, the Court of Chancery was asked to determine the validity of exclusive forum-selection bylaws that were unilaterally adopted by the directors of Chevron and FedEx. The plaintiffs argued that the bylaws were statutorily invalid because they exceeded the board’s authority under the DGCL. The plaintiffs also claimed that the bylaws were contractually invalid because they were unilaterally adopted by the board of directors without any stockholder approval. The Court of Chancery disagreed, explaining that Delaware has rejected the so-called “vested rights” doctrine,<sup>36</sup> which limits a board’s ability to “modify bylaws in a manner that arguably diminishes or divests pre-existing shareholder rights absent stockholder consent.”<sup>37</sup>

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in shares of capital stock of the Corporation shall be deemed to have notice of and consented to the provisions of this [bylaw].  
*Boilermakers Local 154*, 73 A.3d at 942 (quoting Chevron Compl. ¶ 21).  
<sup>36</sup> *Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934, 963 (Del. Ch. 2013) (citing *Fed. United Corp. v. Havender*, 11 A.2d 331, 335 (Del. 1940)).  
<sup>37</sup> *Id.* (quoting Joseph A. Grundfest & Kristen A. Savelle, *The Brouhaha over Intra-Corporate Forum Selection Provisions: A Legal, Economic, and Political Analysis*, 68 Bus. Law. 325, 376 (2013)); see also *Kidsco Inc. v. Dinsmore*, 674 A.2d 483, 492 (Del. Ch. 1995)

Instead, the court explained that a board of directors “may act unilaterally to adopt bylaws,” addressing any subject allowed under 8 *Del. C.* § 109(b).<sup>38</sup> This is because, as a group, “stockholders have assented to a contractual framework established by the DGCL and the certificates of incorporation,” which explicitly allows bylaws to be adopted unilaterally by their boards.”<sup>39</sup>

Because corporate bylaws are merely contractual agreements between the corporation, directors, and the stockholders, the Court of Chancery concluded in *Boilermakers* that forum-selection bylaws are presumptively valid. Specifically, the court explained that “stockholders contractually assent to be bound by bylaws that are valid under the DGCL—that is an essential part of the contract agreed to when an investor buys stock in a Delaware corporation.”<sup>40</sup> The plaintiffs appealed but voluntarily dismissed the appeal before the Delaware Supreme Court could address the issue raised.

During the three years leading up to the *Boilermakers* decision, over 250 publicly traded corporations adopted forum selection bylaws.<sup>41</sup> Since the decision in *Boilermakers*, corporate boards have continued to do so. The Conference Board Governance Center has reported that from June 2013 through October 2013—the

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(“[W]here a corporation’s by-laws put all on notice that the by-laws may be amended at any time, no vested rights can arise that would contractually prohibit an amendment.”), *aff’d and remanded*, 670 A.2d 1338 (Del. 1995).

<sup>38</sup> *Boilermakers Local 154*, 73 A.3d at 955 (citing *Kidsco*, 674 A.2d at 492–93).

<sup>39</sup> *Id.* at 956 (citing *Kidsco*, 674 A.2d at 492–93).

<sup>40</sup> *Boilermakers Local 154*, 73 A.3d at 958 (Del. Ch. 2013).

<sup>41</sup> *Id.* at 944.

period just following the *Boilermakers* decision—at least another 112 Delaware corporations adopted or announced plans to adopt exclusive forum bylaws.<sup>42</sup> A recent article confirms that over 100 public corporations have in fact added exclusive forum provisions to their bylaws.<sup>43</sup> Jurisdictions in addition to Delaware have recognized the validity of a Delaware corporation’s forum-selection bylaw. As of this point, courts in California,<sup>44</sup> Illinois,<sup>45</sup> Louisiana,<sup>46</sup> New York,<sup>47</sup> Texas,<sup>48</sup> and Ohio<sup>49</sup> have upheld forum-selection bylaws adopted by Delaware corporations.<sup>50</sup>

*City of Providence v. First Citizens BancShares, Inc.*

Forum selection clauses need not favor Delaware to be valid according to the Delaware Court of Chancery’s decision in *City of Providence v. First Citizens*

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<sup>42</sup> Claudia H. Allen, *Trends in Exclusive Forum Bylaws: They’re Valid, Now What?*, CONFERENCE BOARD GOVERNANCE CENTER, January 2014, at 3, available at [http://www.conference-board.org/retrievefile.cfm?filename=TCB\\_DN-V6N2-141.pdf](http://www.conference-board.org/retrievefile.cfm?filename=TCB_DN-V6N2-141.pdf).

<sup>43</sup> See Joseph M. McLaughlin, *Enforceability of Board-Adopted Forum Selection Bylaws*, available at <http://www.newyorklawjournal.com/id=1202672782148/Enforceability-of-BoardAdopted-Forum-Selection-Bylaws?slreturn=20140926230802>.

<sup>44</sup> *Groen v. Safeway Inc.*, No. RG14716641 (Cal. Super. Ct. May 14, 2014).

<sup>45</sup> *Miller v. Beam Inc.*, 2014-CH-00932 (Ill. Ch. Ct. Mar. 5, 2014).

<sup>46</sup> *Genoud v. Edgen Group Inc.*, No. 625,244 (La. Dist. Ct. Jan. 17, 2014).

<sup>47</sup> *Hemg Inc. v. Aspen Univ.*, No. 650457/13, 2013 WL 5958388 (N.Y. Sup. Ct. Nov. 14, 2013).

<sup>48</sup> Order Granting Defendants’ Motion to Dismiss Because of Mandatory Forum Selection Clause, *Daugherty v. Ahn*, Cause No. CC-11-06211 (Cnty. Ct. at Law No. 3, Dallas Cnty. Tex., February 15, 2013); *In re MetroPCS Commc’ns, Inc.*, 391 S.W.3d 329, 341 (Tex. App. 2013).

<sup>49</sup> *North v. McNamara*, 2014 WL 4684377 (S.D. Ohio Sept. 19, 2014).

<sup>50</sup> See also *In re MetroPCS Commc’ns, Inc.*, 391 S.W.3d 329 (Tex. App. 2013) (reversing a Texas trial court because it did not consider the forum selection provision before issuing a temporary restraining order). But see *Roberts v. TriQuint Semiconductor, Inc.*, No. 1402-02441 (Cir. Ct. Or. Aug 14, 2014); see also Claudia H. Allen, *Oregon State Court Refuses to Enforce Forum Selection Bylaw*, 2014 WLNR 24608853 (2014).

*BancShares, Inc.*<sup>51</sup> Following the line of reasoning set forth by then-Chancellor Strine in *Boilermakers*, Chancellor Bouchard held that a Delaware corporation may validly adopt a bylaw that designates an exclusive forum other than Delaware for litigating intra-corporate disputes, including those brought under the DGCL.<sup>52</sup> The forum-selection bylaw at issue in *City of Providence* was virtually identical to the bylaws approved in *Boilermakers*, except that it selected the federal and state courts of North Carolina instead of Delaware as the exclusive forum for intra-corporate disputes and stated that it was applicable “only to the fullest extent permitted by law.”<sup>53</sup>

In dismissing the shareholder’s challenge to the bylaw, the court found that First Citizens’ Charter granted its board the right to unilaterally amend the bylaws, and thus the company’s shareholders were on notice that they would be bound by the board’s decision to adopt new bylaws.<sup>54</sup> Further, the court determined that nothing in the *Boilermakers* decision prohibited directors of a Delaware corporation from designating an exclusive forum other than Delaware in its bylaws.<sup>55</sup> The court noted that North Carolina was the “the second most obviously

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<sup>51</sup> *City of Providence v. First Citizens BancShares, Inc.*, C.A. No. 9795, 2014 WL 4411604 (Del. 2014).

<sup>52</sup> *Id.* at \*1.

<sup>53</sup> *Id.* at \*1, \*3.

<sup>54</sup> *Id.* at \*3 (“[A]n essential part of the contract stockholders [like Providence] assent to when they buy stock in [FC North] is one that presupposes the board's authority to adopt binding bylaws consistent with 8 *Del. C.* § 109.”) (citing *Chevron*, 73 A.3d at 940).

<sup>55</sup> *City of Providence*, 2014 WL 4411604, \*4.

reasonable forum given that [defendant] is headquartered and has most of its operations there.”<sup>56</sup> Thus, choosing North Carolina as the exclusive forum for intra-corporate disputes did not “call into question the facial validity of the Forum Selection Bylaw.”<sup>57</sup>

Finally, the Court of Chancery held that the forum selection bylaw was valid as applied to the case before it.<sup>58</sup> The court found that the plaintiff failed to sufficiently plead facts showing that the bylaw was being used unjustly or in an unreasonable manner.<sup>59</sup> The court noted that the board’s adoption of the bylaw on the same day it announced a challenged merger transaction did not automatically render it invalid.<sup>60</sup> The court found that City of Providence had failed to show any improper motive by the directors in adopting the bylaw, stating:

[T]he Forum Selection Bylaw merely regulates “where stockholders may file suit, not whether the stockholder may file suit or the kind of remedy that the stockholder may obtain.” That the Board adopted it on an allegedly “cloudy” day when it entered into the merger agreement with FC South rather than on a “clear” day is immaterial given the lack of any well-pled allegations . . . demonstrating any impropriety in this timing.<sup>61</sup>

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<sup>56</sup> *Id.*

<sup>57</sup> *Id.*

<sup>58</sup> *Id.* at \*6.

<sup>59</sup> *Id.* at \*6.

<sup>60</sup> *City of Providence*, 2014 WL 4411604, \*8.

<sup>61</sup> *Id.* at 9 (citing *Chevron*, 73 A.3d at 952).

Notwithstanding the policy of the Council of Institutional Investors against forum selection clauses,<sup>62</sup> the number of corporate boards that are adopting forum selection bylaws to avoid the risk of costly shareholder suits in multiple jurisdictions continues to grow. Perhaps even more significant, the Chancellor upheld a forum selection bylaw adopted on the same day as a board-announced corporate merger transaction.

*ATP v. Deutscher Tennis Bund*

A bylaw subject that is more problematic is one that shifts litigation fees to an unsuccessful plaintiff stockholder. In May 2014, the Delaware Supreme Court decided *ATP Tour, Inc. v. Deutscher Tennis Bund*<sup>63</sup> on a certified question from the United States District Court for the District of Delaware. In *ATP Tour*, we were asked whether Delaware law allowed a board of a Delaware non-stock corporation to adopt a bylaw provision shifting all litigation fees, costs, and expenses to a plaintiff in an unsuccessful intra-corporate suit. Essentially, ATP Tour modified through its bylaw the “American rule” on attorneys’ fees, “which generally requires each party to pay his or her own legal costs,” even if the party ultimately prevails.<sup>64</sup> We found that such a bylaw is not prohibited by the Delaware General Corporation law or common law and thus is facially valid.

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<sup>62</sup> Council of Institutional Investors, *Policies on Corporate Governance* (May 9, 2014), available at [http://www.cii.org/corp\\_gov\\_policies](http://www.cii.org/corp_gov_policies).

<sup>63</sup> 91 A.3d 554 (Del. 2014).

<sup>64</sup> *Sternberg v. Nanticoke Mem’l Hosp., Inc.*, 62 A.3d 1212, 1218 (Del. 2013).

In the opinion, the Court noted that a “facially valid” bylaw requires three things. First, that it be “authorized by the Delaware General Corporation Law (DGCL);” second, the bylaw is “consistent with the corporation’s certificate of incorporation;” and third, it is not “otherwise prohibited.”<sup>65</sup> We noted that “it is settled that contracting parties may agree to modify the American Rule and obligate the losing party to pay the prevailing party’s fees.”<sup>66</sup> Taken together, a corporate bylaw that contains a fee-shifting provision “would not be prohibited under Delaware common law.”<sup>67</sup>

Even though the Court found that a fee-shifting bylaw is not *per se* prohibited under Delaware law, this does not mean that a fee-shifting bylaw will be enforced. Rather, the enforceability of a bylaw in a court of equity “depends on the manner in which it was adopted and the circumstances under which it was invoked. Bylaws that may otherwise be facially valid will not be enforced if adopted or used for an inequitable purpose.”<sup>68</sup> Thus, “the enforceability of a facially valid bylaw may turn on the circumstances surrounding its adoption and use.”<sup>69</sup> For example, in *Schnell v. Chris–Craft Industries*, the Delaware Supreme Court refused to enforce a board-adopted bylaw that sought to reschedule the

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<sup>65</sup> *ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554, 557–58 (Del. 2014).

<sup>66</sup> *Id.* at 558.

<sup>67</sup> *Id.*

<sup>68</sup> *Id.*

<sup>69</sup> *ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554, 559 (Del. 2014).

annual stockholder meeting for a month earlier.<sup>70</sup> The Court held that the board’s intention in moving the meeting was to “perpetuat[e] itself in office” and “obstruct[] the legitimate efforts of dissident stockholders in the exercise of their rights to undertake a proxy contest against management.”<sup>71</sup>

And in *Hollinger International, Inc. v. Black*, the Court of Chancery considered the validity of a bylaw amendment, passed by a controlling shareholder, that prevented the board “from acting on any matter of significance except by unanimous vote” and “set the board’s quorum requirement at 80%.”<sup>72</sup> The Court of Chancery held that the bylaws were “adopted for an inequitable purpose and have an inequitable effect,” and thus had “no force and effect.”<sup>73</sup>

But in *Frantz Manufacturing Co. v. EAC Industries*, the Supreme Court found that a majority stockholder’s amendments to the corporation’s bylaws to “limit the [defendant] board’s anti-takeover maneuvering after [the stockholder] had gained control of the corporation” were not inequitable and thus enforceable.<sup>74</sup> This was because the bylaw amendments were “a permissible part of [the

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<sup>70</sup> *Schnell v. Chris–Craft Indus.*, 285 A.2d 437, 438–40 (Del. 1971).

<sup>71</sup> *Id.* at 439.

<sup>72</sup> *Hollinger Int., Inc. v. Black*, 844 A.2d 1022, 1077 (Del. Ch. 2004), *aff’d sub. nom.*, *Black v. Hollinger Int’l Inc.*, 872 A.2d 559 (Del. 2005).

<sup>73</sup> *Id.* at 1080, 1082.

<sup>74</sup> *Frantz Manufacturing Co. v. EAC Inds.*, 501 A.2d 401, 407–08 (Del. 1985).

stockholder's] attempt to avoid its disenfranchisement as a majority shareholder” and, thus, were “not inequitable under the circumstances.”<sup>75</sup>

Since the Court's decision in *ATP Tour*, a number of commentators have assumed that it applies equally to for-profit, stock corporations.<sup>76</sup> The Delaware Supreme Court did not say that in *ATP Tour*, so this remains an open question. Nevertheless some commentators have suggested that the application of *ATP Tour* to stock corporations would effectively mitigate the cost of stockholder litigation.<sup>77</sup> In 2013, stockholder plaintiffs challenged approximately 94% of all announced transactions, a significant rise from 2008, where only 54% of corporate transactions were challenged.<sup>78</sup> Other commentators have argued that such a bylaw in this context would have a chilling effect on meritorious litigation and insulate directors from potential liability.<sup>79</sup> A majority of the Delaware State Bar Association's Council of the Corporation Law Section had a similar concern and earlier this year proposed an amendment to the DGCL through Senate Bill 236, which would prohibit fee-shifting bylaws from a stock corporation's governing

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<sup>75</sup> *Id.* at 407.

<sup>76</sup> E.g., Nathan A. Cook, *What Fiduciary Duties? Delaware Supreme Court Okays One-Way Fee-Shifting Bylaws*, GRANT & EISENHOFER (2014), available at <http://www.gelaw.com/articles/What-Fiduciary-Duties.pdf>.

<sup>77</sup> See *Fee-Shifting Bylaws: The Delaware Supreme Court Decision in ATP Tour, Its Aftermath and the Potential Delaware Legislative Response The Decision*, available at <http://www.skadden.com/insights/fee-shifting-bylaws-delaware-supreme-court-decision-atp-tour>.

<sup>78</sup> *Id.*

<sup>79</sup> See Steven Davidoff Solomon, *A Ruling's Chilling Effect on Corporate Litigation*, N.Y. TIMES DEALBOOK (May 23, 2014 5:01 P.M.), [http://dealbook.nytimes.com/2014/05/23/a-rulings-chilling-effect-on-corporate-litigation/?\\_php=true&\\_type=blogs&\\_r=0](http://dealbook.nytimes.com/2014/05/23/a-rulings-chilling-effect-on-corporate-litigation/?_php=true&_type=blogs&_r=0).

documents.<sup>80</sup> The proposed legislation garnered substantial attention and prompted a significant amount of lobbying efforts for and against the bill.<sup>81</sup> In June 2014, the Senate Bill was tabled in favor of a resolution giving representatives of the Delaware bar more time to study the use and effect of fee-shifting bylaws.<sup>82</sup> Although tabled for now, the proposed legislation has put entities and investors alike on notice that an amendment to the DGCL will likely be considered again when the legislative session resumes in 2015.<sup>83</sup>

Several companies have adopted one-way fee-shifting bylaws in the wake of *ATP Tour* despite the current uncertainty surrounding their validity.<sup>84</sup> For example, a number of IPO's have adopted fee-shifting bylaws, including: Alibaba,

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<sup>80</sup> Kimberly M. Burke, *Delaware Legislature Asked To Address Corporate Fee-Shifting Bylaws After ATP Tour Decision*, NAT'L L. REV. (June 3, 2014), <http://www.natlawreview.com/article/delaware-legislature-asked-to-address-corporate-fee-shifting-bylaws-after-atp-tour-d>.

<sup>81</sup> See Fee-Shifting Bylaws: The Current State of Play, *available at* [http://www.skadden.com/newsletters/Fee-Shifting\\_Bylaws\\_The\\_Current\\_State\\_of\\_Play.pdf](http://www.skadden.com/newsletters/Fee-Shifting_Bylaws_The_Current_State_of_Play.pdf)

<sup>82</sup> *Id.*

<sup>83</sup> See Kevin LaCroix, *Though Delaware Legislature Has Tabled Action, Upcoming Judicial Review of Fee-Shifting Bylaws Seems Likely* (July 28, 2014), *available at*, <http://www.dandodiary.com/2014/07/articles/corporate-governance/though-delaware-legislature-has-tabled-action-upcoming-judicial-review-of-fee-shifting-bylaws-seems-likely/>.

<sup>84</sup> See Gretchen Morgenson, *Shareholders, Disarmed by a Delaware Court* (Oct. 25, 2014), *available at* [http://www.nytimes.com/2014/10/26/business/shareholders-disarmed-by-a-delaware-court.html?\\_r=0](http://www.nytimes.com/2014/10/26/business/shareholders-disarmed-by-a-delaware-court.html?_r=0); Alison Frankel, *Sneaky New Trend in IPOs: Make Shareholders Pay If They Sue and Lose* (Oct. 9, 2014), *available at* <http://blogs.reuters.com/alison-frankel/2014/10/09/sneaky-new-trend-in-ipos-make-shareholders-pay-if-they-sue-and-lose/>.

Further, one State has gone so far as to amend its corporate statute to provide for mandatory fee-shifting for all derivative suits brought in the state. "The Oklahoma State Legislature amended the Oklahoma General Corporation Act to specifically require fee-shifting for all derivative lawsuits brought in the state, whether against an Oklahoma corporation or not. Unlike the fee provision in *ATP Tour*, however, the law also affords derivative plaintiffs the right to recover their fees and costs should they win final judgment." See <http://blogs.orrick.com/securities-litigation/tag/derivative-claims/>.

Smart & Final, and ATD Corp. These bylaws purport to make investors liable for all litigation-related costs of the defendants, unless the investors obtain a judgment on the merits that substantially achieves, in substance and amount, the full remedy sought.<sup>85</sup> Not surprisingly, they are being challenged when they are raised before the Delaware Court of Chancery.

In *Kastis v. Carter*,<sup>86</sup> a case currently before Chancellor Bouchard, Philadelphia-based Hemispherx BioPharma, an immune-diseases drug manufacturer, unilaterally adopted a fee-shifting bylaw during the pendency of litigation that would retroactively require stockholder plaintiffs to cover legal fees—even in the pending litigation—should they lose.<sup>87</sup> The company argued that the bylaw was consistent with the *ATP Tour* decision, but the plaintiffs vigorously disagreed and filed a motion to have it invalidated.<sup>88</sup>

Chancellor Bouchard determined that the fee-shifting bylaw issue must be resolved before any other issue in the case. The Chancellor found that by adopting

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<sup>85</sup> See Gretchen Morgenson, *Shareholders, Disarmed by a Delaware Court* (Oct. 25, 2014), available at [http://www.nytimes.com/2014/10/26/business/shareholders-disarmed-by-a-delaware-court.html?\\_r=0](http://www.nytimes.com/2014/10/26/business/shareholders-disarmed-by-a-delaware-court.html?_r=0).

<sup>86</sup> *Kastis v. Carter*, C.A. No. 8657 (Del. Ch. 2014).

<sup>87</sup> *Id.*

<sup>88</sup> In the motion to invalidate the bylaw, the plaintiffs noted the difference between the bylaw in *ATP Tour* and the bylaw at issue, arguing that the bylaw adopted by Hemispherx (1) applied to passive investors in a publicly traded stock corporation, (2) was not reciprocal, but only imposed liability on stockholders and not Defendants, (3) applied retroactively to litigation that had been pending for a year, (4) imposed retroactive liability for Defendant's litigation costs incurred prior to enactment of the bylaw, and (5) imposed a bond requirement.

the bylaw after the plaintiffs' claim was filed, Hemispherx had put the plaintiffs in a position of "having a cloud hang over their decisions . . . knowing down the road, the bylaws could potentially still have some application." Soon thereafter, Hemispherx advised the trial court by letter that it would not seek to apply the fee-shifting bylaw to any aspect of the litigation.

Most recently, in *Strougo v. Hollander*, a plaintiff filed an amended class action complaint challenging, among other things, a company's fee-shifting bylaw that would allow it to recoup all litigation costs if the plaintiff's suit was unsuccessful.<sup>89</sup> The plaintiff is challenging both the application and scope of the fee-shifting bylaw.<sup>90</sup> Chancellor Bouchard has agreed to determine the validity of the bylaw, and briefing on the issue is underway and should be completed by January.<sup>91</sup>

Another category of bylaw generating discussion, but not yet litigation in Delaware, is a mandatory arbitration bylaw covering intra-corporate disputes that waives a shareholder's right to a class action. Some commentators have concluded that a board has the unilateral power to do this after the *Boilermakers* decision.<sup>92</sup>

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<sup>89</sup> See *Court Schedules Briefing in Pending Challenge to Fee-Shifting Bylaw*, available at <http://www.bna.com/court-schedules-briefing-n17179896464/>.

<sup>90</sup> See <http://www.law.du.edu/index.php/corporate-governance/governance-cases/strougo-v.-hollander>.

<sup>91</sup> *Id.*

<sup>92</sup> See Claudia H. Allen, *Bylaws Mandating Arbitration of Stockholder Disputes?* (June 23, 2014), available at <http://clsbluesky.law.columbia.edu/2014/06/23/bylaws-mandating-arbitration-of-stockholder-disputes/>.

However, in *Boilermakers*, then-Chancellor Strine expressly noted that the bylaw at issue did not regulate whether the stockholder may file suit.<sup>93</sup>

Moreover, a significant issue exists as to whether a bylaw, unilaterally adopted by a board, that eliminates the equitable standing of a stockholder to sue derivatively on behalf of a corporation is *per se* an inequitable purpose under an *ATP* analysis. In *Schoon v. Smith*, the Delaware Supreme Court traced the historic origins in equity of the derivative action to the 14<sup>th</sup> century in England.<sup>94</sup> “To prevent ‘a failure of justice,’ courts of equity granted equitable standing to stockholders to sue on behalf of the corporation ‘for managerial abuse in economic units which by their nature deprived some participants of an effective voice in their administration.’”<sup>95</sup> The policy foundation for this is the ancient maxim that equity will not suffer a wrong without a remedy.<sup>96</sup> Our Court of Chancery has explained that “[t]he derivative action was developed by equity to enable stockholders to sue in the corporation’s name where those in control of the corporation refused to assert a claim belonging to the corporation.”<sup>97</sup> Whether or not arbitration and a class-action waiver would be upheld when equitable standing to bring a derivative

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<sup>93</sup> *Boilermakers*, 73 A.3d at 951–52.

<sup>94</sup> *Schoon v. Smith*, 953 A.2d 196, 201 (Del. 2008).

<sup>95</sup> *Id.* (internal citations omitted).

<sup>96</sup> See *Fischer v. Fischer*, 1999 WL 1032768, at \* 4 (Del. Ch 1999) (“As equity will not suffer a wrong without a remedy, I must permit plaintiff’s individual claims to proceed.”).

<sup>97</sup> *Id.* (quoting *Harff v. Kerkorian*, 324 A.2d 215, 218 (Del. Ch. 1974), *aff’d in part, rev’d in part on other grounds*, 347 A.2d 133, 134 (Del. 1975)).

suit was designed “to set in motion the judicial machinery of the court,”<sup>98</sup> likely will be a central issue in litigation over the validity of such an arbitration bylaw in Delaware.

### *The Road Ahead*

I want to conclude by looking forward to the road ahead, which will have several legal milestones to help navigate the legality of governance bylaws. Several milestones relating to forum selection bylaws are already behind us. In the months ahead, the Delaware General Assembly and the Delaware courts will address fee-shifting bylaws. And whether arbitration bylaws will be adopted and litigated in Delaware remains to be seen.

As corporate counsel, you know that the advantage of the Delaware General Corporation Law is its enabling nature and the ability it gives for private ordering subject to the fiduciary duties of care and of loyalty. Before adopting governance bylaws a board of directors should ask itself, with your assistance, three important questions: (1) Is the bylaw facially valid?; (2) As applied, will the bylaw be inequitable?; and (3) Even if valid, facially and as applied, is it wise for our company to adopt this bylaw? A board’s answers to these questions will vary depending on the nature of the bylaw itself. There is a growing trend to include a forum selection bylaw as part of any merger transaction as was done in the *City of*

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<sup>98</sup> *Id.* at 202 (internal quotations omitted).

*Providence* case because of the economy that litigation in a single forum provides if a deal is challenged. But the benefit of the other more controversial bylaws which I have mentioned is not so obvious. Does the adoption of a fee-shifting bylaw suggest an inequitable purpose of entrenchment or signal a board concern that there actually are grounds for a governance concern that would attract stockholder activism? The same question could be raised in the context of an arbitration bylaw. In some cases I have seen, private arbitration has taken much longer to resolve a case than if it had been litigated. We have resolved cases with pleadings, briefings, and full trials in our Court of Chancery in as little as 30 days and decided appeals in 24 hours. An additional question for arbitration would be, is it wise to subject the board and the corporation to the decision of an arbitrator on issues of corporate governance when there is virtually no appellate review of the decision the arbitrator makes? These are judgments for a board of directors to make on an informed basis with your help as corporate counsel.

### *Conclusion*

With the evolving role of bylaws, these are very interesting times in Delaware corporate jurisprudence and in corporate governance. I hope that my discussion of these developments and trends will be useful to you. Thank you.