Bylaw Wars: Boards Awaken

by Beth I.Z. Boland, Michael Kirwan and Neda Sharifi

The growing frequency and success of shareholder activism campaigns are shaking up the rules of engagement between corporations and their owners. As shareholders have turned their sights to shaping their agenda through litigation, management and boards are now taking a fresh look at their bylaws, which lay out many of the rules for these high-pressure shareholder challenges in both the boardroom and the courtroom.

Many forests have been felled in the ongoing commentary on the balance of power between shareholders versus boards versus management of a corporation, and in particular the fundamental shift of power due to the rise of activist shareholders. At the heart of that battle lies the lowly corporate bylaw.

Long ignored, corporate bylaws can be anything but boilerplate or boring. They help define the "rules of engagement" for shareholder voting and litigation rights, and can tilt the playing field toward the board (or toward shareholders).

A company's relationship with its shareholders is shaped most by fundamental forces like a sound corporate strategy and a willingness to engage with well-meaning and informed challenges to that strategy, whether they come from within the company or without.

In the meantime, as shareholders demand more power, boards have become increasingly creative in their adoption of bylaws to keep the playing field level. These bylaws are often subject to challenge in the courts or even to legislative override. Corporate bylaws have now become ground zero in this ongoing saga.

While many boards have been reactive to changes in corporate governance over the past 25 years, more boards have now become far more proactive. In addition to stepping up the quantity and quality of communications with their shareholders, boards should also focus on reviewing their bylaws to craft rules of engagement that make the most sense for the company.

Much of the battle has shifted from bylaws affecting shareholders' ability to shape a majority of the board to shareholders' ability to prevail in litagation. At the same time that Delaware courts are moving to curb frivolous litigation challenging mergers and acquisitions, boards have also adopted bylaws targeting frivolous shareholder suits. Some of these bylaws have gained widespread acceptance, while others are on the cutting edge and have yet to be battle-tested.

The mechanics and timing of amending corporate bylaws—your corporation/shareholder "rules of engagement" for proxy matters—are important.

The corporation/shareholder rules of engagement are typically housed in the company's articles of incorporation or its bylaws. These articles and bylaws create a contract between the corporation and its shareholders, and courts interpret the viability of those provisions using basic corporate contract law.

Articles of incorporation contain certain specified information required by state law, and require shareholder approval. Corporate bylaws, by contrast, are adopted by the board. They may contain any provision that is proper and not inconsistent with the articles of incorporation. Given this flexibility, most companies allow their bylaws to be amended solely by the board without shareholder approval, although bylaws occasionally require shareholder approval for their amendment.

The mechanics and timing of amending these rules of engagement are important. Once a company is in the throes of a shareholder battle, the ability

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to quickly amend the bylaws can provide critical breathing room for the board right when it needs it. Even during clear days, boards often choose to place new provisions in the bylaws in order to provide maximum flexibility.

If the shareholders agree to bylaw changes after full disclosure and review, courts rarely intercede to invalidate them.

The degree to which a court (and proxy advisory services) smile upon bylaw amendments which curb shareholder rights largely depends on whether the changes are approved by the shareholders and the degree of the incursion. If the shareholders agree to the changes after full disclosure and review, courts rarely intercede to invalidate them. As with the formation of a bilateral contract, so long as the parties are consenting adults, courts are disinclined to pry too closely into the parties' relationship.

If, however, the board acts unilaterally and without shareholder approval, both the courts and the proxy advisors may examine the amendments with a more focused eye. In deciding whether boards have exceeded their authority by unilaterally changing the rules mid-stream, the courts are guided by the following standards:

□ *Presumption of validity.* The courts start with the presumption that the bylaw is valid and will, if possible, construe it in a manner consistent with the law.

□ *Reasonable restrictions.* Courts also look to see whether the amendment creates an unreasonable curtailment on its face or if the particular circumstances are inequitable. Such provisions are presumed valid unless they are adopted in bad faith or for an "inequitable purpose."

To the extent courts ever find an "inequitable purpose" (which is rare), it typically occurs when a shareholders' ability to buy additional stock or to vote for board members is unreasonably curtailed. For example, in *Moran* and *Unocal,* the adopted poison pill provisions were not "coercive" or "preclusive" enough for the court to step in.

□ *Vested rights.* Shareholders often argue that a particular bylaw amendment is invalid because it encroaches on their "vested rights." However, courts generally hold that if a corporation's bylaws provide that they may be amended at any time, shareholders do not retain any vested rights which cannot be changed unilaterally by the board. By buying stock in a company which allows board-generated bylaw amendments without shareholder approval, a shareholder cannot later argue it has a "right" to anything in those bylaws.

The Delaware Chancery Court first suggested that boards could promote efficiency and add value by adopting exclusive forum provisions in their corporate charters.

Under these standards, several new bylaw variations have entered the corporate lexicon. Some have unilaterally tilted the playing field so far over the edge (such as "loser pays" provisions) that one legislature has stepped in to outlaw them. Others (such as exclusive forum bylaws) are far enough within the lines that they now are codified by law in Delaware.

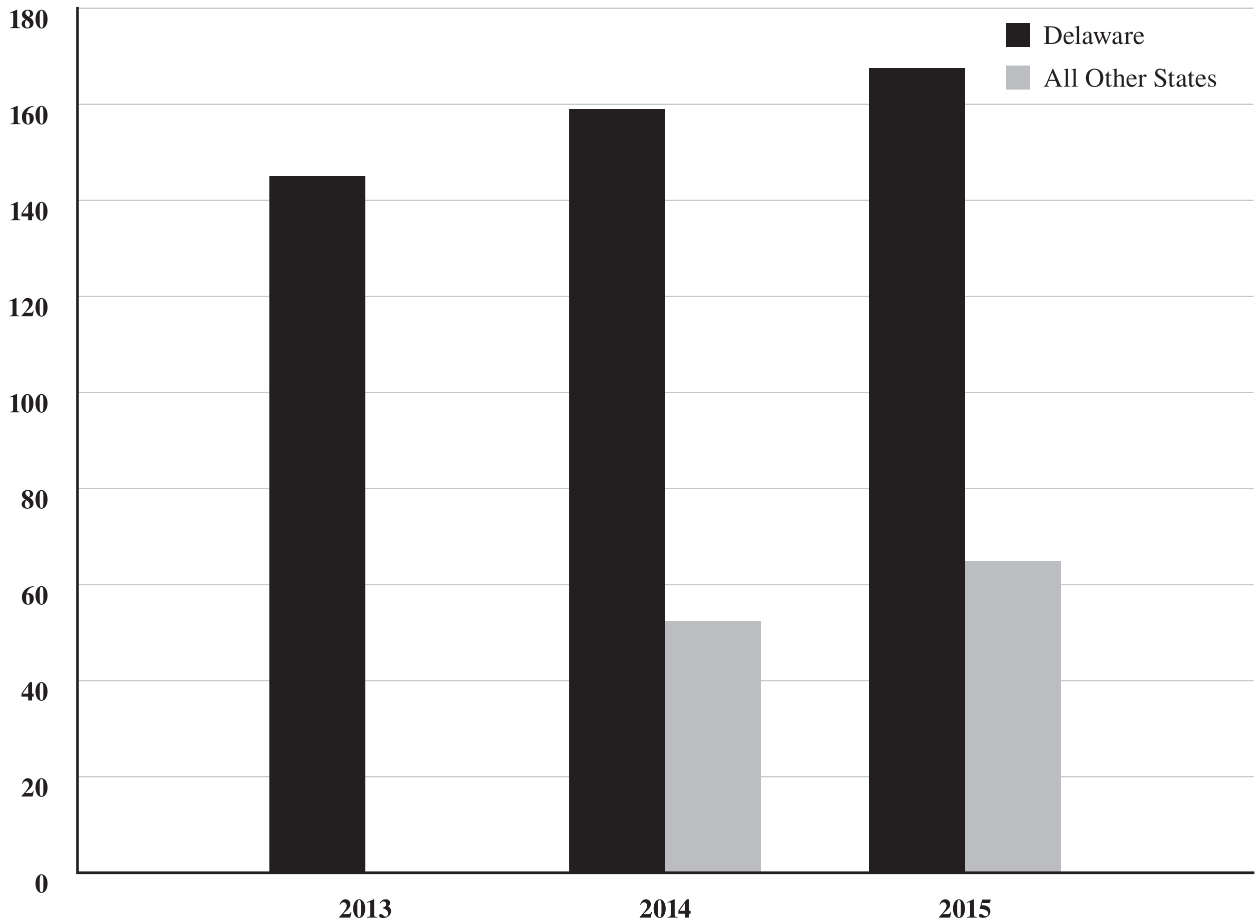
□ ***Exclusive forum bylaws.*** Public corporations have increasingly adopted "exclusive forum" provisions in their bylaws or articles. These provisions designate specific courts to serve as the exclusive venue for shareholder lawsuits asserting fiduciary duty and other intracorporate claims against the company and its directors and officers.

Exclusive forum provisions are a reaction to the significant increase in duplicative, multi-jurisdictional shareholder litigation. According to the latest statistics, almost every public company sale of any appreciable size is quickly followed by one, if not several, lawsuits challenging the deal.

Exclusive forum bylaws are designed to prevent forum-shopping and the unnecessary expense incurred when duplicative lawsuits asserting the same claims are filed in multiple courts. If all such suits were filed in the same court, they would be assigned to the same judge and could be easily consolidated as a single action.

No To Forum Shopping

Corporations Adding Exclusive Forum Bylaws



Duplicative, multi-forum litigation requires the corporation to retain additional counsel in the various locations and incur the additional, unnecessary expense of litigating in multiple forums. More important, it runs the risk that judges in different jurisdictions might reach different conclusions. This puts the corporation in the impossible situation of trying to comply with incompatible orders. Also, since some jurisdictions do not have specialized business courts, exclusive forum bylaws can ensure that shareholder disputes are decided by judges who repeatedly handle such cases.

In 2010, the Delaware Chancery Court, in nonbinding dicta, first suggested that boards could promote efficiency and add value by adopting exclusive forum provisions in their corporate charters. In June 2013, the Court of Chancery upheld the exclusive forum provisions adopted by the boards of directors of Chevron and FedEx. The provisions had been adopted as bylaw amendments during "clear days" (when there was no impending litigation) without seeking shareholder approval.

The Chancery Court noted that each corporation's governing documents permitted the board to unilaterally amend the bylaws, and that the provisions did not impinge on a shareholder's right to file suit, but merely regulated *where* such suit could be filed. The court, however, ruled only on the facial validity of exclusive forum bylaws, but made clear that unique circumstances in a different case might yield a different result.

Courts in California, Illinois, Louisiana, New York, Ohio and Texas soon followed Delaware's lead, ruling that bylaw provisions designating Delaware as the sole legal forum were enforceable. The next three years saw a steady adoption of exclusive forum provisions in the bylaws of U.S. companies. The majority of these provisions have been adopted by Delaware corporations.

By early 2015, the tide of exclusive forum provisions and the litigation over them reached a point where the Delaware legislature stepped in to erase any uncertainty over their validity. Whether prompted by the snowballing acceptance of such provisions, or by a desire to increase Delaware's hegemony in the corporate governance space, in June 2015, the legislature approved a statutory right for Delaware companies to designate Delaware courts (including both the state courts and the federal courts) as the exclusive forum for adjudicating "internal corporate claims."

This statute permits (but does not *require*) Delaware companies to adopt exclusive forum provision, and it does not prohibit the designations of additional forums other than Delaware, so long as Delaware is a permitted forum. It does, however, allow companies to add an exclusive non-Delaware forum provision in a private shareholder agreement. This approach may have more appeal to private companies. Importantly, the statute does not preclude claims that a particular forum selection bylaw operates unreasonably under the specific facts of a case, or that the manner in which the provision was adopted was inequitable.

To date, an overwhelming majority of public corporations with exclusive forum provisions are incorporated in Delaware.

The Delaware Supreme Court upheld the validity of fee-shifting bylaws in 2014, but only for a nonstock corporation.

☐ ***Fee-shifting bylaws.*** At the same time some companies were adopting exclusive forum provisions, others were flirting with provisions placing far more restrictions on shareholder rights to sue. The board of a nonstock corporation, ATP Tour, unilaterally adopted a bylaw requiring a party to intracorporate litigation to pay the winner's legal fees if they lost. The practical effect of fee-shifting would be to dramatically increase the risk to the plaintiffs contemplating a suit against the company and its directors.

In a widely-watched decision, the Delaware Supreme Court upheld the validity of ATP's fee-shifting bylaw in 2014. While the decision was made in the context of a nonstock corporation, the possibility that a Delaware stock corporation could adopt a "loser pays" bylaw drew much attention. By 2015 the Delaware legislature passed legislation to prohibit stock corporations from adopting fee-shifting bylaws and charter provisions.

The new legislation, however, did not prohibit the adoption of a "loser pays" bylaw in all circumstances. First, the prohibition extends only to "internal corporate claims" (i.e., claims based on breaches of fiduciary duty) that fall under the jurisdiction of the Delaware Court of Chancery. Also, it does not extend to federal securities class actions, which are governed by separate rules. Second, the statute applies only to stock corporations, but leaves the ATP ruling intact as to nonstock corporations. Third, like the exclusive forum statute, the anti-fee-shifting statute does not prohibit "loser pays" provisions in private stockholder agreements

Other states may allow courts to impose a "loser pays" system—prompting more plaintiffs to file suit in Delaware.

Other legislatures have also delved into these waters, with strikingly different approaches. New Jersey has enacted a statute which allows (but does not require) a court to shift fees onto a shareholder plaintiff if the court determines that the plaintiff commenced the proceeding "without reasonable cause" or for an "improper purpose." The Oklahoma legislature has gone further and adopted a provision *mandating* a "loser pays" model in derivative suits, but not in shareholder class actions.

The practical effect of these judicial and legislative developments has been profound. To curb the rise of frivolous shareholder suits (especially in the context of mergers and acquisitions), in the recent *Trulia* and *Aruba Networks* cases the Delaware courts have signaled their intention to refuse to award attorneys' fees to plaintiff shareholder counsel who fail to obtain meaningful relief for their clients.

In response, those plaintiffs' counsel bring suits in states other than Delaware (such as the state where the company's principal place of business is located) in order to find courts more sympathetic to awarding their fees. However, some of those other states in turn allow courts to impose a "loser pays" system upon shareholder plaintiffs. The end result is shareholders will likely avoid filing suit in any jurisdiction with a "loser pays" regime, and Delaware companies will increasingly adopt bylaws designating Delaware as the exclusive forum for shareholder suits.

☐ ***"Minimum stake to sue" bylaws.*** Into this fray comes yet another corporate attempt to curb frivolous shareholder suits—"minimum-stake to sue" bylaws. Ironically, these bylaws are the brainchild of a well-known activist investor, Phillip Goldstein of Bulldog Investors. Three public companies for which Goldstein serves as a director have adopted bylaws requiring consent of a minimum number of the company's shareholders before a derivative lawsuit or class action can be filed.

This is reminiscent of the thresholds suggested by the SEC in its proxy access rules. The provision is designed to ensure that shareholders filing lawsuits challenging corporate actions own a certain percentage of the company's outstanding stock, reflecting a minimum degree of shareholder support, and helping ensure they represent the interests of the shareholders themselves (as opposed to plaintiffs' counsel).

As anticipated, a shareholder plaintiff promptly challenged one of the "minimum stake to sue" bylaws in federal court in Florida. The challenge was dismissed before the court could rule on the viability of the bylaw, but the approach merits consideration by other boards.

Legislative precedent suggests that such "minimum stake to sue" bylaws may pass judicial muster. Delaware already has a statute requiring shareholders who file a derivative lawsuit against a public benefit corporation to own a minimum stake of two percent, or at least $2,000,000 if listed on a securities exchange. As with exclusive forum bylaws, a "minimum stake to sue" provision does not *prevent* a shareholder from bringing suit. It merely insures that the shareholder either owns more than a *de minimis* stake, or has the support of other shareholders in so doing.

☐ ***Other bylaws on the horizon.*** Other bylaw provisions being weighed by corporate boards include:

- Proxy access bylaws, typically requiring ownership of three percent of outstanding shares for three years to nominate directors.
- Second-generation advance notice bylaws mandating greater disclosure requirements, and minimizing the size and duration of ownership stakes.
- Provisions mandating arbitration, rather than litigation, of certain shareholder disputes.
- Provisions waiving the ability to file class action shareholder suits.

In the ongoing push-and-pull between corporations and their shareholders, corporate bylaws have become a critical flashpoint for setting the rules of engagement. In the past the battleground was largely limited to the corporate ballot box via bylaws affecting the shareholders' ability to elect one or more directors not backed by management.

Now, that battle has shifted to bylaws affecting shareholder access to the courts. So far, the Delaware courts have proven receptive to efforts to curb frivolous lawsuits, while still ensuring that meritorious suits have their day in court.

Corporate directors should take a close look at their bylaws to ensure that they reflect the appropriate balance of power between the company and its shareholders. Directors would be well-served by having their general or outside counsel review the bylaws afresh in light of the rapidly-shifting legislative and judicial landscape. ■

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