Using Board-adopted By-laws to Reduce Corporate Threats

In her regular column on corporate governance issues, Holly Gregory examines the use of charter provisions and board-adopted by-laws to reduce certain threats related to dissident directors and intra-company litigation.

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Board-adopted corporate by-laws have long been used to provide protections against potential corporate threats, dating back at least to the 1980s and the famous development of the poison pill. In the current era of heightened hedge fund activism, potential shareholder-approved proxy access and increasing shareholder litigation, interest is developing in a new generation of corporate by-laws designed to protect the company from the potential threats posed by dissident directors and intra-company litigation. These include provisions:

- Relating to the qualification of directors.
- Designed to control intra-company litigation, in particular, by-laws that:
  - seek to limit the forum for intra-company disputes (exclusive forum by-laws);
  - require arbitration for intra-company disputes (arbitration by-laws); and
  - allocate the cost of intra-company litigation to a losing plaintiff (fee-shifting by-laws).

Counsel should advise the board cautiously with respect to any of these by-law amendments. Much of the case law to date relates to Delaware corporations. Therefore, companies incorporated outside of Delaware have little guidance. Moreover, the context in which a board adopts these types of by-laws may be scrutinized, since courts are wary of board-adopted by-laws that are reactive to a specific threat from shareholders. By-law amendments are best considered on a "clear day" when no specific threat is apparent. Consideration should also be given to how key shareholders are likely to react to these types of by-law amendments, since some large institutional shareholders, the Council of Institutional Investors (CII) and key proxy advisors have expressed concerns.

This article examines the use of board-adopted by-laws to protect against corporate threats, including guidance from recent case law, and offers practical considerations counsel should think about when weighing the opportunities and risks associated with their adoption.

DIRECTOR QUALIFICATION BY-LAWS

The increase in hedge fund efforts to seat director nominees on the board through a proxy contest, and the potential for shareholders to impose proxy access that would allow shareholders to place nominees directly on the proxy statement, raise legitimate concerns about assuring that these director nominees will abide by company policies and not act in the particular interests of the nominating shareholder. One concern is that shareholder director nominees elected in a proxy contest or through proxy access have not been vetted and selected by the board in a process driven by a nominating and governance committee composed of independent directors who are subject to fiduciary obligations.

The corporate statutes of most states have a provision similar to Delaware General Corporation Law (DGCL) Section 141(b), which specifically allows for provisions relating to the qualification of directors to be included in the certificate of incorporation or the by-laws. Where a board has authority to amend the by-laws, director qualification by-laws provide the board with the ability to impose conditions that can help set the framework for the board's culture and effectiveness.

Qualification requirements may be used to help ensure compliance with regulatory requirements and company policies by addressing issues such as:

- Lack of criminal background.
- Age and term limits.
- Limits on other board service.
- Advance agreement to abide by the company's governance guidelines and corporate code of conduct, including policies regarding:
  - relationships with competitors;
  - conflicts of interest and related person transactions;
  - insider trading and Regulation FD;
  - confidentiality, including strict board confidentiality; and
  - providing required information (for example, as requested on the D&O questionnaire).

In regulated industries, consideration may need to be given to issues such as citizenship and other minimal requirements.

To avoid confusion, director qualification by-laws should be carefully framed to serve as both qualifications for nomination to the board and for serving (or being seated) as a director. Generally, these requirements should be reasonable and should not discriminate between shareholder nominees and board-vetted candidates.

Given how important it is that directors adhere to board policies, including policies relating to confidentiality and disclosure of conflicts, thought should be given to a by-law provision requiring that to qualify to be nominated and be seated, candidates must confirm in writing their agreement to comply with company and board policies. If it is contemplated that a director will be permitted to share information with a shareholder who designated or sponsored the director, that shareholder should be party to that agreement in order to bind the shareholder to appropriate non-disclosure commitments.

COMPENSATORY ARRANGEMENTS FOR SHAREHOLDER DIRECTOR NOMINEES

One area of particular concern that has arisen in the last two years is the practice of some activist shareholders agreeing to compensate their nominees for participating in a proxy contest and/or serving as directors. These arrangements, known colloquially as "golden leash" arrangements, raise legitimate concerns about transparency, perceived and actual conflicts with company interests and the creation of a "constituency director" mindset that is incompatible with service to the company and its shareholders.

In response, some companies have adopted by-law provisions that disqualify from board service either or both of the following:

- A person who fails to disclose third-party compensatory arrangements in connection with board candidacy or service.
- A person who is a party to any "compensatory, payment or other financial agreement, arrangement or understanding" with a person or entity other than the company in connection with service as a director of the company.

Influential proxy advisory firm Institutional Shareholder Services Inc. (ISS) believes that these arrangements should be disclosed, but also has concerns about using director qualification by-laws to restrict the rights of shareholders to select highly qualified individuals and entrench the existing board and management. ISS generally disfavors by-law provisions that could deter legitimate efforts by shareholders to seek board representation through a proxy contest, particularly if those efforts are aimed at recruiting independent board candidates with relevant industry expertise.

However, according to ISS's *Director Qualification/Compensation Bylaw FAQs (January 2014)*, ISS would prefer that companies put these types of by-law provisions to a shareholder vote:

> "The adoption of restrictive director qualification bylaws without shareholder approval may be considered a material failure of governance because the ability to elect directors is a fundamental shareholder right...we may in such circumstances recommend a vote against or withhold from director nominees."

At least annually, counsel should review corporate by-laws, including advance notice and qualification provisions, to consider whether they are up to date and appropriately reflect the best interests of the company with respect to the matters outlined above. This is a matter of business judgment.

Notwithstanding strong arguments in favor of deterring nuisance lawsuits, which are costly to companies and their shareholders, some shareholders, shareholder rights advocates and proxy advisory firms have expressed disfavor with board-adopted exclusive forum and arbitration by-laws.

INTRA-COMPANY LITIGATION PROTECTIONS

Several courts have recently upheld the use of by-laws as contractual devices for controlling intra-company litigation. Specifically:

- The Delaware Court of Chancery has upheld, at least as a general matter, the statutory and contractual validity of board-adopted exclusive forum by-laws. State courts in New York, Illinois and California, in turn, have enforced Delaware exclusive forum by-laws.
- A state court in Maryland has upheld arbitration by-laws.
- The Delaware Supreme Court has upheld the statutory and contractual validity of fee-shifting by-laws.

These courts have clarified that board-adopted by-laws may be enforced against persons whose interest as a shareholder (or in a non-stock corporation, as a member) arose before the by-laws were adopted and therefore had no notice of the restriction at the time of entering into the relationship.

However, even as these court decisions have spurred significant interest in board-adopted by-laws aimed at reducing incentives for the plaintiffs' bar to file claims, caution is advised. Notwithstanding strong arguments in favor of deterring nuisance lawsuits, which are costly to companies and their shareholders, some shareholders, shareholder rights advocates and proxy advisory firms have expressed disfavor with board-adopted exclusive forum and arbitration by-laws (see *Box, Shareholder Reactions*).

Moreover, the Corporation Law Section of the Delaware State Bar Association has proposed a legislative amendment to the DGCL that would effectively prohibit the use of fee-shifting by-laws by Delaware stock corporations. A recent joint resolution of the Delaware House of Representatives and Senate requested further modification to this proposal before reconsidering it in 2015, but the resolution signaled the legislature's general sympathy toward the idea of limiting fee-shifting by-laws.

EXCLUSIVE FORUM BY-LAWS

Almost 98% of takeover transactions valued at over $100 million in 2013 resulted in shareholder litigation, up from 39% in 2005 (*Matthew D. Cain and Steven M. Davidoff, Takeover Litigation in 2013 (Jan. 9, 2014)*). While plaintiffs in the past tended to file intra-company complaints in the jurisdiction of the state of incorporation, the search by plaintiffs' counsel for the most generous forum for plaintiff-counsel fee awards has made it routine for a corporate action to be challenged in a foreign jurisdiction (and often multiple jurisdictions).

In March 2010, Delaware Vice Chancellor J. Travis Laster proposed a potential solution to the problem of forum shopping. In *In re Revlon, Inc. Shareholders Litigation*, Vice Chancellor Laster suggested in *dicta* that Delaware corporations adopt exclusive forum clauses in corporate charters: "[I]f boards of directors and shareholders 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" (*990 A.2d 940, 960 (Del. Ch. 2010)*).

Three years later, the Delaware Court of Chancery upheld exclusive forum by-laws adopted by two boards (*Boilermakers Local 154 Ret. Fund v. Chevron Corp., 73 A.3d 934, 963 (Del. Ch. 2013)*). The fact that some shareholders had made their investments prior to the boards' adoption of these by-laws was not an impediment. Under the contracts theory of by-laws emphasized by then-Chancellor Leo E. Strine, Jr.:

> "[T]he bylaws of a Delaware corporation constitute part of a binding broader contract among the directors,

Shareholder Reactions

The Council of Institutional Investors (CII) strongly disfavors the adoption of charter provisions or by-laws (whether adopted by the board or shareholders) aimed at reducing intra-company litigation. According to CII Policy Section 1.9 (Judicial Forum), "[c]ompanies should not attempt to restrict the venue for shareowner claims by adopting charter or by-law provisions that seek to establish an exclusive forum."

Similarly, under Section D.16 of the AFL-CIO's Proxy Voting Guidelines:

> "The voting fiduciary should vote against management proposals to restrict the venue for shareowner claims by adopting charter or by-laws provisions that seek to establish an exclusive judicial forum. Rules about where shareholders may sue are generally set by statute through the legislative process which balances competing concerns. Corporations should not deprive shareholders of the ability to bring lawsuits in the judicial forum of the shareholders' choosing."

It has been reported that the New York State Common Retirement Fund generally disfavors exclusive forum by-laws because the Fund believes that these provisions limit shareholders' ability to hold corporations accountable.

The two major proxy advisory firms are also wary of exclusive forum by-laws:

- **Glass Lewis.** Under Glass Lewis' policy, if a board adopts an exclusive forum by-law without shareholder approval, Glass Lewis will generally recommend voting against the chair of the governance committee at the next annual meeting. In addition, should a company seek shareholder approval, Glass Lewis generally will recommend against shareholder approval unless the company provides a compelling argument on why the by-law would directly benefit shareholders and the company otherwise has a record of good corporate governance practices.
- **ISS.** According to its *2014 US Proxy Voting Summary Guidelines*, ISS will review forum selection by-law proposals on a case-by-case basis, taking into consideration whether the company has been materially harmed by shareholder litigation outside its jurisdiction of incorporation and has implemented certain good governance provisions (including an annually elected board, a majority vote standard in uncontested director elections and the absence of a poison pill, unless the pill was approved by shareholders).

> officers, and shareholders...This contract is, by design, flexible and subject to change in the manner that the DGCL spells out and that investors know about when they purchase stock in a Delaware corporation."
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> (*73 A.3d at 939*.)

Chancellor Strine noted, however, that based on the facts and circumstances of a particular case, a board-adopted exclusive forum by-law may be subject to challenge if it operates unreasonably as applied or has been adopted or used for an inequitable purpose. He also emphasized that shareholders who object to these provisions have recourse in the form of board elections and shareholder proposals to amend or repeal the by-laws. The appeal of this decision was dropped before it came to the Delaware Supreme Court, but the decision in *ATP Tour, Inc. v. Deutscher Tennis Bund* (see below *Fee-Shifting By-laws*) implies that the Delaware Supreme Court agrees with the Delaware Court of Chancery's analysis in *Boilermakers*.

In the wake of the *Boilermakers* decision, a number of Delaware corporations have adopted exclusive forum by-laws. According to a paper by Claudia Allen published by The Conference Board in January 2014:

> "In total, 112 Delaware corporations adopted or announced plans to adopt exclusive forum bylaws from June 25, 2013, through October 31, 2013, and the pace of adoptions has not slowed since then. To put these numbers in perspective, only one company adopted an exclusive-forum bylaw during the comparable period in 2012."

While some observers have cautioned companies that courts outside of Delaware may be hesitant to enforce exclusive forum by-laws, the courts that have addressed the matter have enforced board-adopted exclusive forum by-laws that were adopted before the intra-company dispute at issue arose. These cases include:

- ***Groen v. Safeway Inc.*** A California state court recently dismissed intra-company claims in light of a board-adopted exclusive Delaware forum by-law. Critically, the court expressly distinguished *Galaviz v. Berg*, a federal court decision pre-dating the *Boilermakers* decision that had declined to enforce an exclusive forum by-law adopted after the facts giving rise to the alleged wrongdoing. In *Safeway*, the board had adopted the exclusive forum by-law prior to the facts giving rise to plaintiffs' claims. (*Groen v. Safeway Inc., No. RG14716641 (Super. Ct. of Cal., Alameda County, May 14, 2014)*.)
- ***Miller v. Beam Inc.*** An Illinois court granted defendants' motion to dismiss, enforcing an exclusive Delaware forum

by-law. As in *Safeway*, the plaintiffs had urged the court to follow *Galaviz*. However, the court relied on the holding in *Boilermakers* that Delaware boards may unilaterally adopt by-laws that select an exclusive forum for addressing internal affairs claims. Beam's board had adopted the exclusive forum by-law prior to the alleged wrongdoing challenged in the litigation. (*Miller v. Beam Inc., 2014-CH-00932 (Ill. Ch. Ct. Mar. 5, 2014)*.)

- ***Hemg Inc. v. Aspen University.*** A New York state court granted defendants' motion to dismiss shareholder derivative claims based on an exclusive Delaware forum by-law. (*Hemg Inc. v. Aspen Univ., No. 650457/13, 2013 WL 5958388 (N.Y. Sup. Ct. Nov. 4, 2013)*.)

In addition to these decisions, a Louisiana state court, in *Genoud v. Edgen Group, Inc.*, enforced an exclusive Delaware forum clause in a corporate charter, granting the defendant's motion to dismiss on the basis of the exclusive forum clause (*No. 625244, 2014 WL 2782221 (La. Dist. Ct. Jan. 17, 2014)*).

Companies should consider, based on their particular ownership structure, whether the benefits of adopting exclusive forum by-laws outweigh the risks that shareholders will seek to amend the by-laws to remove a director-adopted provision or otherwise take negative action through advisory shareholder proposals or a campaign against directors who adopted the provision.

Search By-laws or Certificate of Incorporation: Delaware Forum Selection for a sample forum selection clause selecting the Delaware Court of Chancery as the exclusive jurisdiction for intra-company disputes.

ARBITRATION BY-LAWS

In a pair of recent decisions relating to a real estate investment trust (REIT), a Maryland state court upheld by-laws requiring shareholders to arbitrate rather than litigate claims (*Katz v. CommonWealth REIT, No. 24-C-13-001299 (Md. Cir. Ct. Feb. 19, 2014); Corvex Mgmt. LP v. CommonWealth REIT, No. 24-C-13-001111, 2013 WL 1915769 (Md. Cir. Ct. May 8, 2013)*).

Citing the Delaware Court of Chancery's *Boilermakers* decision, the *Katz* court concluded that all shareholders "assent to a contractual framework that explicitly recognizes that they will be bound by bylaws adopted unilaterally." And, further, that they have "purchased their shares with constructive knowledge that the Arbitration Bylaws were in effect and that their shares were subject to them." The *Katz* court found that such constructive notice prior to purchase "is enough to constitute mutual assent of the parties."

In a related case, *Delaware County Employees Retirement Fund v. CommonWealth REIT*, a federal court denied the plaintiffs' request for a declaratory judgment invalidating the arbitration in light of the earlier Maryland decisions, and therefore would not prevent the defendants from seeking to arbitrate the plaintiffs' shareholder claims (*No. 13-10405-DJC (D. Mass. Mar. 26, 2014)*).

Like exclusive forum by-laws, some shareholders and shareholder rights groups may take issue with board-adopted arbitration by-laws. According to CII's Corporate Governance Guidelines (Section 1.9), companies should not attempt "to bar shareowners from the courts through the introduction of forced arbitration clauses."

FEE-SHIFTING BY-LAWS

Generally in the US, unless parties to a lawsuit have otherwise agreed by contract (or a specific statute provides that the court can allocate costs against a losing party), each litigant is responsible for paying its own attorneys' fees and court costs. Some jurisdictions outside the US rely on a "loser pays" system to help discourage lawsuits of questionable merit and avoid pressures on companies to settle non-meritorious lawsuits early in the interests of saving the company time and money and avoiding uncertainty.

On May 8, 2014, the Delaware Supreme Court sitting *en banc*, in *ATP Tour, Inc. v. Deutscher Tennis Bund*, ruled that a board-adopted by-law that provided for a losing plaintiff to pay defendants' attorneys' fees and costs associated with its intra-company lawsuit was consistent with the provisions of the DGCL and Delaware common law (*No. 534, 2013, 2014 WL 1847446 (Del. May 8, 2014)*).

In 2006, the board of ATP Tour, Inc. (ATP), a non-stock, Delaware membership corporation, had amended its by-laws to provide that if a current or former member brought a lawsuit or counterclaimed against ATP, fellow members or certain affiliates, and the member asserting the claim failed to "obtain a judgment on the merits that substantially achieves, in substance and amount, the full remedy sought," the member must reimburse the fees, costs and expenses incurred by ATP or other parties defending against the claim or counterclaim.

Thereafter, two members sued the company and six directors in the US District Court for the District of Delaware and lost on the merits. ATP moved to recover its fees, costs and expenses under the fee-shifting by-law. Ultimately, the district court certified the issue of by-law validity and enforceability to the Delaware Supreme Court. Although the Supreme Court warned that an otherwise valid by-law would not be enforced if adopted or used for inequitable purposes, it stated that "intent to deter litigation…is not invariably an improper purpose."

In finding the by-law at issue facially valid and enforceable, the Supreme Court also noted that a valid fee-shifting by-law could require the plaintiff to bear the defendants' expenses and could validly provide that such fee-shifting will occur only if the plaintiff is wholly unsuccessful, or as in the case before it, even if the plaintiff was partially successful. Further, the Supreme Court noted that fee-shifting by-laws can be enforced against pre-existing members of the corporation. Although the lawsuit arose in the context of a non-stock membership corporation, the provisions of the DGCL concerning by-laws that were at issue apply to both stock and non-stock corporations, meaning the ruling is not on its face limited to non-stock corporations.

The *ATP* ruling has given rise to interest in the use of fee-shifting by-laws in traditional stock corporations. However, the potential for fee-shifting by-laws to be used as a mechanism to discourage nuisance lawsuits is uncertain. The Corporate Law Section of the Delaware State Bar Association, including attorneys who typically defend Delaware corporations, petitioned the Delaware legislature to amend the DGCL to limit the effect of the *ATP* ruling. The proposed amendments would clarify that fee-shifting by-laws, or other charter or by-law provisions, may not impose monetary liability on shareholders of Delaware stock corporations. The stated concern behind the petition was that requiring a losing shareholder plaintiff to bear the costs of litigation would:

- Unduly chill meritorious shareholder claims.
- Undermine the limited liability protections afforded to shareholders by Delaware corporate law.

On June 18, 2014, the Delaware Senate and House of Representatives passed a joint resolution with the approval of the Governor that acknowledged these concerns, but that also called on the Delaware State Bar Association and its Corporate Law Section to continue examining the proposed amendments. Although it effectively delays any legislative action until 2015, the resolution should not be taken as a signal from the Delaware legislature that fee-shifting by-laws will not be subject to limitation (even if adopted before any amendment passes into law).

PRACTICAL CONSIDERATIONS

Companies should carefully consider the opportunities and risks associated with using charter provisions and board-adopted by-laws to reduce corporate threats. In particular:

- Counsel should first review the company's certificate of incorporation to confirm that the board has the power to amend the by-laws.
- Counsel should review the by-laws annually and think about whether it is prudent for the board to consider any amendments.
- Any consideration of adopting protective by-laws should be undertaken on a "clear day," at a time when the company is not under a specific threat of dissident activity or litigation.
- Before adopting any amendments, the company should assess the potential reaction of its shareholder base and the proxy advisors who may have significant influence on its shareholders.
- Delaware companies should monitor legislative developments when considering whether to adopt a fee-shifting by-law.
- A company that is planning on going public and has the opportunity to adopt protective provisions in its certificate of incorporation or original by-laws should evaluate the advantages of doing so. By-laws adopted by the board after going public could subject the board to criticism from shareholders and other groups and later-adopted provisions may not be enforced if they are not adopted on a "clear day."
- Careful attention should be given to ensuring that board minutes accurately and fully reflect the board's deliberations and the reasons why the board believes, in its business judgment, that the provisions are in the best interests of the company and its shareholders. This may help to avoid equitable concerns that might lead a court to find the by-law unenforceable.

The views stated above are solely attributable to Ms. Gregory and do not necessarily reflect the views of Sidley Austin LLP or its clients.