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Volume 50 | Number 4

Article 11

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2017

### The Battle Over Corporate Bylaws

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#### Recommended Citation

Ariel Beverly, Comment, The Battle Over Corporate Bylaws, 50 Loy. L.A. L. Rev. 847 (2017).

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## The Battle Over Corporate Bylaws

### Cover Page Footnote

J.D. Candidate, May 2018, Loyola Law School, Los Angeles; B.A., Sociology, University of California, Berkeley. Thank you to Professor Elizabeth Pollman for your guidance and support throughout the writing process (and beyond), the members of the Loyola of Los Angeles Law Review for their hard work preparing this Comment for publication, and my family and friends for their everlasting encouragement.

# THE BATTLE OVER CORPORATE BYLAWS

*Ariel Beverly\**

## I. INTRODUCTION

Corporations face unprecedented levels of shareholder litigation. Yet, the rise in litigation does not appear attributable to increased instances of director and officer misbehavior. Consider the fact that in 2011, “96 percent of all mergers and acquisitions valued at or over \$500 million were subject to litigation.”<sup>1</sup> In 2013, 97.5 percent of all deals over \$100 million were challenged and “each transaction triggered an average of *seven* separate lawsuits.”<sup>2</sup>

If the challenged mergers and acquisitions tended to result in some commensurate benefit to shareholders, then the proliferation of shareholder suits would not warrant scrutiny or a corporate response. However, a report by Cornerstone Research studying 612 law suits found that *none* went to trial and “*all* judgments, including summary judgments or judgments on the pleadings were granted to the defendants.”<sup>3</sup> In 2015, shareholders lost about \$183 *billion* related to all securities class actions—an increase of 25% from the year before.<sup>4</sup> Moreover, median settlement amounts have failed to exceed

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\* J.D. Candidate, May 2018, Loyola Law School, Los Angeles; B.A., Sociology, University of California, Berkeley. Thank you to Professor Elizabeth Pollman for your guidance and support throughout the writing process (and beyond), the members of the *Loyola of Los Angeles Law Review* for their hard work preparing this Comment for publication, and my family and friends for their everlasting encouragement.

1. Joseph A. Grundfest & Kristen A. Savelle, *The Brouhaha Over Intra-Corporate Forum Selection Provisions: A Legal, Economic, and Political Analysis*, 68 BUS. LAW. 325, 335 (2013).

2. Jill E. Fisch et al., *Confronting the Peppercorn Settlement in Merger Litigation: An Empirical Analysis and a Proposal for Reform*, 93 TEX. L. REV. 557, 559 (2015).

3. *Investors Sued in 94% of M&A Deals Over \$100 Million in 2013, Report Finds*, WESTLAW J. DEL. CORP., Mar. 2014, at \*1.

4. *NERA: Investor Losses on US Filings Amount to 183 Billion*, CONSULTANCY.UK (Feb. 8, 2016), <http://www.consultancy.uk/news/3258/nera-investor-losses-on-us-filings-amount-to-183-billion>; *Investor Losses and Aggregated Securities Class Action Settlements Increased in 2015*, FRT (Apr. 14, 2016), <http://frtservices.com/investor-losses-and-aggregated-securities-class-action-settlements-increased-in-2015>.

3% of total alleged investor losses for the last 15 years and dropped to 1.4% in the first six months of 2016.<sup>5</sup>

In response to the significant amount of shareholder litigation and concerns about its cost and utility, many corporations have adopted bylaw provisions aimed at curtailing or limiting this litigation by, for example, providing for a shifting of fees to plaintiff-shareholders.<sup>6</sup> As a general matter, corporate bylaws structure the internal governance of corporate affairs.<sup>7</sup> Bylaws typically provide requirements for the time, place, and manner of conducting and giving notice of shareholders' and directors' meetings, the use and execution of proxies, quorum for committee and directors' meetings, appointment of the board, etc.<sup>8</sup> Most corporate codes, including the Delaware General Corporation Law ("DGCL"), include a provision that allows corporate bylaws to contain any provision consistent with the law so long as the bylaw relates to the business of the corporation and the conduct of its affairs.<sup>9</sup> The freedom and flexibility granted by such bylaws have spurred "innovative litigation reform efforts in the form of bylaw revisions."<sup>10</sup>

Corporate bylaw provisions defining the parameters of shareholder litigation, such as those concerning the shifting of fees in shareholder litigation, have ignited fierce debate among attorneys, legislatures, and scholars.<sup>11</sup> "Issues about their use are embedded in broader debates over the value of shareholder litigation, the role of private enforcement, the comparative power of shareholders and directors, the role of Delaware in U.S. corporate law, and other longstanding, polarized, and possibly intractable fights."<sup>12</sup>

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5. Monica K. Loseman, *2016 Mid-Year Securities Litigation Update*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (July 30, 2016), <https://corpgov.law.harvard.edu/2016/07/30/2016-mid-year-securities-litigation-update/>.

6. C. HUGH FRIEDMAN ET AL., CALIFORNIA PRACTICE GUIDE CORPORATIONS ¶ 4:397 (2017).

7. *Id.* at ¶ 4:397.11.

8. *See id.* at ¶ 4:196.

9. *See, e.g.*, DEL. CODE. ANN. tit. 8, § 109 (West 2015).

10. Stephen Bainbridge, *Oklahoma Leads on Fee Shifting Bylaws, Will Delaware and MCBA Follow?*, PROFESSORBAINBRIDGE.COM (Oct. 2, 2014), <http://www.professorbainbridge.com/professorbainbridgecom/2014/10/oklahoma-leads-on-fee-shifting-bylaws-will-delaware-and-mbca-follow.html>.

11. Verity Winship, *Contracting Around Securities Litigation: Some Thoughts on the Scope of Litigation Bylaws*, 68 SMU L. REV. 913, 913 (2015).

12. *Id.*

This Comment contextualizes the recent Delaware Chancery Court decision in *Solak v. Sarowitz*<sup>13</sup> within that debate. *Solak* involved two shareholder litigation bylaws unilaterally adopted by a corporation's board of directors. One provision directed that Delaware be the exclusive forum for all internal corporate claims.<sup>14</sup> The second provision imposed costs and attorneys' fees upon a shareholder who brought internal corporate claims outside the state of Delaware—unless the plaintiff obtained a judgment that substantially achieved the full remedy sought.<sup>15</sup>

The board adopted these provisions after a series of developments in Delaware corporate law. The period began with a Chancery Court opinion recognizing the validity of forum selection provisions in corporate bylaws,<sup>16</sup> followed by a decision from the Delaware Supreme Court upholding a fee-shifting provision.<sup>17</sup> Shortly after the holdings, the legislature amended the DGCL. One amendment codified the Chancery Court decision that established the validity of forum selection provisions.<sup>18</sup> The other amendment essentially overturned the Delaware Supreme Court's recognition of fee-shifting provisions and expressly prohibited bylaws that would burden a shareholder-plaintiff with the attorneys' fees of the corporation.<sup>19</sup> In *Solak*, the Chancery Court resolved any uncertainty as to whether the concurrent amendments signaled the validity of limited fee-shifting provisions that would only be implicated when a shareholder brought a claim outside of Delaware in violation of a forum selection bylaw.<sup>20</sup> The court definitively held that the DGCL prohibited *any* form of fee-shifting provisions in corporate bylaws.<sup>21</sup>

After locating fee-shifting bylaws in the social and political discourse, this Comment advocates enabling statutory schemes that grant entities the space and flexibility to innovatively experiment in

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13. 153 A.3d 729 (Del. Ch. 2016), *appeal denied*, 154 A.3d 1167 (Del. 2017).

14. *Id.* at 733.

15. *Id.*

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

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

18. DEL. CODE ANN. tit. 8, § 115 (West 2017).

19. DEL. CODE ANN. tit. 8, § 109(b) (West 2017).

20. Meredith E. Kotler & Mark E. McDonald, *Chancery Court Invalidates Bylaw Purporting to Shift Litigation Expenses onto Stockholders who Violate a Valid Forum-Selection Bylaw*, CLEARY GOTTlieb (Jan. 9, 2017), <http://www.clearmawatch.com/2017/01/chancery-court-invalidates-bylaw-purporting-shift-litigation-expenses-onto-stockholders-violate-valid-forum-selection-bylaw/#more-2293>.

21. *Id.*

their corporate governance structures. Allowing corporations to develop diverse choices in corporate governance encourages efficiency and innovation that enriches the entire corporate landscape.

This Comment proceeds as follows: Part II examines the development of shareholder litigation provisions in corporate governance documents, Part III explores the different perspectives advocated in the literature, and Part IV concludes by suggesting areas for future scholarship.

## II. BACKGROUND: THE EMERGENCE OF LITIGATION PROVISIONS IN CORPORATE BYLAWS

This Part examines the appearance of shareholder litigation provisions in corporate governance documents. It provides the background of the matters at issue in *Solak* and demonstrates the resourcefulness that private ordering responses foster.

### A. Exclusive Forum Selection Provisions

In the past decade, shareholder litigation reached a level that caused commentators to describe the situation as a “crisis.”<sup>22</sup> Alongside the rise of shareholder litigation was a rise in the proportion of suits filed outside the state of Delaware. Roberta Romano and Sarath Sanga reported that most complaints brought against Delaware corporations were filed exclusively in Delaware in 2000, but by 2010 Delaware corporations were defending over half of their lawsuits in multiple forums and a third exclusively out of state.<sup>23</sup>

In the case of multi-forum litigation, a corporation is forced to defend the same claims for the same class in multiple forums.<sup>24</sup> The causes and consequences of the multi-forum phenomenon are thought to be unrelated and adverse to stockholder welfare.<sup>25</sup>

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22. Stephen Brainbridge, *Fee-Shifting: Delaware's Self-Inflicted Wound*, 40 DEL. J. CORP. L. 851, 852 (2016) (“In recent years, [shareholder litigation] reached crisis proportions.”); Sean J. Griffith, *Correcting Corporate Benefit: How to Fix Shareholder Litigation by Shifting the Doctrine on Fees*, 56 B.C.L. REV. 1, 25 (2015) (“The patterns [...] reveal a crisis in shareholder litigation.”).

23. Roberta Romano and Sarath Sanga, *The Private Order Solution to Multiforum Shareholding Litigation*, 14 J. EMPIRICAL LEGAL STUD. 31, 34 (2017).

24. Winship, *supra* note 11, at 915.

25. Grundfest, *supra* note 1, at 340.

Plaintiffs' counsel have an incentive to maximize their fees, leading them to file claims in forums believed to be generous in the award of attorneys' fees—apparently Delaware Courts have a reputation of being frugal in this regard.<sup>26</sup> Additionally, “plaintiff’s counsel may file multiple lawsuits as part of a rational business model designed ‘to get a seat at the table . . . because it gives them a better shot at the action and better leverage in terms of fees.’”<sup>27</sup> And of course, strategic forum selection, which secures an advantage by way of procedural rules or having a case heard before a judge tasked with applying unfamiliar law, is not unusual.<sup>28</sup> However, unlike the typical forum shopping context, shareholders’ interests are disadvantaged by tactical filings aimed to generate delay or uncertainty in rulings.<sup>29</sup> Scholarship further documents other perverse effects that arise from shareholder litigation.<sup>30</sup> Allowing claims to be litigated in multiple forums simultaneously wastes judicial resources, creates an opportunity for conflicting outcomes, and unjustifiably taxes shareholders’ investments to compensate attorneys for pleading and defending the same lawsuit in multiple jurisdictions.<sup>31</sup>

Lawmakers, commentators, and attorneys have suggested various means to resolve the multi-forum problem.<sup>32</sup> Vice Chancellor Travis Laster of the Delaware Chancery Court endorsed the use of forum selection provisions to remedy the problem in a 2010 decision, *In re Revlon, Inc., Shareholders Litigation*,<sup>33</sup> writing that “if boards of directors and stockholders believe that a particular forum would provide an efficient and value-promoting locus for dispute resolution, then corporations are free to respond with charter provisions selecting an exclusive forum for intra-entity disputes.”<sup>34</sup> Corporations promptly acted. Hundreds of publicly traded entities

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26. *Id.*

27. *Id.* at 341.

28. *Id.* at 342.

29. *Id.* at 342–43.

30. *See id.* at 341–42; *see also* John C. Coffee, Jr., *Forum Selection Clauses and the Market for Settlements*, N.Y.L.J. (May 17, 2012), <https://advance.lexis.com/search?crd=b24c6303-640c-43bb-9fbc-37d452145c9f&pdsearchterms=LNSDUID-ALM-NYLAWJ-1202554035470&pdbypasscitator docs=False&pdmfid=1000516&pdisurlapi=true&cbc=0>.

31. *See* Coffee, *supra* note 30, at 3, 5.

32. Winship, *supra* note 11, at 915.

33. 990 A.2d 940, 960 (Del. Ch. 2010).

34. *Id.*; Winship, *supra* note 11, at 915; Coffee, *supra* note 30, at 1.

adopted intra-corporate forum selection provisions.<sup>35</sup> Shortly thereafter, “a brouhaha . . . erupted over [their] validity.”<sup>36</sup>

The Delaware Chancery Court formally addressed forum selection provisions in a 2013 case, *Boilermakers v. Chevron*.<sup>37</sup> The court found the bylaws at issue to be valid and enforceable contractual clauses.<sup>38</sup> The decision relied upon the corporation-as-contract paradigm wherein shareholders are deemed to have consented to the authority of the board of directors.<sup>39</sup> The enabling structure of the Delaware corporate code allows corporate charters to include provisions that grant directors the ability to adopt bylaws unilaterally.<sup>40</sup>

Chevron’s certificate of incorporation contained a clause granting its board authority to unilaterally adopt bylaws.<sup>41</sup> The court explained that “the bylaws of a Delaware corporation constitute part of a binding broader contract among the directors, officers, and stockholders formed within the statutory framework of the DGCL.”<sup>42</sup> The contract is malleable by design and subject to change in any manner consistent with the DGCL;<sup>43</sup> investors are assumed to be on notice of the nature of the contractual relationship when they purchase stock in a Delaware corporation.<sup>44</sup> “[A]n essential part of the contract stockholders assent to [when purchasing stock in a corporation that grants the board of directors the power to *amend* bylaws] is one that presupposes the board’s authority to *adopt* binding bylaws. . . .”<sup>45</sup>

These Chancery Court opinions encouraged innovative private ordering responses to multi-forum litigation. The statutory scheme and judicial recognition of the contractual relationship among corporate actors enabled corporations to experiment in addressing internal governance matters.

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35. Grundfest, *supra* note 1, at 326.

36. *Id.*

37. 73 A.3d 934 (2013).

38. *Id.* at 939.

39. *Id.*

40. DEL. CODE ANN. tit. 8, § 109 (West 2017); *Boilermakers*, 73 A.3d at 942.

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

42. *Id.* at 939.

43. *Id.*

44. *Id.*

45. *Id.* at 940 (emphasis added).



*B. The Expansion of Litigation Provisions*

Shareholders then challenged the board's ability to unilaterally adopt fee-shifting provisions. Fee-shifting provisions in commercial contracts are not rare. In generic form, the prevailing party, in addition to whatever remedy sought, is awarded attorneys' fees. Such provisions displace the standard American Rule, under which each party pays for his or her own attorney. Fee-shifting provisions appearing in corporate bylaws, while not uniform, tended to be unilateral and have a harsh conception of the prevailing party;<sup>46</sup> the average fee-shifting provision permitted the corporation to recover litigation expenses in all circumstances except when the shareholder was *fully* successful.<sup>47</sup>

The reasoning of the court in *Boilermakers* provided a logical foundation to support diverse litigation clauses in corporate bylaws.<sup>48</sup> The "corporation-as-contract" metaphor, upon which the court rooted its decision, had long been influential in corporate law scholarship.<sup>49</sup> However, the *Boilermaker* decision extended that metaphor by making it literally so.<sup>50</sup>

With the corporation-as-contract rationale set forth in *Boilermakers* and the prominence of fee-shifting provisions in commercial contracts, the Supreme Court of Delaware readily upheld the facial validity of the fee-shifting bylaw in *ATP Tour, Inc. v. Deutscher Tennis Bund*.<sup>51</sup> The court reasoned that neither the DGCL nor any other Delaware statute prohibited corporations from adopting fee-shifting provisions,<sup>52</sup> and that no principle of common law prohibited it.<sup>53</sup> Moreover, bylaws that "[allocate] risk among parties in intra-corporate litigation" seem to satisfy the requirement that bylaws relate "to the business of the corporation, the conduct of its

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46. Verity Winship, *Shareholder Litigation by Contract*, 96 B.U.L. REV. 485, 506 (2016); Albert H. Choi, *Optimal Fee-Shifting Bylaws* (U. of Va. Sch. of L., L. & Econ. Res. Paper Ser., Working Paper No. 2016-15, 2016), [http://www.law.nyu.edu/sites/default/files/upload\\_documents/Optimal%20Fee-Shifting%20Bylaws%2010.20.16.pdf](http://www.law.nyu.edu/sites/default/files/upload_documents/Optimal%20Fee-Shifting%20Bylaws%2010.20.16.pdf) ("While the exact meaning of the word, 'prevail,' is not entirely clear, courts have ruled that . . . 'prevail' does not mean that the party must have achieved the 'complete relief' sought.").

47. Winship, *supra* note 46, at 506.

48. *Id.*

49. Griffith, *supra* note 22, at 33.

50. *Id.* at 33–34.

51. 91 A.3d 554 (2014); *id.* at 558.

52. *Id.* at 558.

53. *Id.*

affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees.”<sup>54</sup> Last, the litigation provision at issue in *ATP Tour* would be unenforceable if enacted for an improper purpose.<sup>55</sup> However, the intent to deter litigation is not unfailingly an improper purpose.<sup>56</sup> All fee-shifting provisions work to deter litigation, yet they are not *per se* invalid.

As in *Boilermakers*, the decision in *ATP Tour* acknowledged that the enabling statutory framework of the DGCL grants corporations great latitude in matters of corporate governance. The flexibility inherent in the statutory framework provided corporations the opportunity to employ a tailored, private ordering solution to excessive shareholder litigation.

In the twelve months following the Delaware Supreme Court’s decision in *ATP Tour*, fifty-nine corporations adopted fee-shifting bylaws.<sup>57</sup> Among many corporations, however, there was a reluctance to enact a provision so seemingly hostile to shareholder suits.<sup>58</sup> Conflict with shareholders and proxy advisory firms would inevitably follow any enactment of fee-shifting provisions which would be interpreted as adversarial.<sup>59</sup> And it did. Institutional investors sent letters in support of a proposed bill to forbid fee-shifting provisions, and proxy advisory firms urged their clients to “recommend that shareholders vote to remove directors who adopt fee-shifting bylaws.”<sup>60</sup>

### C. *The End of Litigation Provisions?*

Soon after the Delaware Supreme Court approved the use of loser-pays bylaws, the Corporate Law Council of the Delaware State Bar Association proposed amendments that would ban fee-shifting provisions in corporate bylaws.<sup>61</sup> Reforms were promptly introduced and enacted in 2015.<sup>62</sup> One amendment expressly permitted a

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54. *Id.*; DEL. CODE ANN. tit. 8, § 109 (West 2017).

55. *ATP Tour*, 91 A.3d at 560.

56. *Id.*

57. *See Fee-Shifting Bylaws*, COUNCIL OF INSTITUTIONAL INVS. (May 13, 2015), <https://perma.cc/VGS6-LCP5>.

58. Winship, *supra* note 46, at 511–12.

59. *Id.* at 513.

60. *Id.* at 513–14.

61. David A. Skeel Jr., *The Bylaw Puzzle in Delaware Corporate Law*, 72 BUS. LAW. 1, 9 (2017).

62. *Id.* at 10.

Delaware corporation to adopt bylaws that mandated internal corporate claims be filed exclusively in Delaware—a codification of the *Boilermakers* decision.<sup>63</sup> Simultaneously, the state legislature enacted an amendment that displaced the Delaware Chancery Court decision in *ATP Tour* and forbid provisions “that would impose liability on a stockholder for the attorney’s fees or expenses of the corporation [. . .] in connection with an internal corporate claim.”<sup>64</sup>

Many commentators and attorneys questioned whether the language of the 2015 amendments forbidding corporations from including fee-shifting provisions in their charter or bylaws in connection with internal corporate claims permitted any limited use of fee-shifting.<sup>65</sup> As written, the statute applies to derivative claims based on a breach of a director’s fiduciary duties.<sup>66</sup> Whether the statute reached claims brought under federal securities law was debatable.<sup>67</sup> Some proposed that this might have been a deliberate tailoring of the statute that permitted use in securities litigation where interests on both sides of the Delaware Bar might be injured.<sup>68</sup> Others dismissed that theory and offered explanations based on preemption.<sup>69</sup>

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63. *Solak v. Sarowitz*, 153 A.3d 729, 732 (Del. Ch. 2016), *appeal denied*, 154 A.3d 1167 (Del. 2017).

64. *Id.* at 732–33 (quoting DEL. CODE ANN. tit. 8, § 109(b) (2017)). The last time the state legislature aggressively redirected the trajectory of Delaware law was in 1986, after *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) *overruled by* *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009). Skeel, *supra* note 61, at 10. In the notorious Delaware Supreme Court decision, the divided court permitted directors to be personally liable for monetary damages for the breach of the duty of care. *Id.* The legislature swiftly amended the DGCL to permit exculpatory bylaw provisions. *See* Skeel, *supra* note 61 for a hypothesis on why the Delaware Legislature took this unusual action to usurp the ruling of the judiciary.

65. John C. Coffee, Jr., *Fee-Shifting Bylaw and Charter Provisions: Can They Apply in Federal Court?—The Case for Preemption* (Colum. L. Sch., L. & Econ. Res. Paper Ser., Working Paper No. 498, 2014), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2508973](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2508973); J. Robert Brown Jr., *Staying in the Delaware Corporate Governance Lane: Fee Shifting Bylaws and a Legislative Reaffirmation of the Rules of the Road* 12 (U. of Denv. Sturm C. of L., Legal Stud. Res. Paper Ser., Working Paper No. 15-23, 2015), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2611746](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2611746).

66. Brown, *supra* note 65, at 12.

67. Winship, *supra* note 11, at 913.

68. John C. Coffee, *Delaware Throws a Curve Ball*, THE CLS BLUE SKY BLOG (Mar. 16, 2015), <http://clsbluesky.law.columbia.edu/2015/03/16/delaware-throws-a-curveball/>; Stephen Brainbridge, *Delaware’s Proposed Ban on Fee Shifting Bylaws and Its Application to Federal Securities Litigation*, PROFESSORBRAINBRIDGE.COM (Mar. 29, 2015), <http://www.professorbrainbridge.com/professorbrainbridgecom/2015/03/delawares-proposed-ban-on-fee-shifting-bylaws-and-its-application-to-federal-securities-litigation.html>.

69. *See* Brown, *supra* note 65, at 13.

*D. The Solak Decision: Statement of the Case & Reasoning of the Court*

Shortly after the amendments to the DGCL, the Paylocity Holding Corporation board of directors adopted two new bylaws.<sup>70</sup> The board adopted an exclusive forum provision which mandated that all internal corporate claims be brought in the state of Delaware—absent the corporation’s consent otherwise.<sup>71</sup> The second addition to the bylaws, and the basis for the action, shifted the fees and costs of the corporation to an unsuccessful shareholder who filed suit outside of the state of Delaware without the consent of the corporation.<sup>72</sup> The corporation could only invoke the fee-shifting provision in the limited circumstance that an unsuccessful shareholder brought an intracorporate claim outside of Delaware.<sup>73</sup>

The court made short shrift of Paylocity’s argument that the dual enactment of the DGCL amendments conveyed the intent of the legislature to permit limited fee-shifting provisions.<sup>74</sup> Relying on the unambiguous statutory language that prohibited corporate bylaws from including “any provision” that “would shift to a stockholder the attorneys’ fees or expenses incurred by the corporation ‘in connection with an internal corporate claim,’ irrespective of where such a claim is filed,” the court held the fee-shifting provision invalid.<sup>75</sup> A fee-shifting provision that is only triggered when a claim is filed outside the state of Delaware cannot escape the purpose or effect of the unconditional ban on fee-shifting provisions.<sup>76</sup>

Next, the court addressed Paylocity’s meritless assertion that the DGCL did not displace the common law, which permits fee-shifting provisions.<sup>77</sup> The court distinguished fee-shifting provisions in a private contract, an issue presented in an earlier opinion, from a fee-shifting provision in bylaws.<sup>78</sup> In fact, the legislative synopsis expressly distinguished the two forms when it indicated that the

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70. *Solak v. Sarowitz*, 153 A.3d 729, 733 (Del. Ch. 2016), *appeal denied*, 154 A.3d 1167 (Del. 2017).

71. *Id.*

72. *Id.*

73. *Id.*

74. *See id.* at 741–42.

75. *Id.* at 741.

76. *Id.*

77. *Id.* at 742.

78. *Id.*

amendment was not intended “to prevent the application of any provision in a *stockholder agreement* or *other writing signed by the stockholder against whom the provision is to be enforced*.”<sup>79</sup> Given the clear statutory authority banning such provisions, the court concluded that Paylocity’s fee-shifting bylaw could not be exercised lawfully under any circumstances.<sup>80</sup> The fee-shifting bylaw adopted by Paylocity unquestionably violated the newly amended DGCL 109(b) clause prohibiting the use of fee-shifting provisions.

The use and debate over fee-shifting provisions is not over; forty-nine states have yet to ban their use, and at least one state, Oklahoma, expressly permits them.<sup>81</sup> Corporations may be swayed to incorporate or re-incorporate in states more amenable to fee-shifting provisions and other private ordering solutions. A framework for understanding the relationship between corporate actors must be explored and an enabling statutory scheme encouraging experimentation in corporate governance must be established.

### III. ANALYSIS

This Part reviews the literature and explores implications of the *Solak* case. After engaging in the current discussion of shareholder litigation provisions, this Comment advocates for statutory frameworks that provide entities with the flexibility to experiment with private ordering solutions. Finally, this section concludes with insights for the future orientation of bylaws.

#### *A. Issues of Contract and Consent*

In the context of divisive views on the value and role of shareholder litigation, legislative and other responses have proven unable to effectively address an unyielding rise in litigation. However, diverse interests have embraced the corporation-as-contract paradigm.<sup>82</sup> Innovative experimentation in private ordering

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79. *Id.* (emphasis added).

80. *Id.* at 743.

81. *See* OK. STAT. tit. 18, § 1126 (2015) (“In any derivative action instituted by a shareholder of a domestic or foreign corporation, the court having jurisdiction, upon final judgment, shall require the nonprevailing party or parties to pay the prevailing party or parties the reasonable expenses, including attorney fees, taxable as costs, incurred as a result of such action.”).

82. *See* Verity Winship, *Shareholder Litigation by Contract*, 96 B.U.L. REV. 485, 506 (2016); D. Gordon Smith et. al., *Private Ordering with Shareholder Bylaws*, 80 FORDHAM L. REV. 125 (2011).

solutions enables firms to identify and customize procedures for their unique needs.

The flexible corporate contract provides a negotiation platform for both shareholders and directors. Professors Farr and Clark's work counsels a rejection of uniform and universal governance systems where private ordering is not possible.<sup>83</sup> Their work recognizes that entities have specific and distinct needs which require different governance structures.<sup>84</sup> Empowering shareholders to contract through shareholder bylaws, they argue, provides the opportunity to "to create laboratories of corporate governance that benefit the entire corporate governance system."<sup>85</sup> Other commentators may challenge shareholder activism with institutional competency arguments, but they nonetheless would endorse the preference for private ordering. Moreover, they would agree that, "[i]n a system in which private ordering is encouraged, corporate bylaws, through experience and adaptation, become solutions to common governance problems faced by corporations."<sup>86</sup>

Scholars' most prominent criticism of the corporation-as-contract paradigm concerns the issue of consent. Bylaws, which are procedural and process-oriented, "'set forth the rules by which the corporate board conducts its business' and 'the procedures through which board and committee action is taken.'"<sup>87</sup> While different corporate governance documents implicate adherence to different procedures, bylaws tend to be the most problematic.<sup>88</sup> This is because DGCL 109(b) vests the authority to amend the bylaws in the shareholders, and yet, also allows the certificate of incorporation to delegate authority to amend bylaws to the directors.<sup>89</sup> If a corporation has such a provision in its certificate of incorporation, this means that the bylaws may be adopted, amended, or repealed *unilaterally* by the board of directors (*i.e.*, without the need for shareholder approval).<sup>90</sup>

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83. Smith, *supra* note 82, at 188.

84. *Id.*

85. *Id.*

86. *Id.* at 174.

87. Winship, *supra* note 46, at 495.

88. *See id.* at 496.

89. *Id.*

90. *Id.* Importantly, shareholders have the irrevocable concurrent right to adopt, amend, or appeal bylaws. *Id.*

Given the validity of private ordering procedures in consumer and commercial contracts, the legitimacy of private ordering procedures in corporate bylaws would seem to be an accepted application.<sup>91</sup> However, consent in the corporate contract is consent to the corporate governance structure, not to any individual provision adopted by the board.<sup>92</sup> Investors are deemed on notice of the board's authority to enact bylaws and bound by their terms.<sup>93</sup> Thus, unlike the purchase of goods—where the terms are presented in full before the transaction is complete—in a stock purchase, the central but implicit term consented to is the power and authority of the board.

Beyond the issue of consent, scholars have attempted to mark the boundaries of shareholder litigation provisions. Substantive law, like a natural border, proves an intuitive line of demarcation. Accordingly, the scope of procedural provisions would be best decided by corporate substantive law.<sup>94</sup> This reasoned argument is concerned with the ability to skirt mandatory substantive law through artful shaping procedures.<sup>95</sup> “If a party cannot contract around a substantive obligation, then the party should not be able to eliminate it by disabling enforcement.”<sup>96</sup> By way of example, if substantive corporate law mandates fiduciary duties, those duties could not be circumvented by contractually prohibiting claims for their enforcement.<sup>97</sup> A recent Delaware Court of Chancery decision illustrated the scope of permissible bylaws when it invalidated a removal provision unilaterally adopted by the board of directors.<sup>98</sup> The board amended a bylaw governing the removal of directors.<sup>99</sup> As amended, the bylaw provided that director removal required a two-

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91. The Supreme Court has signaled its approval of contract procedures. See *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585 (1991).

92. *Winship*, *supra* note 46, at 497–98.

93. *Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934, 955–56 (Del. Ch. 2013); *Winship*, *supra* note 46, at 498.

94. *Winship*, *supra* note 46, at 522.

95. *Id.*

96. *Id.*

97. *Id.* *Winship* distinguishes procedural limits that do not rise to the level of waiver from effective elimination of those rights. However, even in the case of waiver, *Winship* does not advocate an outright ban, but asserts that such provisions “would trigger heightened consent requirements.” *Id.* at 526.

98. *Frechter v. Zier*, C.A. No. 12038-VCG, 2017 WL 345142, at \*2 (Del. Ch. Jan. 24, 2017).

99. *Id.* at \*3.

thirds majority vote of shareholders rather than the simple majority requirement of the DGCL.<sup>100</sup>

The scope of permissible bylaw provisions turns back to the issue of consent. Even for those accepting of the corporation-as-contract model, there are provisions that confront the limits of the doctrine of corporate consent.<sup>101</sup> Professor Lawrence Hamermesh proposes four principles to identify whether provisions “should be deemed contrary to law, and not the product of meaningful consent.”<sup>102</sup> While all four principles undoubtedly inform the notion of consent, only one of his suggested criteria does not call for a reformation of the Delaware court’s doctrine of corporate consent: “whether [a] provision impairs some strong and reasonable expectation on the part of investors, in light of other known elements of the so-called corporate contract.”<sup>103</sup>

Shareholders consent to a governance structure and defer to the discretion of a board with some basic expectations of the relationship.<sup>104</sup> Hamermesh’s expectation principle aligns with the themes of the DGCL<sup>105</sup> and the concern over procedural provisions intended to evade substantive law—which aim to protect the interests of shareholders. However, identifying and defining “reasonable expectations” is not without issues.<sup>106</sup> In addition to the problems inherent in any standard of reasonableness, expectations are not static.<sup>107</sup> The substantive law should, therefore, be the only restraint on the scope of bylaws.

Substantive law need not act as a complete bar to shareholder litigation provisions. As mentioned above, restrictions that fall short of forfeiting a right may be permitted. Provisions that amount to a waiver could also be permitted, but required to meet a stricter standard of consent.<sup>108</sup> For example, a majority of shareholders would be required to approve a specific provision that waives

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100. *Id.* at \*3–4; 8 DEL. CODE ANN. tit. 8, § 141(k) (West 2017).

101. See Lawrence A. Hamermesh, *Consent in Corporate Law*, WIDENER L. SCH. LEGAL STUD. RES. PAPER SER. NO. 14-31, Aug. 2014, <https://ssrn.com/abstract=2488209>.

102. *Id.* at 14.

103. *Id.* at 15.

104. Such as the directors and officers acting in profit maximizing ways.

105. The DGCL requires shareholder approval for specified transactions.

106. Hamermesh, *supra* note 101, at 16.

107. *Id.* at 17.

108. Winship, *supra* note 46, at 526.



substantive law.<sup>109</sup> Courts may also employ a more flexible sliding scale model, requiring something approaching actual consent<sup>110</sup> the closer a provision fell towards waiver, while relying on consent to the governance structure in provisions which merely offend substantive rights.<sup>111</sup> Support for such a model exists and was illustrated in the court's reasoning in *Solak*, which distinguished between bylaw provisions and terms in a private contract.<sup>112</sup> Recognizing the force and effect of a given provision will halt bylaws that evade the law while allowing innovative experimentation that addresses matters of corporate concern, such as excessive shareholder litigation.<sup>113</sup>

Other scholars, recognizing the versatility of private ordering responses, appear more interested in the substance and effect of shareholder litigation provisions promulgated by corporate boards. Boards adopted shareholder litigation provisions in an effort to deter frivolous litigation. But few asked whether it worked—whether the provisions had the precise effect of deterring frivolous litigation while leaving room for meritorious claims.

The one-sided fee-shifting arrangements at issue in *Solak* and *ATP Tour* threatened to deter even meritorious suits.<sup>114</sup> The provisions adopted by ATP Tour and Paylocity impose fee liability on shareholders in nearly every instance.<sup>115</sup> Economic analysis reveals that a shareholder is less likely to bring a case with a high probability of success under a Paylocity or ATP Tour type fee-shifting provision.<sup>116</sup> This is particularly true where the probability of partial recovery is substantial.<sup>117</sup>

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109. *Id.*

110. Given that actual consent would require unanimous approval, that need not be the standard.

111. Winship, *supra* note 46, at 528.

112. *See supra* Part II.D. However, this appears to undermine the Delaware Court's corporation-as-contract logic. Specifically, the reliance upon the language of the statutory synopsis, which emphasizes the difference between bylaws and other documents such as a shareholder agreement that is signed by the shareholder it is to be enforced against.

113. Winship, *supra* note 46, at 528.

114. Choi, *supra* note 46, at 3–4.

115. The provisions are worded such that the plaintiff must “achieve [the] . . . full remedy sought” to avoid triggering liability. *See ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554 (Del. 2014); *Solak v. Sarowitz*, 153 A.3d 729 (Del. Ch. 2016), *appeal denied*, 154 A.3d 1167 (Del. 2017).

116. *See Choi, supra* note 46, at 12. In the *Solak* provision, the effect on shareholder litigation would be limited to claims brought outside the state of Delaware.

117. *Id.*

What shareholder would risk incurring millions of dollars of liability to right a wrong for a minimal monetary award? A shareholder brings a derivative suit on behalf of the corporation and any recovery flows back to the corporation.<sup>118</sup> Considering that it is typically an attorney initiating suit, he or she would likely have to agree to reimburse the shareholder for any liability incurred through suit before a shareholder would sign on to be lead plaintiff.<sup>119</sup>

Under the corporate benefit doctrine, the corporate defendant pays the shareholder plaintiff's attorneys' fees. The doctrine works one way, creating asymmetry. Fee-shifting provisions adopted by ATP Tour and Paylocity are similarly asymmetrical, imposing fees in only one direction. Arguably, both the corporate benefit doctrine and fee-shifting provisions are sub-optimal.<sup>120</sup> In either case, the rule is over-inclusive and fails to discriminate between meritorious and baseless suits.<sup>121</sup> A more equitable and measured fee-shifting scheme could produce an efficient screening mechanism that does not obliterate all deterrents or incentives to litigation.

One means of correcting the asymmetry of the corporate benefit doctrine is to modify its use. The doctrine has been applied beyond its confines to contexts not justified by its origins.<sup>122</sup> The corporate benefit doctrine originated as a fee-sharing arrangement.<sup>123</sup> Fee-sharing first appeared as the "sharing of fees among all beneficiaries of a fund recovered for the 'common benefit.'"<sup>124</sup> This practice and rationale lent itself to derivative suits. As the Supreme Court of Minnesota reasoned, "[s]ince the corporation is the beneficiary of the recovery of funds or of the corrective benefit of the action, it should stand the expense of it."<sup>125</sup> The doctrine has grown beyond its own logic, and the sharing of fees and costs among plaintiffs has devolved into the shifting of fees and costs to defendants.<sup>126</sup>

Scholars have proposed a refinement of the corporate benefit doctrine that would restore the concept to the confines of its

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118. *Id.* at 18.

119. *Id.* at 20.

120. *See id.*

121. *See id.* at 22.

122. Griffith, *supra* note 22, at 41.

123. *See id.*

124. *Id.* at 37–38.

125. *Bosch v. Meeker Coop. Light & Power Ass'n*, 101 N.W.2d 423, 426 (Minn. 1960).

126. Griffith, *supra* note 22, at 41–42. Griffith traces the modern day form of this doctrine, the Delaware rule, to a 1989 Delaware Supreme Court decision.

origins.<sup>127</sup> The suggestions, while narrowly tailored to preserve the benefits that serve the justifications of the doctrine, require judicial and legislative action. Alternatively, a private ordering response that opts out of the corporate benefit doctrine would correct the imbalance in the award of attorneys' fees that incentivizes attorney initiated shareholder litigation.<sup>128</sup>

### *B. Toward a Solution?*

A review of the literature reveals that the discourse of private ordering and shareholder litigation does not need to answer what the proper role of institutional actors may be, or determine the right amount of shareholder litigation; those are partisan questions best left to be resolved by corporations and their shareholders. Rather, the contribution of scholarly debate must be to create a paradigm for conceptualizing the nature of the relationship.

The corporation-as-contract model provides an appropriate and accepted method for understanding the rights of affected parties. The model allows insightful arguments to be extended by both critics and proponents of board-adopted bylaws and is informed by the rich history of common law. Moreover, envisioning the corporation as a matter of contract protects the enabling character of corporate law by allowing private parties to negotiate agreements that reflect their interests.

A potential perimeter for such provisions, although not discussed in the literature, would be to invoke the standard contractual limitation on terms against public policy. Despite the ability of a public policy limitation to leave undisturbed the corporation-as-contract model favored by the Delaware courts, such an approach invites judicial activism and may lead to concern over the neutrality of a court.<sup>129</sup>

Substantive law furnishes a sensible and objective boundary to delineate the permissible scope of bylaws adopted unilaterally by a board. Employing this limit on the board's authority to independently adopt provisions provides a defined, but expansive, field of

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127. *See id.* at 47.

128. Some commentators are not persuaded that shareholder litigation is anything but a nuisance, and contend there would be no loss from the elimination of shareholder litigation. *See* Bainbridge, *supra* note 22, at 875.

129. *See* Skeel, *supra* note 61, at 23.

autonomy for corporate actors. Any provisions contrary to substantive law could still be adopted, but like major transactions or amendments to the corporate charter, would require some affirmation by stockholders. Maintaining the agility of a board to respond to particular or generalized issues in ways that protect the interests of the corporation is essential to efficiency and innovation.

Delaware is—or has been—the darling of corporate law. Many businesses choose to incorporate, or reincorporate, in Delaware.<sup>130</sup> The small state has been the favored state of incorporation since the 1900s.<sup>131</sup> As such, the DGCL and the opinions from the Delaware Court of the Chancery have been influential sources of corporate law. The DGCL gained notoriety as one of the most flexible and advanced collections of corporation statutes in the United States.<sup>132</sup>

Although it may seem a bit dramatic, the recent turn of events has led commentators to question Delaware's continued preeminence. Given the astonishing amount of shareholder litigation, a single prohibitory amendment is of great significance. At least one state, Oklahoma, amended its corporate code to expressly permit fee-shifting provisions.<sup>133</sup> Many anxiously anticipate that conservative and pro-business states will follow in an effort to entice incorporation and re-incorporation in their state.

The issue of fee-shifting provisions remains unresolved, and the scope of unilateral board adopted bylaws continues to be undefined. The *Solak* opinion confirms that Delaware will not permit even a limited fee-shifting provision. Although the Delaware courts were originally amenable to another approach to fee-shifting bylaws, the legislature's amendments to the DGCL left the Chancery Court with little choice but to rule as it did in *Solak*. This signaling of intolerance increases the allure of incorporation, or reincorporation, in other states that are more enabling of private ordering. As such, a framework for understanding the relationship of corporate parties and their respective rights is of great importance.

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130. LEWIS S. BLACK, JR., WHY CORPORATIONS CHOOSE DELAWARE 1 (Del. Dep't. of State Div. of Corps.) (2007), [https://corp.delaware.gov/pdfs/whycorporations\\_english.pdf](https://corp.delaware.gov/pdfs/whycorporations_english.pdf).

131. *Id.*

132. *Id.* at 2.

133. Stephen Bainbridge, *Oklahoma Leads On Fee Shifting Bylaws, Will Delaware and MCBA Follow?*, PROFESSORBRAINBRIDGE.COM (Oct. 2, 2014), <http://www.professorbainbridge.com/professorbainbridgecom/2014/10/oklahoma-leads-on-fee-shifting-bylaws-will-delaware-and-mbca-follow.html>.

#### IV. CONCLUSION

This Comment advocates enabling statutory schemes that grant entities the space and flexibility to innovatively experiment in their corporate governance structures. Employing a “corporation-as-contract” framework grants boards the autonomy to act in original ways that further the corporation’s interests and residually benefits the corporate field. They must do so, however, in a manner which distinguishes procedural from substantive shareholder rights and adopt a sliding scale approach to tailor appropriate restrictions or limitations designed to properly balance shareholder and corporate interests to achieve equitable yet efficient outcomes.

Private ordering responses will continue to be a subject of debate among scholars. New challenges to creative corporate maneuvers will erupt in further brouhahas.<sup>134</sup> The diversity of governance choices permitted by enabling statutory schemes provides an exciting landscape for original processes and mechanisms for controlling and directing corporations. Research must not succumb to partisanship or entrenched positions. Legal analysis that provides a consistent framework for conceptualizing the relationship and rights of respective parties must be pursued.

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134. See Grundfest, *supra* note 1, at 1.

