

8-16-2017

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Albert H. Choi  
*University of Pennsylvania Law School*

Geeyoung Min  
*Columbia University*

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## Recommended Citation

Choi, Albert H. and Min, Geeyoung, "Amending Corporate Charters and Bylaws" (2017). *Faculty Scholarship*. 1898.  
[http://scholarship.law.upenn.edu/faculty\\_scholarship/1898](http://scholarship.law.upenn.edu/faculty_scholarship/1898)

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# Amending Corporate Charters and Bylaws

Albert H. Choi and Geeyoung Min \*

August 16, 2017

## Abstract

Recently, courts have embraced the contractarian theory that corporate charters and bylaws constitute a “contract” between the shareholders and the corporation and have been more willing to uphold bylaws unilaterally adopted by the directors. This paper examines the contractarian theory by drawing a parallel between amending charters and bylaws, on the one hand, and amending contracts, on the other. In particular, the paper compares the right to unilaterally amend corporate bylaws with the right to unilaterally modify contract terms, and highlights how contract law imposes various limitations on the modifying party’s discretion. More generally, when the relationship of contracting parties is compared to that of shareholders and managers, the paper notes several important differences that could make shareholders (particularly, minority shareholders) more vulnerable to potential hold-up and counter-party opportunism. For example, unlike contracting parties who have the right to terminate the contractual relationship or opt out of undesirable modifications, shareholders lack the right of termination or opt-out. As a possible solution, the paper considers various mechanisms, including optional redemption, more robust disclosure, shareholder voting, and active judicial oversight. The paper suggests that active judicial oversight, through vigorous application of the “proper” and “equitable” purpose test or imposition of good faith and fair dealing obligations, would be better in retaining the desired flexibility and policing opportunism by both managers and controlling shareholders.

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\* Professor and Albert C. BeVier Research Professor of Law, University of Virginia Law School, and Adjunct Assistant Professor and Postdoctoral Fellow in Corporate Law and Governance, Columbia Law School, respectively. We would like to thank Rick Brooks, Larry Hamermesh, Joshua Mitts, Roberta Romano, Sarath Sanga, Matt Shapiro, Emily Stolzenberg, George Triantis, and workshop participants at the University of Virginia Law School for many helpful comments and suggestions. We would also like to thank MacLane Taggart for excellent research assistance. Comments are welcome to [albert.choi@virginia.edu](mailto:albert.choi@virginia.edu) and [geeyoung.min@gmail.com](mailto:geeyoung.min@gmail.com).

## Introduction

Over the past decade or so, courts have been more willing to apply the “contractarian” theory to the organizational documents of corporations: charters (certificates or articles of incorporation) and bylaws. The notion that the charters and bylaws can be thought of as “contracts”—between a corporation and its shareholders and among the shareholders—dates back to the seminal work by Jensen and Meckling and to the idea that the corporate organization can be viewed as a “nexus of contracts.”<sup>1</sup> Based in part on this theory, numerous practitioners and corporate law scholars have argued that corporate law should take a more enabling approach by minimizing the number of mandatory provisions, by offering an optimal set of default (“off the rack”) terms, and by enforcing parties’ arrangements of their affairs (“private ordering”) in charters and bylaws.<sup>2</sup> Perhaps due to the influence of the contractarian theory, corporate statutes—

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<sup>1</sup> See Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *Journal of Financial Economics* 305 at 310 – 311 (1976) (stating that “most organizations are simply *legal fictions which serve as a nexus for a set of contracting relationships among individuals...the private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships*”) (emphasis original). Jensen and Meckling make numerous inferences to Ronald Coase’s earlier work. See Ronald Coase, *The Nature of the Firm*, 4 *Economica* 386 (1937). Numerous scholars have analyzed the theory over the years. See John Coffee, *No Exit?: Opting Out, The Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 *Brooklyn Law Review* 919 (1988); John Coffee, *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 *Columbia Law Review* 1618 (1989); Lucian Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 *Harvard Law Review* 1820 (1989); Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or “The Economics of Boilerplate”)*, 83 *Virginia Law Review* 713 (1997); Henry Hansmann, *Corporation and Contract*, 6 *American Law and Economics Review* 1 (2006); James Cox, *Corporate Law and the Limits of Private Ordering*, 93 *Washington University Law Review* 257 (2015); Ann Lipton, *Manufactured Consent: The Problem of Arbitration Clauses in Corporate Charters and Bylaws*, 104 *Georgetown Law Review* 583 (2016); Jonathan Rohr, *Corporate Governance, Collective Action and Contractual Freedom: Justifying Delaware’s New Restrictions on Private Ordering*, forthcoming in *Delaware Journal of Corporate Law* (2017). The nexus of contract theory, while facially correct, is a bit misleading in the corporation and agency contexts. When two parties, e.g., a prospective client and a lawyer, enter into an agency relationship using a contract, obviously, the vertical relationship is based on and is created through a contract, but most of the post-formation issues, that are not expressly (or impliedly) dealt with in the contract, including amending the initial contract, can be subject of the agency law, rather than contract law, triggering additional obligations, such as fiduciary duty. One purpose of this paper is to deal with the issue of to what extent can an agent change the agency relationship when the right of modification is granted upon her in the initial agency contract. See Deborah DeMott, *Forum-Selection Bylaws Refracted through an Agency Lens*, 57 *Arizona Law Review* 269 (2015) on the application of the agency law principles to unilaterally adopted forum-selection bylaws.

<sup>2</sup> See Frank Easterbrook & Daniel Fischel, *The Corporate Contract*, 89 *Columbia Law Review* 1416 (1989) (stating that the corporation is a complex set of explicit and implicit contracts, and corporate law enables the participants to select the optimal arrangement for the many different sets of risks and opportunities that are available in a large economy. No one set of terms will be best for all; hence the ‘enabling’ structure of corporate law”) and Roberta Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, 89 *Columbia Law Review* 1599 (1989) (arguing that mandatory corporate law cannot be easily justified). But see Jeffrey Gordon, *The Mandatory Structure of Corporate Law*, 89 *Columbia Law Review* 1549 (1989) (doubting that full contractual freedom in corporate law will lead to private wealth maximization and advocating for some mandatory rules). See also Coffee (1989), *supra* note 1, at 1621 (stating that the “stable mandatory core” of corporate law is the “institution of judicial oversight”).

Delaware statutes, in particular—require only a small number of provisions in the charter and leave almost complete discretion with respect to the contents of the bylaws.<sup>3</sup>

What is new and controversial, however, is the fact that the courts have been willing to apply these ideas even to cases where the directors unilaterally have amended bylaws without shareholders' express ex post approval.<sup>4</sup> With respect to corporate charters, state statutes mandate a set of procedures that must be satisfied when a corporation wants to amend its charter.<sup>5</sup> Under both the Model Business Corporation Act and Delaware General Corporation Law, for example, only the directors can make a proposal to amend the charter and, apart from a few exceptions,<sup>6</sup> there must be express shareholder approval of the proposal for an amendment to be effective.<sup>7</sup> More importantly, neither the directors nor

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<sup>3</sup> See, e.g., Model Business Corporation Act §§2.02 and 2.06; and Delaware General Corporation Law §§102(a) and 109. At various sections, Delaware statute, for instance, expressly incorporates the phrase, “unless otherwise provided in the certificate of incorporation,” and allows the parties to opt out of the default terms. Even the directors' managerial rights provision is subject to restrictions in the charter. Delaware General Corporation Law §141(a) states: “the business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided...in its certificate of incorporation.” With respect to the charter, the most important mandatory provision is the one on capital structure. Delaware law expressly allows certain optimal provisions in the charter and some of these are almost always included in the charters of publicly traded corporations. They are: (1) liability limitation for the directors and officers under DGCL §102(b)(7); (2) granting the directors discretion to issue preferred stock (“blank check preferred provision”) under DGCL §102(a)(4); (3) right to amend bylaws under DGCL §109(a); and (4) the right to change the number of authorized shares without a class vote under DGCL §242(b)(2). This is not to say that the Delaware statute has fully embraced the contractarian theory. If we look outside the charter, there are various mandatory provisions, such as stockholders electing directors annually (§211(b)), stockholders have the right to vote by proxy (§212(b)), and not having more than three classes on the board (§141(d)). See Gordon (1989). With respect to the opting out hypothesis, Hansmann (2006) has argued that, due to various impediments, including draft (amending) costs and network externality, corporations are more likely to not opt out of default provisions and, instead, to “delegate” future amendments to state legislatures and courts. See also Kahan and Klausner (1997) (examining the network externality effects of corporate charter provisions).

<sup>4</sup> Earlier scholarly debate over contractarian (nexus of contract) theory focused mostly on the issues of mid-stream charter amendments, problems of collective action and shareholder apathy with respect to voting on charter amendment proposals, and whether there is room for mandatory corporate law. See *supra* notes 1 and 2. This paper takes a step further by examining the validity of the contractarian theory as it is applied to the issues of delegation and unilateral amendment of bylaws.

<sup>5</sup> See, e.g., Model Business Corporation Act §10.03 and Delaware General Corporation Law §242. For a more detailed analysis of charter amendments, including the requirements and procedures under the federal securities laws, see Geeyoung Min, *Shareholder Activism and Charter Amendments*, forthcoming in *Journal of Corporate Law* (2018).

<sup>6</sup> For Delaware corporations, unless expressly prohibited by the charter, the directors can unilaterally change the name of the corporation, delete the names of the incorporators, or delete the provisions that were necessary to effect stock exchange, reclassification, etc., when such changes have become effective. See Delaware General Corporation Law §241(b)(1). See also Model Business Corporation Act §10.05. Furthermore, the charter can grant the right to issue new classes of stock with desired preferences to the directors. See Delaware General Corporation law §102(a)(4). Such a provision is known as the “blank-check preferred” provision.

<sup>7</sup> See Model Business Corporation Act §10.03 and Delaware General Corporation Law §242. Charter amendment is considered to be a “fundamental” change to the corporation, thereby triggering shareholder approval requirement. When a proposed charter amendment “adversely affects” a certain class of

the shareholders can unilaterally amend the charter. Amending the bylaws, however, is a different matter. While reserving the amendment authority (including the right of unilateral amendment) to the shareholders, corporate statutes allow directors to unilaterally amend the bylaws, either as a matter of default or when the shareholders grant such power through a provision in the charter.<sup>8</sup> While the precise scope of this authority (e.g., whether they can amend shareholder-adopted bylaws) remains somewhat uncertain,<sup>9</sup> recent cases have meaningfully expanded directors' freedom.

The recent focus on and controversy over unilaterally amended bylaws<sup>10</sup> is not surprising in light of the rise of shareholder activism and concerns over deal-related shareholder litigation perceived as being “out of control.”<sup>11</sup> For instance, if the directors want to counteract an activist hedge fund, doing so through charter amendment would be undesirable. Because a charter amendment requires an express shareholder approval, not only will the amendment be time-consuming and costly, but the proposal may also fail to secure requisite shareholder approval. Furthermore, influential proxy advisory firms, such as Institutional Shareholder Services and Glass Lewis, have the policy of giving negative recommendations at the next director election when a firm adopts a charter provision considered adverse to the interests of shareholders, such as staggering the board.<sup>12</sup> Such factors render charter amendments an unattractive and ineffective strategy against shareholder activism. The same rationale applies in the case of directors dealing with imminent shareholder litigation, for instance, when the corporation is about to execute a merger and the directors expect shareholder lawsuits to be filed once it is announced.<sup>13</sup>

In contrast, unilaterally amending the bylaws can be done fast, at low cost, and with certainty. Bylaws—which, in most cases, deal with more “procedural” than “substantive” issues—are considered less salient from the shareholders' and the market's perspective. For example, by requiring all shareholder lawsuits to be filed in Delaware, the directors can better “manage” out-of-control shareholder litigation. Similarly, incumbent directors can better prepare for a potentially costly proxy fight by adopting a bylaw that requires any insurgent shareholder to provide detailed information about their director-nominees. Finally, because directors can dictate the contents of bylaws, even when they adopt a bylaw

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shareholders, that class will get to vote on the proposal as a separate class. See Delaware General Corporation Law §242(b)(2).

<sup>8</sup> See, e.g., Model Business Corporation Act §10.20 and Delaware General Corporation Law §109. Almost all publicly traded corporations that are incorporated in Delaware have the express provision in their charters granting the right to amend bylaws to the directors. See Min (2018).

<sup>9</sup> The ambiguity stems from the fact that the statute expressly reserves the right of the shareholders to amend bylaws without consent or approval by the directors. See *infra* part I for more detailed discussion.

<sup>10</sup> See Lawrence Hamermesh, *Director Nominations*, 39 Delaware Journal of Corporate Law 117 (2014) for examples of directors' adopting advance notice bylaws in response to shareholder activism regarding director elections.

<sup>11</sup> See Albert Choi, *Optimal Fee-Shifting Bylaws*, forthcoming in Virginia Law Review (2018) for a brief overview about the concerns over deal-related shareholder litigation and how that led corporations to adopt fee-shifting and exclusive forum bylaws.

<sup>12</sup> See Min (2018) for a more detailed analysis.

<sup>13</sup> Since fee-shifting bylaws have been prohibited by Delaware statute, the most common response against merger-related litigation seems to be adopting an exclusive forum bylaw.

putatively in response to shareholders' demands, they can devise a system that is potentially more favorable to them, while still showing "fidelity" to the wishes of the shareholders.<sup>14</sup>

Recent examples of bylaws unilaterally amended by directors include those pertaining to: (1) advance notice; (2) exclusive forum; (3) special shareholder meeting, and (4) fee-shifting.<sup>15</sup> An advance notice bylaw, for instance, requires insurgent shareholders to submit notice to directors of both their intention to wage a proxy fight and also information regarding their proposed slate of director-nominees within a stipulated window of time (say, between 90 and 120 days) before the shareholder meeting.<sup>16</sup> An exclusive forum bylaw requires shareholders to file corporate lawsuits only in a certain forum, e.g., the forum of the state of incorporation. The right to convene special shareholder meeting bylaw allows only those shareholders with requisite ownership (often 5% or more of the outstanding stock) to call a special shareholders' meeting. Finally, a fee-shifting bylaw allows the corporation to recover fees and expenses from the plaintiff-shareholders if the plaintiff-shareholders do not completely "prevail" in either direct or derivative litigation.<sup>17</sup>

While most of these bylaw amendments seem to deal more with "procedural" issues, they can undoubtedly affect the substantive rights of shareholders. When shareholders challenged bylaw amendments in court, the courts have upheld the amendments by applying the contractarian principle. Delaware Supreme Court's opinion in *ATP Tour, Inc. v. Deutscher Tennis Bund*<sup>18</sup> is exemplary. Upholding a fee-shifting bylaw unilaterally adopted by the directors of ATP Tour, Inc., the court stated that charters and bylaws constitute a "contract" between a corporation and its shareholders,<sup>19</sup> and directors can amend the bylaws by adopting a fee-shifting provision because that right is granted to them in ATP's charter. The Delaware Chancery Court applied similar reasoning

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<sup>14</sup> This is the idea behind the "compromised implementation," as noted in Min (2018), where the directors, putatively in response to shareholders' (often repeated) requests to institute a certain corporate governance regime, would adopt a bylaw provision but with variation (or "compromise"). By doing so, the directors can argue that they are being faithful to shareholders' demands while (potentially) protecting their own interests. Whether such compromised implementation is, in fact, shareholder value-reducing is an empirical question which needs further examination.

<sup>15</sup> Other examples include: amending the size of the board (after stipulating in the charter that only the board can determine the size); adopting a majority voting standard for director elections; allowing insurgent shareholders access to the company's proxy (usually combined with a strong advance notice requirement); and imposing procedural requirements for the stockholders to execute a written consent. For an overview of recently contested bylaws, see Min (2018), Hamermesh (2014), Jill Fisch, *The New Governance and the Challenge of Litigation Bylaws*, 81 Brooklyn Law Review 1637 (2016), and Jill Fisch, *Governance by Contract: The Implications for Corporate Bylaws*, forthcoming in California Law Review (2018).

<sup>16</sup> See Hamermesh (2014) for a detailed analysis and examples of recently contested advanced notice bylaws.

<sup>17</sup> See Choi (2018) for a detailed analysis of fee-shifting bylaws. Exclusive forum and fee-shifting bylaws, in particular, have been used more as a response to shareholder litigation (in particular, deal-related litigation) that has been perceived as out of control. *Id.*

<sup>18</sup> 91 A.3d 554 (Del. 2014).

<sup>19</sup> According to the Court, "corporate bylaws are 'contracts among a corporation's shareholders'..." *Id.* at 558. Due partly to concern over chilling, even legitimate shareholder lawsuits, the Delaware Legislature will later amend the corporate statute and prohibit fee-shifting provisions from being included either in the charter or the bylaws. See DGCL §§109(b) and 115. See generally Choi (2018).

when validating an exclusive forum bylaw in *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*<sup>20</sup> The court stated that “the bylaws constitute a binding part of the contract between a Delaware corporation and its stockholders,”<sup>21</sup> and when the right to amend bylaws has been granted to the directors, according to the court, the shareholders “will be bound by bylaws adopted unilaterally by their boards.”<sup>22</sup>

The *Boilermakers* court emphasized the fact that, if the shareholders are displeased with the amended bylaw, they can either repeal the bylaw, adopt their own bylaw, or even remove directors from the board.<sup>23</sup> Yet, the court imposed little restriction on the directors’ right to amend bylaws.<sup>24</sup> But, does the adoption of contractarian principle, combined with the fact that shareholders granted the right to unilaterally amend bylaws, imply that there should be very little, if any, judicial check on the directors’ ability to unilaterally amend bylaws? What if a controlling shareholder, with more than 50% voting power, were to adopt a bylaw? To the extent that we apply the “contractual framework” to the charters and bylaws, what can we learn from how modification is treated under contract law? What about its treatment of unilateral modifications? What similarities or differences can we learn by comparing bylaws and charters with contracts? Finally, as a matter of policy, should the directors or the shareholders be able to unilaterally amend bylaws with little or no oversight from the courts?

The purpose of this paper is to shed some light on these issues. While the paper deals more generally with charter and bylaw amendments, its particular focus will be on unilateral bylaw amendments. The paper foremost draws on how contract law deals with modifications and the problems that arise when one party grants the other the right to

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<sup>20</sup> 73 A.3d 934 (Del. Ch. 2013). After the decision, there was even a debate about whether the directors can adopt a mandatory arbitration provision in the bylaws. See Claudia Allen, *Bylaws Mandating Arbitration of Shareholder Disputes?*, 39 Delaware Journal of Corporate Law 751 (2015) and Lipton (2016) (analyzing the issues over mandatory arbitration clause in charters or bylaws and the problems of treating charters and bylaws literally as contracts). The issue over mandatory arbitration bylaws became moot when the Delaware Legislature amended the corporate statutes to allow forum selection clauses which designate Delaware but not other forums, including arbitration. See DGCL §115. See also David Skeel, *The Bylaw Puzzle in Delaware Corporate Law*, 72 Business Lawyer 1 (2016) (arguing that the Delaware legislature’s decision to uphold an exclusive forum bylaw while disallowing a fee-shifting bylaw channelled more litigation back to Delaware, determining the direction of multi-forum litigation); and Roberta Romano & Sarath Sanga, *The Private Ordering Solution to Multiforum Shareholder Litigation*, 14 Journal of Empirical Legal Studies 31 (2017) (empirically analyzes corporations that adopted exclusive forum provisions either in the charter or the bylaws).

<sup>21</sup> Id. at 955.

<sup>22</sup> Id. at 956. According to the court, “a corporation’s bylaws are part of an inherently flexible contract between the stockholders and the corporation under which the stockholders have powerful rights they can use to protect themselves if they do not want board-adopted forum selection bylaws to be part of the contract between themselves and the corporation.” Id.

<sup>23</sup> According to the court, if shareholders disagree with a bylaw adopted by the directors, they can repeal it with their own resolution and, furthermore, discipline the directors by removing them from the board. Id. Unfortunately, however, there are substantial limitations, legal and practical, to the rights of shareholders in obtaining these remedies. See *infra* note – and surrounding text.

<sup>24</sup> As mentioned below, under Delaware jurisprudence, bylaw amendments are subject to judicial scrutiny according to the degree that their purpose is determined “proper” and “equitable.” Neither the *Boilermakers* court, nor the ATP Tour court applies this test in earnest. See *infra* Part I.

unilaterally modify the contract.<sup>25</sup> Briefly, under existing law, amending a contract is subject to various statutory and judicial restrictions. Probably the most relevant contract doctrine applicable to charter and bylaw amendment is the duty of good faith and fair dealing.<sup>26</sup> Contract modifications, including those that are “voluntarily” agreed to by both parties, must be done in “good faith” or be “fair and equitable.”<sup>27</sup> Even when exercising a contractually granted right to unilaterally modify the contract, the party with the right must exercise it in good faith and must deal fairly with the counterparty. While different courts have constituted this duty with different elements, in the context of unilateral modifications, the most common requirements include the obligation (1) to disclose the proposed modification to the counterparty; (2) to grant the right to opt out of the proposed modification (usually through termination of the contract); and (3) to not retroactively apply the modified provision.

We then compare the rights of the contracting parties with those of the shareholders and uncovers several important factors that would make shareholders—minority shareholders, in particular—more vulnerable than contracting parties. First, as noted by other scholars, even for charter (and bylaw) amendments that require express shareholder approval, for corporations with dispersed ownership, shareholders face the problems of collective action and rational apathy (or rational ignorance).<sup>28</sup> When such problems

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<sup>25</sup> Coffee (1988) argued that we examine actual contract law to better understand a corporation’s opting out of default rules through charter amendments. According to Coffee, “the risk of [managerial] opportunism is greatest when the charter provision is added by an amendment that shareholders do not fully understand,” and to guard against such opportunistic amendment, we could look at contract law’s regulation of modification, including Restatement (Second) of Contracts §89 that requires modification to be “fair and equitable in view of circumstances not anticipated by the parties when the contract was made.” *Id.* at 938 – 939. We expand this approach to both charter and bylaw amendments and also, more specifically, to unilateral bylaw amendments.

<sup>26</sup> Good faith duty under contract law should be distinguished from directors’ good faith obligations to the corporation under corporate law. See, e.g., Delaware General Corporation Law §102(b)(7). There used to be some uncertainty in Delaware case law as to what the directors’ good faith obligation entails and whether the obligation is separate from the other fiduciary duties of care and loyalty. Although, in theory, the courts could have harmonized the good faith obligation under corporate law with that under contract law, Delaware case law took a divergent approach by placing the good faith duty as part of the duty of loyalty. See *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (stating that “although good faith may be described colloquially as part of a ‘triad’ of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty...[w]here directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.”) See generally David Rosenberg, *Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contractarian Approach*, 29 Delaware Journal of Corporate Law 491 (2004) on how Delaware courts have grappled with the “triad” fiduciary duties of care, loyalty, and good faith.

<sup>27</sup> See Restatement (Second) of Contracts §89 and UCC §2-209. See generally, Allan Farnsworth, *Contracts* (2004) at §4.22.

<sup>28</sup> See Bebchuk (1989) (noting how voting shareholders have little incentive to be informed over charter amendment proposals, for instance, by studying the lengthy proxy material, and would remain uninformed or under-informed). See also Gordon (1989) (raising concerns over opportunistic mid-stream charter amendments due to collective action and other problems). Romano (1989) and Coffee (1989) have noted that shareholders’ rational apathy does not necessarily mean that they will blindly vote in favor of management proposals. The uninformed shareholders can, instead, vote against all management proposals



become severe, the process of shareholder approval provides little meaningful protection against managerial opportunism. Similarly, when ownership is concentrated, for instance, with a controlling shareholder who has more than 50% of the voting rights, while the collective action and rational apathy problem for the shareholders *as a class* may be absent, minority shareholders (and possibly also the directors and the officers) may be harmed by the opportunism of the controlling shareholder.

Second, particularly for publicly traded corporations, although the shareholders' right to receive amendment notification is relatively well-enforced under federal securities laws, unlike in the contract setting, shareholders do not have the right to truly "terminate" their relationship with the corporation. They can always sell their stock but the shareholder-corporation relationship remains preserved through the sale, and the corporation is not harmed—at least not directly or immediately—by the sale. Third, the relationship between the managers and the shareholders (and between a controlling shareholder and the minority shareholders) is more "vertical" and "hierarchical," based on a notion of agency, rather than "horizontal" and "arms-length," based on contractual relationship. Fourth, and more generally, whenever one party is granted the right to re-adjust or modify the relationship, this presents the possible dangers of externality and hold-up.

Building on these differences, with the lessons learned from contract law, we argue that there is a policy-based justification to be more vigilant against charter and bylaw amendments and, in particular, against unilateral bylaw amendments.<sup>29</sup> The policy goal should be to preserve flexibility in amending bylaws and charters while policing opportunism by managers and controlling shareholders. The paper considers various policy instruments, including optional redemption, robust disclosure obligation, more reliance on shareholder voting and approval, and more judicial oversight. After considering the costs and benefits, we suggest that the courts more vigorously apply the "proper" and "equitable" purpose or effect test under corporate law<sup>30</sup> and, borrowing from

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(they can "just say no") or vote in favor of management proposals only some of the time (i.e., using a mixed strategy in game theory parlance). If shareholders were to always vote against management proposals, there would be too much rigidity in charter provisions.

<sup>29</sup> The fact that the "contractual framework" is being applied to charters and bylaws does not mean that they should be literally treated as contracts subject to all doctrines of contract law. As a matter of fact, it is likely infeasible to apply all contract law doctrines to corporate organizational documents. See George Geis, *Ex-Ante Corporate Governance*, 41 *Journal of Corporation Law* 609 (2016) (arguing that corporate law should not "outsource the resolution of ex-ante governance problems to generalized principles of contract law") and Lipton (2016) (noting the dangers of treating charters and bylaws as contracts since the directors will be able to adopt mandatory arbitration provisions which must be enforced under the Federal Arbitration Act).

<sup>30</sup> See *Frantz Mfg. Co. v. EAC Indus.*, 501 A.2d 401, 407 (Del. 1985) (stating that "bylaws must be reasonable in their application" and holding that bylaw amendments, which required unanimous approval for any board action, among others, done for the purpose of avoiding a majority shareholder's disenfranchisement, are valid) and *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437, 438—439 (Del. 1971) (holding that the directors' amending the bylaws and advancing a shareholder meeting date "for the purpose of perpetuating itself in office...[and] for the purpose of obstructing the legitimate efforts of dissident stockholders in the exercise of their rights to undertake a proxy contest against management" is "inequitable"). Although both *Schnell* and *Frantz Mfg.* devised and applied the proper and equitable (or

contract law, apply the good faith and fair dealing obligations.<sup>31</sup> With stronger judicial oversight, we argue, the benefits of flexibility can be preserved while value-destroying hold-up and externality (by managers' or the controlling shareholder's exercise of discretion in "bad faith") can be better deterred.

The paper is organized as follows. Part I briefly reviews the statutory requirements of charter and bylaw amendments and recent developments in case law. In so doing, the part highlights how the courts, especially those in Delaware, have become more disposed to apply the "contractarian" principle to charters and bylaws. Part II focuses on the treatment of modifications and, in particular, change-of-terms clauses in contract law. While the courts have utilized various doctrines in imposing restrictions against possible abuse of the right of contract modification—such as unconscionability, illusory promise (indefiniteness), good faith and fair dealing, and different canons of construction—the part will focus primarily on the duty of good faith and fair dealing and show how the application of this principle has often led to the duty of disclosure combined with the right to terminate the contract (or opt out of proposed amendment). Part III compares the contract law regime with the corporate law regime, highlighting important differences that can make shareholders more vulnerable to hold-up and counter-party opportunism. Part IV shows how the courts can remedy the problem by more vigorously applying the "equitable" or "proper" purpose test as well as the good faith and fair dealing obligations to unilateral bylaw amendments. By doing so, the paper argues, we not only advance the goal of preserving flexibility while policing opportunism (by the managers or the controlling shareholders), but also harmonize corporate law with the principles laid out in both contract law and agency law. The last part concludes.

## **I. Amending Charters and Bylaws under Corporate Law**

After a corporation comes into existence with its organizational documents, certificate or articles of incorporation (charter) and bylaws and issues stock, the corporation can subsequently amend those documents as the directors and the shareholders see fit, subject to certain restrictions.<sup>32</sup> With respect to charters, both the Model Business

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reasonable) test fairly vigorously, as we will argue in Part II, courts more recently seem to have stepped away from such vigorous application, if they applied the test, at all.

While the proper and equitable purpose or reasonableness test was devised by the earlier cases of Schnell and Frantz Mfg., courts recently have applied it with much less vigor, if at all.

<sup>31</sup> While we are in favor of borrowing and applying the implied obligation of good faith and fair dealing as a rule of interpretation, we do not advocate the wholesale incorporation of other contract law doctrines, such as unconscionability, indefiniteness, mutual assent, and various rules on remedy. This is consistent with the agency law principles. See Restatement (Third) of Agency §8.07 cmt. b (stating that "contract law principles of general applicability govern whether such agreements are enforceable and how they are to be interpreted, among other questions."). Coffee (1989) has made a similar argument in favor of judicial activism. According to Coffee, "judicial activism is the necessary complement to contractual freedom" and comparing a corporation to a long-term, relational contract, "the court's role becomes that of preventing one party from exercising powers delegated to it for the mutual benefit of all shareholders for purely self-interested ends." *Id.* at 1621.

<sup>32</sup> At minimum, charter provisions must be "lawful" and "proper to insert in an original certificate of incorporation filed at the time of the amendment." See Delaware General Corporation Law §242(a). The case law has also ruled that the charter and bylaw provisions must be consistent with public policy.

Corporation Act and Delaware General Corporation Law mandate a set of procedures that must be satisfied when a corporation wants to amend its charter.<sup>33</sup> For instance, under DGCL §242, only the directors can make a proposal to amend the charter<sup>34</sup> and, except for a small number of provisions, shareholders must expressly approve the proposal for the amendment to be effective.<sup>35</sup> Furthermore, under Delaware statute, if a proposed amendment falls under one of three special categories, the most important of which is “adversely” affecting a class (or series) of shares, the affected class (or series) will get to vote on the amendment separately as a class.<sup>36</sup> Finally, neither the directors nor the shareholders can unilaterally amend the charter.

Amending bylaws, however, is a different matter. The Model Business Corporation Act vests both the directors and the shareholders with the power to amend bylaws. MBCA §10.20(b) allows directors to amend the bylaws unless (1) the articles of incorporation reserve that power solely to the shareholders or (2) the shareholders amend the bylaw in question and stipulate in the bylaw that the directors cannot thereafter amend it.<sup>37</sup> For Delaware corporations, the right to amend bylaws belongs to the shareholders but it can be granted to the directors through a provision in the charter. Delaware General Corporation Law §109(a) states that “the power to adopt, amend or repeal bylaws shall be in the stockholders entitled to vote...Notwithstanding the foregoing, any corporation may, in its certificate of incorporation, confer the power to adopt, amend or repeal bylaws upon the directors...”<sup>38</sup> The statute, at the same time, imposes two important restrictions on the directors’ power. First, it expressly preserves the right of the shareholders to amend bylaws, which, with certain limitations, allows them to repeal or amend board-adopted

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<sup>33</sup> For a more detailed analysis of charter amendments, see Min (2018).

<sup>34</sup> Delaware General Corporation Law §242(b)(1) states that the corporation’s “board of directors shall adopt a resolution setting forth the amendment proposed, declaring its advisability, and either calling a special meeting of stockholders entitled to vote...or directing that the amendment proposed be considered at the next annual meeting of the stockholders.”

<sup>35</sup> See Delaware General Corporation Law §242. Charter amendment is considered to be a “fundamental” change to the corporation, thereby requiring shareholder approval. See also Model Business Corporation Act §10.

<sup>36</sup> See Delaware General Corporation Law §242(b)(2). The other two categories that require a class vote are: (1) changing the number of authorized shares and (2) changing the par value of the stock. With respect to changing the number of authorized stock, however, if the original charter or the charter amendment that created the stock so provides, all shareholders can vote as a single class. In addition to section 242, there is another way of amending the charter, through merger (“amendment through merger”). See Delaware General Corporation Law §251(3). Unlike §242(b), however, §251(e) does not mandate a class vote even when a certain class is adversely affected.

<sup>37</sup> See Model Business Corporation Act §10.20.

<sup>38</sup> See Delaware General Corporation Law §109(a). Amending bylaws is one of the few actions that the shareholders can initiate under Delaware law. Most of other “fundamental” changes to the corporation, such as charter amendment, merger, and sale of all or substantially all of the assets, expressly require a board resolution. See, e.g., DGCL §§242(b), 251(b), and 271(a). See Stephen Bainbridge, *Who Can Amend Corporate Bylaws*, Professor Bainbridge Blog (January 5, 2006) available at <http://www.professorbainbridge.com/professorbainbridgecom/2006/01/who-can-amend-corporate-bylaws.html>.

bylaws.<sup>39</sup> Section 109(a) of the Delaware statute states, “[t]he fact that such power has been so conferred upon the directors...shall not divest the stockholders...of the power, nor limit their power to adopt, amend or repeal bylaws.”<sup>40</sup> Second, there are substantive and hierarchical limitations. Section 109(b) states, “[t]he bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or power or the rights or power of its stockholders, directors, officers or employees.”<sup>41</sup> As such, the bylaw must be consistent with state law and the corporation’s charter and must relate to the “business” or “affairs” of the corporation or the rights of various constituents.

With respect to the first limitation, while, in theory, deciding whether the directors should have the power to unilaterally amend the bylaws is up to the shareholders, in practice, almost all publicly traded corporations incorporated in Delaware have such a granting clause in their charters.<sup>42</sup> This is not surprising. Perhaps, directors should have the right to amend the bylaws as necessary, considering that most corporate charters do not contain detailed provisions relating to the business or affairs of the corporation, nor do they stipulate the rights of various investors and other constituents. Ultimately, it is the directors who have the authority to manage “the business and affairs” of the corporation.<sup>43</sup> Furthermore, given that amending the charter is time-consuming and costly, due largely to the obligation of convening a shareholders’ meeting, granting such a right to the directors can better preserve the flexibility for the corporation for unforeseen future contingencies and circumstances. At the same time, this also creates a danger that the directors, as agents of the corporation and the shareholders, may abuse that discretion to the detriment of the corporation and its shareholders. As a matter of theory, it is unclear how much discretion should be given to directors and what types of procedural or substantive checks must be imposed.

Recently, courts, especially those in Delaware, have moved towards granting more freedom to the directors in unilaterally amending the bylaws. The theory is that the bylaws, along with the charters, constitute a “contract” between the corporation and shareholders

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<sup>39</sup> Because Delaware law does not expressly stipulate that shareholders have the power to limit the board’s right to amend (or repeal) shareholder-adopted bylaws, some commentators have noted that this raises the possibility of “cycling amendments and counter-amendments.” *Id.* However, once the charter expressly grants directors the right to unilaterally amend bylaws, if shareholders were to try, through a provision in the bylaws, to prevent the board from amending or repealing shareholder-adopted bylaw, such a restriction would be inconsistent with the charter and likely invalid. See Hamermesh (1998). See also *Airgas, Inc. v. Air Prods. & Chems., Inc.*, 8 A3d 1182 (Del. 2010) (invalidating a bylaw provision that advanced a shareholder meeting because it is inconsistent with the staggered board provision in the charter). There also are other legal and practical limitations. For instance, shareholders cannot adopt a bylaw that would interfere with the board’s ability to manage the affairs of the corporation under DGCL §141(a). See Lawrence Hamermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?*, 73 *Tulane Law Review* 409 (1998), Gordon Smith, Matthew Right & Marcus Hintze, *Private Ordering and Shareholder Bylaws*, 80 *Fordham Law Review* 125 (2011), and Fisch (2018).

<sup>40</sup> *Id.*

<sup>41</sup> See Delaware General Corporation Law §109(b).

<sup>42</sup> See Min (2018).

<sup>43</sup> See Delaware General Corporation Law §141(a).

(and, also, among the shareholders).<sup>44</sup> Once the shareholders grant the right to unilaterally amend bylaws to the directors (under DGCL §109(a)), the directors can go ahead and exercise that right. Under the theory, the shareholders have, at least implicitly, agreed to such unilateral changes by including the granting provision in the charter<sup>45</sup> and, if shareholders are displeased with such changes, they can either take the right away by amending the charter or, possibly, by unilaterally repealing or amending the bylaw provision adopted by directors.<sup>46</sup> In theory, the shareholders have procedural mechanisms to protect their rights against potential abuse by the board. And, perhaps such mechanisms require little or no judicial oversight: shareholders and directors should be able to “privately order” their affairs with minimal intervention from courts.

Directors have indeed been fairly active in deploying this power. Recently, they have unilaterally amended bylaws to include: (1) advance notice provisions requiring shareholders to provide detailed notice to the board about their upcoming proposals (including possible proxy fights) during a specified window before the shareholders meeting; (2) exclusive forum provisions requiring prospective plaintiff-shareholders to bring corporate law-based suit only in Delaware; (3) special shareholder meeting provisions that allow only a shareholder with substantial share ownership (often 5% or more) to call a special shareholders’ meeting; and (4) fee-shifting provisions that require non-prevailing shareholder to reimburse all the fees and expenses that the corporation and its directors have incurred in dispute.<sup>47</sup>

Though it was initially uncertain whether such bylaw provisions would be upheld by the court, Delaware courts have become more lenient towards directors. The case of *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*,<sup>48</sup> is exemplary. The directors of Chevron and FedEx adopted exclusive forum bylaws that required shareholders to

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<sup>44</sup> Once we determine that the charters and bylaws constitute a “contract” among the shareholders, directors, and the corporation, it seems appropriate to deal with the scope and content of such “contractual” obligations using the principles of contract law rather than those of fiduciary law. For instance, in terms of interpreting the provisions of charters or bylaws, the directors (and the shareholders) would be subject to the interpretation rules of contract law. Although corporate law is unclear on this issue, this approach is taken in agency law. See, e.g., Restatement (Third) of Agency §§8.07 and 8.13. According to the official comment b to §8.07, “[a]lthough a contract is not necessary to create a relationship of agency, many agents and principals enter into agreements. Contract-law principles of general applicability govern whether such agreements are enforceable and how they are to be interpreted, among other questions.” If, on the other hand, we were to apply fiduciary obligations, unilateral bylaw amendments are most likely to receive the protection of the business judgment rule, unless heightened judicial scrutiny, such as the entire fairness rule or the Unocal proportionality test, apply. With business judgment rule protection, because the plaintiff-shareholders must show that the directors were “grossly negligent” when amending the bylaws, this seems more deferential to the directors’ decisions than the contractual duty of good faith and fair dealing.

<sup>45</sup> The Chancery Court in *Boilermakers* called this an “implied consent.” 73 A.2d at 955 – 956. Obviously, how “consent” has been given by the shareholders to the directors is an open question. As we will see shortly, the courts treat this as a question of interpretation in change-of-terms contract disputes.

<sup>46</sup> See supra note – on legal and practical limitations on shareholders’ ability to amend or repeal board-adopted bylaw.

<sup>47</sup> For an overview of recently contested bylaws, see Hamermesh (2014), Choi (2018), Min (2018), and Fisch (2018).

<sup>48</sup> 73 A.3d 934 (Del. Ch. 2013).

initiate corporate law-based litigation only in Delaware.<sup>49</sup> In relevant parts, the bylaw stated:

Unless the Corporation consents in writing to the selection of an alternative forum, the Court of Chancery of the State of Delaware shall be the sole and exclusive forum for (i) any derivative action or proceeding brought on behalf of the Corporation, (ii) any action asserting a claim of breach of fiduciary duty owed by any director, officer or other employee of the Corporation to the Corporation or the Corporation's stockholders, (iii) any action asserting a claim arising pursuant to any provision of the Delaware General Corporation Law, or (iv) any action asserting a claim governed by the internal affairs doctrine. Any person or entity purchasing or otherwise acquiring any interest in shares of capital stock of the Corporation shall be deemed to have notice of and consented to the provisions of this [bylaw].<sup>50</sup>

Without the application of such a bylaw, shareholders, presumably, would be able to bring suit against the corporation or the directors (and officers) under the rules of civil procedure. Traditionally, such suits were usually brought either in the state of incorporation or the state where the corporation's headquarters is located, or both.<sup>51</sup>

When the exclusive forum bylaw was challenged by shareholders, the Chancery Court upheld its facial validity. The court reasoned that, "the bylaws constitute a binding part of the contract between a Delaware corporation and its stockholders, and the bylaw dealing with litigation forum is a proper subject matter under Delaware General Corporation Law §109(b).<sup>52</sup> The court then reasoned that when the shareholders grant the right to unilaterally amend the bylaws to the directors in the charter, they have "assented to a *contractual framework* established by the DGCL and the certificate of incorporation that explicitly recognizes that stockholders will be bound by bylaws adopted unilaterally by their boards," and "[u]nder that clear *contractual framework*, the stockholders assent to not having to assent to board-adopted bylaws."<sup>53</sup> (Emphasis added.) According to the court, in case the shareholders are displeased with a board-adopted bylaw, instead of filing a shareholder lawsuit, they can either repeal or amend the board-adopted bylaw or even

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<sup>49</sup> While both Chevron and FedEx conduct business throughout the US and many parts of the world, Chevron is headquartered in California, while FedEx is headquartered in Tennessee. Both stocks are listed on the New York Stock Exchange.

<sup>50</sup> Id. at 942.

<sup>51</sup> Citation needed.

<sup>52</sup> Boilermakers, at 955.

<sup>53</sup> Id. at 956. In an earlier case, the federal district court in California ruled that unilaterally adopted forum selection bylaw is invalid under the principles of contract law. *Galaviz v. Berg*, 763 F.Supp.2d 1170 (N.D. CA 2011). The Galaviz court stated that: "under contract law, a party's consent to a written agreement may serve as consent to all the terms therein, whether or not all of them were specifically negotiated or even read, but it does not follow that a contracting party may thereafter unilaterally add or modify contractual provisions." Id. at 1174. The Boilermakers court criticized this reasoning, stating that the conclusion "rests on a failure to appreciate the contractual framework established by the DGCL for Delaware corporations and their stockholders." Boilermakers, at 956.

remove the directors at the next shareholders' meeting.<sup>54</sup> The reasoning strongly implies that the dispute over board-adopted bylaws should be resolved in the boardroom rather than in the courtroom.

Furthermore, even though the court mentioned that the bylaws should be “interpreted using contractual principles,”<sup>55</sup> the cases the court mainly relied on were a few U.S. Supreme Court cases, *The Bremen v. Zapata Off-shore Co.*<sup>56</sup> and *Carnival Cruise Line v. Shute*,<sup>57</sup> which validated forum selection clauses with only passing references to contract law doctrines. Citing *Bremen*, the *Boilermakers* court stated that the forum selection clauses are valid, so long as they are “unaffected by fraud, undue influence, or overweening bargaining power” and that the provisions “should be enforced unless enforcement is shown by the resisting party to be ‘unreasonable.’”<sup>58</sup> Hence, while there was some attempt to examine both the procedural and substantive aspects of the adoption of the forum selection bylaw, examining the issues of “fraud, undue influence, or overweening bargaining power” and whether the enforcement of the provision would be “unreasonable” would still leave directors plenty of latitude.<sup>59</sup> In fact, in *ATP Tour Inc. v. Deutscher Tennis Bund*,<sup>60</sup> the case that validated fee-shifting bylaws, there was little

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<sup>54</sup> *Id.*

<sup>55</sup> *Id.* at 957.

<sup>56</sup> 407 U.S. 1, 92 S. Ct. 1907 (1972).

<sup>57</sup> 499 U.S. 585, 111 S. Ct. 1522 (1991).

<sup>58</sup> *Id.* citing *Bremen*, 407 U.S. at 10.

<sup>59</sup> The *Boilermakers* court does not apply the proper or equitable purpose test to forum selection bylaws, except to state that: “the plaintiff may sue in her preferred forum and respond to the defendant’s motion to dismiss for improper venue by arguing that...the forum selection clause should not be respected because its application would be unreasonable. The plaintiff may also argue that...the forum selection clause should not be enforced because the bylaw was being used for improper purposes inconsistent with the directors’ fiduciary duties.” See 73 A.3d 934 at 958 (Del. Ch. 2013). The court also states that the bylaws are presumed to be valid and to successfully challenge the “facial statutory and contractual validity of the bylaws,” the plaintiffs must show that “the bylaws cannot operate lawfully or equitably *under any circumstances.*” (emphasis original). See 73 A.3d 934 at 948 (Del. Ch. 2013). The ATP Tour court similarly states: the fact that “under some circumstances, a bylaw might conflict with a statute, or operate unlawfully, is not a ground for finding it facially invalid.” 91 A.3d 554, 558 (Del. 2013). The analysis, however, is in tension with an earlier ruling by the Delaware Supreme Court. In *CA, Inc. v. AFSCME Employees Pension Plan*, the Delaware Supreme Court struck down a bylaw that would require reimbursement of proxy expenses (even by those waging proxy fights against the incumbent directors) by finding that complying with the bylaw will lead to a breach of directors’ fiduciary duties under “at least one...hypothetical.” 953 A.2d 227, 238 (Del. 2008). This paper is certainly not arguing that the exclusive forum bylaw, or any other unilaterally adopted bylaws, is unreasonable and should be prohibited. The paper’s main argument focuses more on advocating for the judicial oversight on unilaterally adopted bylaws.

<sup>60</sup> 91 A.3d 554 (Del. 2013). While the ATP Tour court does mention the requirement that the amendment must be done for a “proper” or “equitable” purpose (and effect), it does not delve into more details about the purpose behind the fee-shifting bylaws. According to the court, “the enforceability of a facially valid bylaw may turn on the circumstances surrounding its adoption and use,” but the certification from the US Third Circuit Court “does not provide the stipulated facts necessary to determine whether the ATP bylaw was enacted for a proper purpose or properly applied.” See 91 A.3d 554, 559 (Del. 2014). The court nevertheless states that the “intent to deter [shareholder] litigation...is not invariably an improper purpose.” *Id.* at 560.

mention of whether the bylaws should be examined under the principles of contract, even though the decision relied heavily on the “contractarian principle.”<sup>61</sup>

## II. Bilateral and Unilateral Modifications under Contract Law

The adoption of the contractarian principle to the charters and bylaws naturally leads us to think about how modification of such “contracts” would be dealt with under contract law. In particular, with respect to bylaws, granting directors the right to amend bylaws is akin to giving one party the right to unilaterally amend (or modify) the contract.<sup>62</sup> These are often called “change-of-terms” clauses, and such provisions are prevalent particularly in consumer and employment contracts, including credit card agreements and end user license agreements (EULAs). They are also visible in agreements among commercially sophisticated entities.<sup>63</sup> Under contract law, modification, in general, raises at least two important issues: (1) whether the parties have assented to the modification (so called the “manifestation of mutual assent” requirement);<sup>64</sup> and (2) whether a modification is “fair and equitable” or made “in good faith.”<sup>65</sup>

The change-of-terms clause, in addition, raises at least four issues: (1) whether the right is so open-ended as to make the contract (or the “promise”) illusory or too indefinite; (2) whether the right grants too much power to one party so as to make the term unconscionable; (3) what the parties might have intended by granting one party to unilaterally modify the contract; and (4) in case the right is exercised, whether the exercise is in “good faith.”<sup>66</sup> This section will illustrate that cobbling together different doctrinal

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<sup>61</sup> There are a few areas in which a bylaw amendment will be subject a heightened judicial scrutiny. If the directors were adopting a bylaw, say, with an anti-takeover feature against a hostile takeover attempt, the bylaw amendment will be scrutinized under the *Unocal* proportionality standard. Also, if the directors are deemed to interfere with the shareholder franchise, the bylaw will be subject to the *Blasius* compelling justification test.

<sup>62</sup> An important difference between contract and corporate regimes is that under contract law, unless contract stipulates otherwise, no party is given the right to unilaterally modify the contract. By contrast, under corporate law, shareholders always have the right to unilaterally modify bylaws. Technically, there is also a difference between having a change-in-terms clause in a contract versus a right to unilaterally amend bylaws in the charter, since the relationship between the charter and the bylaws is hierarchical. We doubt, however, that these differences would matter much, unless the bylaw provision in question is in conflict with the charter. For instance, even if the statute would have allowed a granting clause to be contained in the shareholder-approved bylaws, rather than the charter, unless there is another provision in the charter with which it conflicts, it seems unlikely that the court would have come to a different conclusion.

<sup>63</sup> The most common commercial agreements that allow one party to dictate the terms of the transaction are output and requirements contracts as well as open-price contracts, which allow either the buyer or the seller to determine, ex post, the quantity or price of the good to be produced. See Uniform Commercial Code §2-306 and 2-209.

<sup>64</sup> See DeMott (2015) and Lipton (2016) on the problems of constructing “consent” (or the manifestation of mutual assent) in the case of corporate charter and bylaw amendments.

<sup>65</sup> Fair and equitable requirement is imposed by the Restatement while the Uniform Commercial Code uses the good faith approach. See Restatement (Second) of Contracts §89 and UCC §2-209.

<sup>66</sup> There also is a question of whether there is mutual assent to the unilateral modification. This issue arises most often with respect to consumer contracts, when the notification is sent through a bill stuffer. One reason why the courts often required a meaningful opt out (or termination) was to satisfy the mutual assent requirement. See generally Peter Alces & Michael Greenfield, *They Can Do What!?: Limitations on the Use*



frameworks under contract law, courts have imposed a substantial restriction on how the contractually granted right can be exercised.

#### A. Illusory Promise and Indefiniteness

On the issue of whether a change-of-term provision constitutes an “illusory” promise, under contract law, granting one contracting party too much flexibility can lead to a lack of commitment, which is essential for there to be a contract.<sup>67</sup> The unilateral right to amend a contract can raise an analogous problem.<sup>68</sup> When the parties expressly include certain obligations, such as advance written notice, courts have held that such an obligation will no longer make the unilateral modification clause illusory.<sup>69</sup> Even without any express obligation, courts have, in other circumstances, attempted to solve this issue by imposing certain obligations, such as the implied covenant of good faith and fair dealing.<sup>70</sup> In other areas of contract law, the duty of good faith and fair dealing is expressly required by statute. The primary example comes from the requirements of the Uniform Commercial Code on output and open-price contracts,<sup>71</sup> under which one of the parties has the right to set either the quantity or the price term. The Uniform Commercial Code imposes an obligation to set the price and quantity terms in “good faith.”<sup>72</sup> Because the duty of “good faith” is an obligation, this also presumably solves the illusory promise problem.

#### B. Unconscionability

The doctrine of unconscionability is another line of attack often been used by plaintiffs against the change-of-terms clauses. If a court finds a contract term

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*of Change-of-Terms Clauses*, 26 Georgia State University Law Review 1099 (2010); Oren Bar-Gill & Kevin Davis, *Empty Promises*, 84 Southern California Law Review 1 (2010) and David Horton, *The Shadow Terms: Contract Procedure and Unilateral Amendments*, 57 UCLA Law Review 605 (2010). The papers ultimately argue for a statutory mechanism to deal with commercial entities arbitrarily modifying their contracts with consumers. See also Michael DeMichele & Richard Bales, *Unilateral-Modification Provision in Employment Arbitration Agreements*, 24 Hofstra Labor & Employment Law Journal 63 (2006).

<sup>67</sup> Contract requires a promise and for there to be a promise, there has to be some sort of a “commitment” by the promisor. See Restatement (Second) of Contracts §§1 and 2. When there is no commitment and therefore, no promise, the contract also lacks consideration. Accordingly, some courts treat the illusory promise problem as a lack of consideration problem. See *infra* note 67.

<sup>68</sup> See, e.g., *Cheek v. United Healthcare of the Mid-Atlantic, Inc.*, 378 Md. 139 (2003) (finding a change-of-terms clause in an employee handbook illusory and declining to enforce an arbitration clause later added by the employer); *Floss v. Ryan’s Family Steak House, Inc.*, 211 F.3d 306 (2000); and *Dumais v. American Golf Corp.*, 299 F.3d 1216 (2002).

<sup>69</sup> See *Pearson’s Pharmacy, Inc. v. Express Scripts, Inc.*, 2009 U.S. Dist. LEXIS 100915 (2009) (the change-of-terms clause required Express Scripts to provide written notice of any modifications and to give the pharmacy an option to terminate the contract if they disagreed with the changes) and *Morrison v. Circuit City Stores, Inc.*, 70 F.Supp.2d 815 (1999) (change-of-terms clause with an obligation to give advance notice and the right could be exercised only at certain times of the year).

<sup>70</sup> See *Fagerstrom v. Amazon.com, Inc.*, 141 F.Supp.3d 1051 (2015) (declaring that an arbitration agreement that contained a right of unilateral modification is not illusory because Amazon was bound by the duty of good faith “to act within the common purpose of the agreement and to the justified expectations of the customers”).

<sup>71</sup> See UCC §2-306 for output and requirements contracts and §2-305 for open-price contracts.

<sup>72</sup> *Id.*

“unconscionable,” the court can strike it from the contract, modify the term, or even declare the entire contract unenforceable.<sup>73</sup> The change-of-terms clause can be subject to unconscionability analysis because one party is given a (much) more favorable deal to the possible detriment of the other. To prevail on an unconscionability claim, the claimant must show that (1) the term is both procedurally and substantively unconscionable; and (2) the unconscionability was present at the time of the contract’s formation.<sup>74</sup> Because the second prong requires a demonstration of unconscionability at the time of formation, some courts have applied the doctrine to resolve the question of whether the change-of-terms clause itself is unconscionable.<sup>75</sup> Others have been willing to apply to the time of modification, reasoning that formation and modification raise similar issues.<sup>76</sup> If this were so, the plaintiff must show that the modification (and not the initial formation) was both procedurally and substantively unconscionable. With respect to the latter, the plaintiff must show that the modified term is unreasonably favorable to the modifying party. This is very much an open question, and the courts will likely grapple with whether the modified term will have an unreasonably favorable effect for the plaintiff. More importantly, the plaintiff will also have to show that the amendment process itself was procedurally unconscionable. In many ways, this inquiry is similar to that into whether the modification was done in “good faith.”

### C. Interpretation

Some courts have raised the issues of interpretation and ex ante intent with respect to change-of-terms clauses. Basically, when one party grants the other the right to modify the contract, this can raise the question of ex ante intent, such as what degree of discretion the contracting parties intended and whether the altered term falls within that expectation. The case of *Badie v. Bank of America* illustrates this dilemma.<sup>77</sup> The case dealt with credit card agreements between the plaintiff-consumers and Bank of America. The original agreement contained a change-of-terms clause which, in relevant parts, stated:

We May Change or Terminate Any Terms, Conditions, Services or Features of Your Account (Including increasing Your Finance Charges) at Any Time. We May Impose Any Change in Terms on Your Outstanding Balance, as Well as on Subsequent Transactions and Balances. We may also add new terms, conditions, services or features to your Account. To the extent required by law, we will notify you in advance of any change in terms by mailing a notice to you at your address as shown on our records.

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<sup>73</sup> See Restatement (Second) of Contracts §208 and UCC §2-302.

<sup>74</sup> *Id.*

<sup>75</sup> See, e.g., *Flemma v. Halliburton Energy Services*, 2013-NMSC-022 (2013) (finding an employment contract that contained a change-of-terms clause unconscionable because it was unreasonably favorable to the company). But see *Gillman v. Chase Manhattan Bank*, 73 N.Y.2d 1 (1988) (finding that a change-of-terms clause in a credit card agreement is not unconscionable because the term was normal in the industry).

<sup>76</sup> See *Powertel, Inc. v. Bexley*, 743 So. 2d 570 (1991) (stating that the exercise of change-of-terms clause by including an arbitration clause is unconscionable because the clause is added without a bargain, and the counterparty did not have an opt out option, creating an absence of meaningful choice).

<sup>77</sup> 67 Cal. App. 4th 779 (Ct. App. CA 1998).

Subsequent to opening the credit card accounts, Bank of America attempted to insert a mandatory arbitration clause into the agreement by mailing half-page bill stuffers to its customers.

The *Badie* court determined that inserting the mandatory arbitration clause raised an issue of interpretation, in addition to other contract law issues, such as unconscionability, good faith and fair dealing.<sup>78</sup> Bank of America argued that the change-of-terms provision authorized any modification whatsoever, but the court disagreed. According to the court, the only “terms” actually included into the original agreement pertained to “percentage rates for purchases, various fees, the method of computing balance, and the grace period.”<sup>79</sup> While the broadly worded change-of-terms clause supported the Bank’s interpretation (that they could subsequently add the mandatory arbitration clause), the court reasoned that the plaintiffs’ narrow interpretation that the “terms” of the original agreement do not include issues of dispute resolution. Between these two possible interpretations of the clause, the court ultimately determined that the plaintiffs’ more narrow interpretation was more reasonable, and therefore, the Bank could not unilaterally impose a mandatory arbitration clause.<sup>80</sup>

#### D. Implied Duty of Good Faith and Fair Dealing

At a high level of generality, all contracts require the contracting parties to exercise “good faith” in both performance and enforcement of the contract.<sup>81</sup> Furthermore, the application of good faith usually presumes that there is some discretionary component in the performance of the contractual obligations. So, sometimes the court will say that a party has to exercise “good faith” in the discretion granted under contract. This principle is applicable to the case of unilateral modification. While the precise contours of what exactly “good faith” obligation entails is unclear, with respect to unilateral modifications, case law suggests that the courts have required a (different) combination of (1) a notice provision which obligates the amending party to notify the counterparty about the proposed amendment several days prior; (2) a termination or opt-out right, allowing the counterparty to terminate the agreement if she does not agree with the proposed amendment; and (3) a non-retroactive application provision.<sup>82</sup> If we were to apply all three prongs, the modifying

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<sup>78</sup> Id. at 798.

<sup>79</sup> Id. at 799.

<sup>80</sup> Id. at 805 – 806.

<sup>81</sup> Restatement (Second) of Contracts §205 states: “every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.” Official comment a refers to the good faith definitions in the Uniform Commercial Code. UCC §1-201(19) defines “good faith” as “honesty in fact in the conduct or transaction concerned” and, with respect to merchants, UCC §2-103(1)(b) defines good faith to be “honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.” The comment goes on to state that: “the phrase ‘good faith’ is used in a variety of contexts, and its meaning varies somewhat with the context.”

<sup>82</sup> See, e.g., *Badie v. Bank of America*, 67 Ca. App. 4th 779 (Cal. App. 1998) (applying the implied covenant of good faith and fair dealing principle to unilateral insertion of arbitration clause in credit card agreements); and *In re Halliburton Co.*, 80 S.W.3d 566 (Texas 2002) (imposing opt out right and prohibiting retroactive application). Allowing consumers to have the chance to opt out by terminating the contract has been deemed

party must, first, give advance notice to the counterparty; second, allow the counterparty to terminate the contractual relationship (or opt out of the proposed modification); and third, make sure that the modified term will not apply retroactively.

### III. Change-of-Terms Clause vs. Right to Unilaterally Amend Bylaws

Under the current system, unilateral bylaw amendments are at least facially similar to unilateral contract modifications in a few procedural dimensions. First, with respect to publicly traded corporations<sup>83</sup> subject to the federal securities regulations, the directors have an obligation to notify shareholders of the bylaw amendment through an 8-K filing.<sup>84</sup> Furthermore, because 8-K filings are public, the disclosure of bylaw amendment through 8-K is arguably more effective than contract modification disclosure through bill stuffers, as is often done in consumer contracts. Second, if shareholders find the bylaw amendment unattractive, they can “terminate” their relationship with the corporation by selling their stock. Presumably this termination right is strongest for public corporations whose stock is actively traded on a national exchange, such as the New York Stock Exchange and NASDAQ. Third, although the existing case law is not entirely clear, it is unlikely that the courts will allow directors to apply the amended bylaw retroactively against shareholders, probably as a matter of public policy.<sup>85</sup>

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to better satisfy the requirement of mutual assent to the proposed unilateral amendment. See *Stiles v. Home Cable Concepts*, 994 F.Supp. 1410 (1998). The non-retroactivity clause combined with notice provision is often called the “Halliburton savings clause.” See *In re Halliburton Co.*, 80 S.W.3d 566 (Texas 2002) (applying Texas contract law and general contract principles to uphold an arbitration clause unilaterally adopted by an employer) and *In re 24R, Inc.*, 324 S.W.3d 564 (explaining that the Halliburton court “held that because the [amended arbitration agreement] contained a ‘savings clause’—including a ten-day notice provision and a provision that any amendments would only apply prospectively—that prevented the employer from avoiding its promise, the arbitration agreement was not illusory”). The relevant portion of the amended arbitration clause in the Halliburton case stated that, “no amendment shall apply to a Dispute of which...[employer] had actual notice on the date of amendment.” *Id.* at 569 – 570. See *Nelson v. Watch House Int’l, LLC.*, 815 F.3d 190 (5th Cir. 2016) for a recent application of the Halliburton savings clause. In credit card contracts, federal law prohibits or substantially restricts retroactive application. See *Alces & Greenfield* (2010) at 1143 – 1144 (describing the Credit CARD Act prohibits retroactive changes in the annual percentage rate while giving the creditor limited permission to increase the rate applicable to existing balances when the consumer defaults by being late for more than 60 days).

<sup>83</sup> It is unclear what disclosure obligations there are with respect to privately held corporations. In Delaware, there is no statutory obligation to disclose bylaw amendments. Instead, presumably, such obligation is likely to be part of directors’ fiduciary obligation to the corporation and its shareholders. This is sometimes called the duty of candor.

<sup>84</sup> Securities and Exchange Act §13 requires firms subject to the federal securities laws to make filings, including periodic reports, with the SEC to keep investors up to date. General instructions to Form 8-K, as adopted by the SEC under the Exchange Act §13, require the reporting firm to file Form 8-K with the SEC. As one of the events that must be disclosed through an 8-K, Item 5.03(a) includes both charter and bylaw amendments.

<sup>85</sup> There is question over what retroactive application means. One possibility is by looking at the timing when the cause of action arose. For instance, if it arose before the company adopted an exclusive forum clause, shareholders should not be subject to the bylaw. This raises the issue of whether the presence of a cause of action creates a “vested right” for the (future) plaintiff. Another, somewhat narrower approach is to look at the time of (constructive) notice of the lawsuit. If, for instance, shareholders file the lawsuit or give notice to the company of their intention to do so before the bylaws are amended, the lawsuit will not be subject to the bylaw. This was the approach used in *Halliburton*. See *supra* note --.

Even with respect to notification and termination rights, however, there are important differences, which make the rights of shareholders substantially weaker. First, unlike contract modifications, notice of bylaw amendments, as required under the federal securities laws, is *ex post*: by the time the notice is given to shareholders, the amendments have already taken place and are effective. Even under the federal securities regulation, there is no requirement for the directors to notify shareholders of bylaw amendment proposals before the amendments become effective.<sup>86</sup> Second, as noted by other scholars in charter amendment settings,<sup>87</sup> the presence of an actively trading market, combined with the *ex post* notification feature, imply that even if a shareholder were to “terminate” her relationship with the corporation by selling her shares, when the amended bylaw is unattractive for the shareholders, the share price would already be depressed by the time of sale. The damage is already done by the time the shareholder exercises her termination right.<sup>88</sup>

Third, and most importantly, shareholders do not have a meaningful right to opt out or terminate the relationship. Foremost, given that charters and bylaws affect all shareholders (and the corporation) and given the importance of preserving homogeneity, granting individual shareholder (or even individual shares) the right to opt out of amendments would be practically (if not legally) impossible.<sup>89</sup> With respect to the right to terminate, when a shareholder sells her shares after the bylaw amendment, the corporation does not incur a loss, since the shareholder will be selling her shares to new investors rather than back to the corporation.<sup>90</sup> By contrast, in a contract setting, when the counterparty terminates the contract either before or after the contract modification, the party that modifies the contract will lose the contractual surplus that the party was expecting to realize

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<sup>86</sup> Under the 8-K instructions, firms must report certain events, including charter and bylaw amendments, within four business days *after* the occurrence of certain events.

<sup>87</sup> See Easterbrook (1989) and Bebchuk (1989).

<sup>88</sup> There also is a countervailing element that makes the shareholder’s right, vis-à-vis that of a contracting party, more robust. If we assume that the stock price represents the present value of the future “surplus” (e.g., dividends) that the shareholders expect to receive, selling it to a third party allows the shareholder to capitalize the (reduced) surplus. By contrast, when a contracting party terminates the contract, ordinarily, the terminating party does not receive anything, unless stipulated otherwise in the contract, from the counterparty. Tradable stock makes it easier for the shareholder to “terminate” the relationship.

<sup>89</sup> One way of giving differential rights to the shareholders is by creating different classes of stock (Common A, Common B, Preferred A, Preferred B, etc.) and tailoring each class’s rights. But, of course, within each class, the same charter and bylaw provisions apply.

<sup>90</sup> This is true even when the proposed bylaw amendment destroys value and reduces the share price. By contrast, when a corporation is selling stock with undesirable bylaw provisions, presumably the price that the investors will be willing to pay will decrease, which, in turn, reduces the amount of proceeds that the corporation gets. Therefore, at least in theory, the concerns over opportunistic or self-serving bylaw or charter amendments are greater when done “mid-stream” (that is, after the corporation has already received the proceeds from sale) rather than at the initial (or secondary) public offering. See Coffee (1989) and Gordon (1989). At the same time, however, there is doubt as to whether the initial public offering, presumably through its pricing mechanism, can effectively prevent seemingly inefficient charter or bylaw provisions. See Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 *Journal of Law, Economics, and Organization* 83 (2001) (documenting how many firms adopt anti-takeover devices at the time of their initial public offering).

in the future. A shareholder selling her shares (through market trading) is akin to a party to a contract transferring her rights (either through delegation or assignment) to a third party rather than terminating the contract. In a market trading of stock, the relationship between a corporation and a shareholder is preserved and only the identity of the shareholders changes. If we are serious about achieving symmetry, shareholders should be able to get their shares redeemed by the corporation. The fact that the corporation does not suffer a loss when a shareholder sells is important for deterrence and incentive reasons. In a contract setting, if a party thinking about modifying the contract is concerned about possible contract termination by the counterparty in response, the party will think twice before going through the modification. If, on the other hand, there is no loss of contractual surplus, there could be very little deterrence against self-serving modification.

More generally, the relationship between directors and officers, on the one hand, and shareholders, on the other, is based on the notions of agency. The relationship is more “vertical” and “hierarchical,” rather than “horizontal” or “arms-length” like the relationship between two contracting parties.<sup>91</sup> Applying the notions of agency law, we often think of the shareholders as the de facto or de jure “principal” and the directors and the managers as the “agent” who can act on behalf of the corporation and the shareholders.<sup>92</sup> And this vertical relationship imposes the fiduciary duty on directors and officers, which includes the duty of care and the duty of loyalty. While directors and officers, as the agents, have the right to manage the business and the affairs of the corporation under Delaware law,<sup>93</sup> they must do so in the “best interest” of the corporation and its shareholders. When we take into account that these agents are in charge of managing operations (and the shareholders are prohibited from interfering<sup>94</sup>) and that the shareholders are the “residual claimants” of the corporation, it follows that allowing the directors and the officers to unilaterally change the governance structures can give rise to the dangers of externality and hold-up.<sup>95</sup>

#### IV. Policy Implications: Getting the Right Trade-off

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<sup>91</sup> The relationship does not necessarily fit nicely into the classic agency definition in the sense that the directors and the officers are acting “on behalf of” the corporation and its shareholders but subject to the shareholders’ “control.” See Restatement (Third) of Agency §1.01 (defining agency as “fiduciary relationship that arises when one person (a ‘principal’) manifests assent to another person (an ‘agent’) that the agent shall act on the principal’s behalf and subject to the principal’s control, and the agent manifests assent or otherwise consents so to act).

<sup>92</sup> *Id.* Perhaps, this can justify why the breach of an agent’s obligation to the principal can justify stronger remedy, such as disgorgement and punitive damages, while breach of a contractual obligation ordinarily triggers expectation of damages and does not allow the victim to recover punitive damages. See Restatement (Third) of Agency §8.01 (allowing various remedies, including injunction, forfeiture, and rescissory damages).

<sup>93</sup> See Delaware General Corporation Law §141(a).

<sup>94</sup> See Hamermesh (1998) on how bylaws interfering with the directors’ right to manage the corporation under DGCL §141(a) will be invalid. See also *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008) (conflict between proxy expense reimbursement bylaw with DGCL §141(a) and attendant fiduciary duties of the directors).

<sup>95</sup> In economic theory, the principal-agent relationship represents a classic example of how one party’s (agent’s) actions directly affect another’s (principal’s) welfare.

What should be the policy objective with respect to charter and bylaw amendments, and, in particular, with respect to unilateral bylaw amendments? To be clear, we do not argue that just because the courts have applied the “contractarian” framework to corporate charters and bylaws, we should literally treat them as contracts and subject them to contract law doctrines. At the same time, just as the courts are “borrowing” the conception of contractual framework, we can also examine other principles in contract law to better formulate corporate law’s approach to charters and bylaws. Nor do we argue that unilaterally amended bylaws are always detrimental to the shareholders. Some directors and officers undoubtedly act in the best interest of the corporations and attempt to maximize the return for shareholders. They presumably amend bylaws (or make charter amendment proposals) that would enhance such interest. At the same time, no one will seriously argue that there are other directors and officers whose primary objective is to maximize their own private benefits and entrench themselves in the office.<sup>96</sup> The first policy objective, therefore, should be screening: deter charter and bylaw amendments that are harmful to the corporation and detrimental to shareholders while allowing (promoting) amendments that are beneficial.

Further, there is the issue of preserving flexibility. Presumably, one of the reasons why a corporation would want to amend its charter and bylaws (even unilaterally by directors or shareholders), is to make sure that the corporation can effectively respond to new, previously unforeseen circumstances and challenges. This is similar to the reason why contracting parties would want to modify the contract even though the performance has not been finished or would sometimes want to bestow the right to amend the contract to one of the parties.<sup>97</sup> Particularly with respect to giving directors the right to unilaterally amend bylaws, because going through shareholder voting process is costly and time-consuming, maintaining flexibility can be an important goal. In reference to the aforementioned concerns over possible abuse and managerial opportunism, the policy goal, therefore, should be to devise a mechanism that will preserve the benefits of this flexibility while prohibiting value-destroying (and self-serving) amendments. In this section, we discuss several different possibilities.

#### A. Optional Redemption

Assuming that giving each shareholder (or each share) an opt out right is not feasible, the first possibility is to give a redemption right to the shareholders, so that if they disagree with a proposed amendment, they can sell their shares back to the corporation at

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<sup>96</sup> The central rationale behind applying heightened judicial scrutiny in hostile takeover cases is based on the concerns about directors’ and officers’ entrenchment against the interest of shareholders. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

<sup>97</sup> Restatement (Second) of Contracts, for instance, require that the modification must be done “in view of circumstances not anticipated by the parties when the contract is made.” Restatement (Second) of Contracts §89(a). There is some uncertainty as to what “circumstances not anticipated by the parties when the contract is made” means and how strongly courts enforce that “requirement” to the extent that the courts adopt the Restatement’s approach. The Uniform Commercial Code, in contrast, does not impose this requirement. See UCC §2-209.

a redemption price.<sup>98</sup> The redemption price can be set equal to the stock price prevailing before the announcement of the amendment so as to protect shareholders from suffering a loss.<sup>99</sup> This would give the shareholders a bona fide termination right, right comparable to that of contracting parties. Particularly with respect to bylaws that are unilaterally adopted by the directors or charter amendments that are opportunistically implemented by the directors and the officers, a de facto termination right can provide a stronger deterrence against the corporate agents. Just like in a contract termination scenario, the corporation will now suffer an actual loss when the value-reducing bylaws or charters are adopted, and the shares are redeemed in response, compared to the case where the shareholders merely sold their shares to others.

The problem with this proposal, however, is that the redemption right would potentially make corporate organization less stable and make the corporate form less attractive. For instance, if the redemption price is set equal to the stock price prevailing before the amendment or before the announcement of the proposal, but the stock price subsequently goes down for unrelated reasons, the drop could lead to a potentially massive capital withdrawal and subsequent liquidity crisis. Given that one of the primary benefits of choosing a corporate form is the capital lock-in and organizational stability, granting shareholders a strong redemption right could substantially eliminate that benefit. There also is an issue with the deterrence benefit. When redemption does occur, since the loss is born directly by the corporation—and indirectly by the remaining, non-redeeming shareholders, and not personally by directors, the size of the deterrence benefit may also be questionable.<sup>100</sup>

## B. Mandatory Pre-Amendment Disclosure

Another possible solution is to strengthen the disclosure of proposed amendment before, rather than after, the amendment becomes effective. With respect to charter or bylaw amendments that require shareholder approval, such a regime is already in place.<sup>101</sup> So, the proposal is more relevant for bylaw amendments that are done unilaterally by

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<sup>98</sup> Stock issued by a Delaware corporation can be made redeemable at the option of the holder. See Delaware General Corporation Law §151(b) (“any stock...may be made subject to redemption by the corporation at its option or at the option of the holders of such stock or upon the happening of a specified event...”). In fact, in venture capital financing, redemption rights are often granted to preferred shareholders but the rights get triggered only when certain events, such as another round of financing or merger, take place. See National Venture Capital Association Charter.

<sup>99</sup> Another possibility is to grant shareholders an appraisal remedy, under which dissenting shareholders can demand payment of the “fair value” of their shares. Under the Model Business Corporation Act, with respect to certain charter amendments, shareholders have such a right. See MBCA §13.02(a). However, if the shares are publicly traded, shareholders are no longer entitled to the remedy. See MBCA §13.02(b). This is commonly known as the “market out” exception.

<sup>100</sup> To the extent that officers’ and (possibly) the directors’ compensation is tied to stock performance or the market valuation of the company, these corporate agents will also suffer, albeit partially, from any decrease in the stock price.

<sup>101</sup> For instance, under federal securities laws, charter amendment proposals are contained in the proxy for the shareholders’ meeting. See Min (2018). Even without federal securities regulations, under corporate law, any amendment proposal requiring shareholder approval will have to be circulated to shareholders in advance.



directors. The idea is similar to the pre-modification disclosure in contracts, as required under the good faith and fair dealing obligations.<sup>102</sup> In the context of corporations, however, pre-amendment disclosure will often be ineffective, particularly when there is an active trading market for the corporation's stock. With respect to unilaterally amended bylaws, given that the "proposed" bylaw amendment does not require shareholder approval and will become effective with certainty in the near future, the stock price will incorporate that information when the proposal is announced. And, even if an existing stockholder were to try to terminate her relationship with the corporation by selling her stock, it is already too late, since, by then, the stock value has already decreased.<sup>103</sup> Unless shareholders can stop the proposed amendment from becoming effective (e.g., by securing an injunction from a willing court, which will require stronger judicial oversight), the share price has already absorbed the future effects of the amendment, and the shareholders will suffer a loss.

### C. Shareholder Voting and Approval

Another possibility is to rely more on the shareholder approval process. Similar to mandatory pre-amendment disclosure, this is not relevant for charter or bylaw amendments that already require shareholder approval and is applicable to unilateral bylaw amendments. Shareholder approval can take a few different forms. First is to require the directors to get shareholders' express approval (i.e., through voting or written consent) on any proposed bylaw amendment. If the shareholders are displeased with the proposed amendment, they can simply vote down the proposal. There are, at least, two problems associated with this. Foremost, ex post shareholder vote on any proposal renders granting of the right to (unilaterally) amend bylaws to the directors somewhat useless. Instead, it turns the bylaw amendment into something more like a charter amendment.<sup>104</sup> Given that there is a distinction between charters and bylaws, and one of the goals of granting directors the right to unilaterally amend bylaws is to preserve flexibility, this proposal would undermine that objective.<sup>105</sup> Furthermore, the proposal imposes a potentially substantial cost and delay. When the directors want to amend the bylaws, they will have to wait until the next shareholders' meeting or convene a special shareholders' meeting to make the amendment effective. For public corporations, given the cost of having to circulate a proxy under the federal securities laws, this imposes an additional cost on the bylaw amendment process.

A second variation is to strengthen the shareholders' right to undo or amend director-adopted bylaws. Under both the Model Business Corporation Act and Delaware

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<sup>102</sup> See supra section III.D.

<sup>103</sup> Even if the stock is not listed on a national exchange or actively traded, presumably, if an existing shareholder wants to sell her stock to a third party, the amount the third party would be willing to pay for would be lower due to the value-destroying amendment.

<sup>104</sup> To amend the charter, directors must first make an amendment proposal and the proposal must be approved by the shareholders. See Delaware General Corporation Law §242.

<sup>105</sup> As a possible compromise, we could require only the "material" bylaw amendments be submitted to the stockholders for approval. Unless the question of "materiality" is answered through the statute, this can inject a substantial amount of uncertainty.

General Corporation Law, regardless of whether shareholders granted directors the power to amend bylaws, shareholders' right to amend bylaws cannot be restricted.<sup>106</sup> While this is possible, similar concerns arise as in shareholder voting. To modify or repeal the bylaw provision adopted by directors, the shareholders will have to circulate a bylaw amendment proposal, convene a meeting (most likely at an annual shareholder meeting for a large publicly traded corporation, unless a block holder with sufficient ownership can call a special meeting), and secure a requisite affirmative vote to pass the proposal. This may be quite costly and time-consuming. Furthermore, when the directors' right to amend bylaws is in place, one has to wonder whether the directors will promptly undo shareholders' bylaw amendment. So far, there is no case law that directly deals with this issue.<sup>107</sup>

A third option is to leave the system as is, and allow shareholders to hold directors accountable through the director election process. Indeed, this is the solution suggested by the *Boilermakers* court,<sup>108</sup> when the court upheld a forum selection bylaw unilaterally adopted by the directors. Similar to the problem of requiring bylaw amendment proposal be subject to a shareholder vote, this mechanism will also be costly and time-consuming. In fact, compared to the shareholder voting mechanism, this would be even more costly because the shareholders would likely have to engage in a contested election process.<sup>109</sup> Simply voting against directors at director elections would be insufficient. Because the board of directors usually reserves the right to fill any vacancies, when a director fails to receive sufficient vote to be re-elected,<sup>110</sup> the rest of the directors can appoint either the director-nominee who failed to receive the requisite affirmative votes or someone else who would be friendly to their cause. To prevent this problem, the shareholders will have to come up with a competing slate of nominees. Even if there is a block holder (e.g., a hedge fund or an active institutional shareholder), who may be willing to do this, this would require the block holder to wage a potentially costly proxy fight. If there is no such block holder, it is extremely unlikely that any shareholder would be willing to spend the resources to wage a proxy fight. Overall, using director elections to provide a necessary check on bylaw amendments may be a costly overkill.

Finally, relying on shareholder voting mechanism is particularly ineffective if a bylaw has been adopted by a controlling shareholder or a bloc-holder. When a controlling

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<sup>106</sup> See Model Business Corporation Act §10.20(a) and Delaware General Corporation Law §109(a). This, of course, is subject to various legal and practical restrictions. See Fisch (2018) on how the existing legal structure imposes limitations on shareholders' power to amend bylaws, making shareholders' right considerably weaker than that of the directors. What this proposal is advocating for is to broaden or strengthen the rights of shareholders to amend or repeal board-adopted bylaws. See also Smith, Wright & Hintz (2011) (advocating for giving more rights to the shareholders to adopt and amend bylaws).

<sup>107</sup> See supra note – on this cycling and counter-amendment issue. Another problem of relying on shareholders' repeal is that until repeal has been approved by shareholders, the undesired bylaw remains effective. In contrast, if shareholders were to challenge the validity of a bylaw in court, the court can promptly strike it down.

<sup>108</sup> See supra Part I.

<sup>109</sup> See Hamermesh (2014) for various mechanisms that are (or can be) deployed by the resistant directors in minimizing shareholders' nomination rights, particularly through the use of advance notice bylaws.

<sup>110</sup> See Delaware General Corporation Law §223(a)(1). Citation needed on charters and bylaws that grant the right to fill vacancies to the directors.

shareholder, with more than 50% of the voting power, adopts a bylaw through shareholder vote, unless the minority shareholders can challenge the bylaw in court, there is no meaningful way for them to repeal or amend it. Even when there is no controlling shareholder with de facto and de jure control, when a bylaw amendment is initiated and supported by a large bloc-holder, including, for instance, an activist shareholder, public shareholders may face an uphill battle to repeal or amend the bylaw. Especially due to the recent rise of concentrated ownership, many with dual class stock structure, the concerns over controlling shareholders' possible abuse of power have become more salient.<sup>111</sup>

#### D. Stronger Judicial Oversight

The final option we consider is to subject charter and bylaw amendments to stronger judicial oversight. The paper argues that given the relatively weak procedural protections given to dispersed shareholders, such as the weak termination and notification rights, a fairly persuasive case can be made for stronger judicial oversight. Particularly in preserving flexibility while deterring managerial opportunism, stronger judicial oversight can play an effective role. This part first discusses the existing corporate law doctrine of proper and equitable (reasonable) purpose test and then analyzes the idea of applying the good faith and fair dealing test, borrowed from contract law. Lastly, the part discusses the advantages of imposing stronger judicial oversight.

##### 1. Proper and Equitable Purpose Test

Under existing corporate law, courts have broad power to declare certain charter or bylaw provisions invalid or decline to enforce them on a case-by-case basis. Especially for bylaws, existing case law requires the amendments be done for "proper" or "equitable" purpose.<sup>112</sup> If the director-initiated bylaw amendment is deemed improper, inequitable, or unreasonable, shareholders can challenge the bylaw in court, and the court can either strike down the entire bylaw provision or deny it on a case-by-case basis. While the proper or equitable purpose test has been in Delaware's arsenal for quite some time from the seminal cases of *Schnell* and *Frantz Manufacturing*, as noted earlier, Delaware courts recently have seemed to shy away from a robust application of the test, as evidenced by cases such as *ATP Tour* and *Boilermakers*.<sup>113</sup> Stronger judicial oversight implies that the courts revive the proper and equitable purpose test to more closely examine the purpose and effect (and the reasonableness) of charter and bylaw amendments, especially those unilaterally adopted.

##### 2. Borrowing from Contract Law Principles

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<sup>111</sup> See Albert Choi, *Concentrated Ownership and Long-Term Shareholder Value*, forthcoming in *Harvard Business Law Review* (2018) for a discussion over the recent rise of concentrated ownership in the U.S., especially using dual class stock.

<sup>112</sup> See Choi (2018) and Folk on the Delaware General Corporation Law §109.06. See also *Schnell* and *Frantz Mfg.*

<sup>113</sup> See *supra* part II.

We can also find some ideas from contract law. One approach is to utilize contract law's various interpretation principles. As seen earlier, when construing a change-of-terms clause, courts will attempt to infer the parties' *ex ante* intent to determine how wide or narrow the discretion is by examining various extrinsic evidence surrounding the time of contract formation (or when the change-of-terms clause was entered into). Also, if necessary, the court adopts a narrower interpretive posture so as to minimize the potential abuse of discretion and prevent hold-up. Similar interpretation techniques can be applied to charters and bylaws. For instance, if a certain provision has been recommended by the directors and approved by the shareholders, statements in the proxy or other extrinsic evidence (including how such terms were commercially perceived at the time) can be used to infer the parties' intent.<sup>114</sup> Such a technique can be useful in delineating the discretionary scope of the charter provision granting directors the right to unilaterally amend bylaws. Also, when an amended provision is ambiguous, contract law interpretation techniques can be applied to minimize ambiguity. Especially in cases of ambiguity, the interpretation principle of *contra proferentem* can be deployed to interpret the terms against the drafter and to protect the counterparty.<sup>115</sup>

The court can also employ the good faith and fair dealing obligations to charter and bylaw amendments.<sup>116</sup> If the court determines that the amendment is either substantively or procedurally "unfair" to shareholders (or, for that matter, to the directors or officers) or that it is done in "bad faith," the court can declare the amendment invalid or unenforceable.<sup>117</sup> As noted earlier, under contract law, good faith and fair dealing obligations are widely understood to include, on procedural dimension, (1) pre-amendment notification; (2) right to terminate or opt out; and (3) non-retroactive application of the modified terms. Foremost, a persuasive argument can be made that the unilaterally adopted bylaw provision should not be applied retroactively.<sup>118</sup> In addition, given that, especially for corporations with publicly-traded stock, the disclosure right is ineffective and the termination right is absent, a case can be made for more proactive judicial review over the substantive terms to test whether they are "substantively unfair." This would be akin to

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<sup>114</sup> See *Centaur Partners, IV v. National Intergroup, Inc.*, 582 A2d 923 (Del. 1990) (using statements from the proxy to determine the meaning of the phrase "any similar provision contained in the By-Laws of the corporation").

<sup>115</sup> See, e.g., *Aleynikov v. Goldman Sachs Group, Inc.*, C.A. No. 10636-VCL (Del. Ch. 2016) (stating that *contra proferentem* should apply to interpret the word "officer" contained in bylaws against the drafter-corporation).

<sup>116</sup> The good faith and fair dealing obligations under contract law are different from the good faith obligation imposed under corporate law. With respect to the latter, under current case law, the obligation is part of the fiduciary duty of loyalty. See *Stone v. Ritter*, 911 A.2d 362 (Del. 2006). Contract law-based good faith and fair dealing obligations can be imported not as part of the directors' fiduciary duty but because the courts treat charters and bylaws as "contracts" between shareholders and the corporation. See also *supra* note 21. Also, while the "fair dealing" component seems to invoke the entire fairness test under corporate law, the application of the contract law-based good faith and fair dealing test should not be tantamount to applying the entire (intrinsic) fairness test under corporate law. As a starter, the burden of proof will remain on the plaintiff (rather than on the defendant under the entire fairness test) to show that the directors acted in "bad faith" or did not deal "fairly" when amending bylaws.

<sup>117</sup> The test can be applied to the entire clause as a whole (to determine, for instance, its facial validity) or on the application of the clause on a case-by-case basis.

<sup>118</sup> See *supra* note 81 (on "Halliburton" savings clause) and surrounding text.

strengthening the substantive prong in response to weak procedural protection, an approach that courts have often utilized in contract cases.<sup>119</sup>

### 3. Benefits of Stronger Judicial Oversight

Compared to the mechanisms that rely on shareholder voting, the solution of stronger judicial oversight can be deployed without substantial cost or delay. When a shareholder (or a group of shareholders) wants to challenge a charter or a bylaw amendment, she will seek equitable relief to limit its application or undo the amendment. If the court is willing to entertain this argument, the court can decide on the issue of (facial) validity fairly quickly. This provides the advantage of speed and low cost. Also, since the case is likely to be brought in a derivative manner or as a direct class action with an attorney who is incentivized to receive compensation, the mechanism can minimize the problems of collective action.<sup>120</sup> Finally, Delaware courts would be quite capable of allowing value-enhancing amendments while preventing self-serving amendments, thus promoting flexibility through case-by-case resolution.

The principles of “equitable” or “proper” purpose and “good faith” and “fair dealing” will apply equally to unilateral bylaw amendments by shareholders—not just directors. For public corporations with dispersed or passive institutional ownership, shareholders abusing their unilateral amendment power is quite unlikely. On the other hand, potential shareholder abuse (or opportunism) could be important when a corporation has a controlling shareholder, with over 50% of the voting power, or a shareholder with substantial bloc-ownership, e.g., an activist institutional owner.<sup>121</sup> In either case, a controlling shareholder or a bloc-holder can successfully amend the bylaws to either impede the directors’ and officers’ right to manage the business and affairs of the corporation or to undermine the rights of the minority (or passive) shareholders.<sup>122</sup> If we

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<sup>119</sup> See unconscionability cases mentioned in part II.

<sup>120</sup> In most derivative actions, plaintiff’s attorneys will be entitled to receive compensation from the corporation so long as the outcome of the litigation, either through judgment or settlement, creates a “common fund” or produces a “substantial benefit” to the corporation (and the shareholders). Since nullifying a bylaw will not ordinarily create a common monetary fund, the court will have to declare that it produces a substantial benefit to the corporation (or to the shareholders). This substantial benefit test, properly applied, can also function as a screening mechanism against frivolous lawsuits. See Sean Griffith, *Correcting Corporate Benefit: How to Fix Shareholder Litigation by Shifting the Doctrine on Fees*, 56 Boston College Law Review 1 (2015) for more detailed analysis on substantial benefit and common fund doctrines. There are obviously dangers and costs to relying on or inducing more shareholder litigation. But when the courts become more vigilant with respect to whether a “substantial benefit” exists for the corporation and the shareholders, such costs can be more effectively controlled. Recent instances of shareholder litigation in mergers and acquisitions transaction is exemplary. See *In re Trulia, Inc. Stockholder Litig.*, 129 A.3d 884 (Del. Ch. 2016). See also Albert Choi, *Optimal Fee-Shifting Bylaws*, forthcoming in Virginia Law Review (2018) on how the Delaware legislature and the courts could allow symmetric fee-shifting system to encourage meritorious lawsuits while discouraging non-meritorious ones.

<sup>121</sup> See Albert Choi, *Concentrated Ownership and Long-Term Shareholder Value*, forthcoming in Harvard Business Law Review (2018).

<sup>122</sup> See *Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442 (2011) (invalidating a reserve stock split bylaw amendment executed by the directors because it favored the controlling shareholder at the expense of minority shareholders); and *Hollinger International, Inc. v. Black*, 844 A.2d 1022 (Del. Ch. 2004)

were to keep the existing framework and preserve the fidelity to the “contractarian” principle with little judicial oversight, there may be very little that directors or minority shareholders can do police controlling shareholders’ or bloc-holders’ abuse.<sup>123</sup> Through stronger judicial oversight, we can restore the symmetry in deterring abuse by directors and officers, on the one hand, and the shareholders, on the other.

Stronger judicial oversight can also apply to cases where a proposed bylaw or charter amendment has been approved by the shareholders. Under contract law, even for a bilateral modification (a modification that has been agreed to by both parties), the court can still declare the modified provision unenforceable. The purpose, under contract law, is to prevent hold-up and abuse of bargaining power.<sup>124</sup> In the context of charter or bylaw amendments putatively approved by shareholders, particularly when ownership is dispersed, the collective action and rational apathy problems can prevent shareholders from giving meaningful consent to the proposal.<sup>125</sup> The problem may be more acute with respect to charter amendments, where the directors have the sole power to make an amendment proposal,<sup>126</sup> and to cases where there is a controlling shareholder or a bloc-holder. When the directors or the controlling shareholder (or the bloc-holder) are vested with the de facto power to set the agenda, knowing that the dispersed shareholders suffer from the collective action and rational apathy problems, they can implement charter or bylaw provisions that

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(invalidating bylaws enacted by a controlling shareholder that prevented the board “from acting on any matter of significance except by unanimous vote” and “set the board’s quorum requirement at 80%” because the bylaws “were clearly adopted for an inequitable purpose and have an inequitable effect.”). But see *Frantz Manufacturing Co. v. EAC Industries*, 501 A.2d 401 (Del. 1985) (validating bylaws adopted by a majority stockholder that increased the board quorum requirement and mandated that all board actions be unanimous. The court found that the amendments were “a permissible part of [the stockholder’s] attempt to avoid its disenfranchisement as a majority stockholder” and, thus, were “not inequitable under the circumstances.”).

<sup>123</sup> Especially due to the recent rise of dual class stock with concentrated ownership, this issue has become much more salient. Somewhat interestingly, courts have been more willing to apply the “equitable” or “proper” purpose test to controlling shareholders’ unilateral bylaw amendments. See *Choi* (2018) (on the rise of dual class stock and concentrated ownership). These two lines of cases, one dealing with directors and the other dealing with controlling shareholders, have created a curious asymmetry in case law. One of the arguments of the paper is to harmonize these two lines of cases and also to import (or revive) the “good faith” and “fair dealing” principles.

<sup>124</sup> See, e.g., *Lingenfelder v. Wainwright Brewing Co.*, 103 Mo. 578 (1891) and *Alaska Packers’ Assn. v. Domenico*, 117 F. 99 (9th Cir. 1902). Before the adoption of “fair and equitable” test by the Restatement and the “good faith” test by the Uniform Commercial Code, courts used to apply the pre-existing duty rule to safeguard against hold-up and abuse of bargaining power, under which a modification for additional compensation for an existing promise would be held unenforceable. See generally *Farnsworth* (2004) §§4.21 and 4.22.

<sup>125</sup> See *Bebchuk* (1989) (arguing that because the benefits accrue to all shareholders, individual shareholder will under-spend in investigating the likely effects of a charter amendment and this will lead to inaccurate pricing of an amendment proposal) and *Min* (2018) (how even institutional shareholders do not necessarily get informed and are incentivized to adopt the recommendations from proxy advisory firms).

<sup>126</sup> See *Min* (2018) for examples of “opportunistic” or “preemptive” charter amendment proposals made by the directors and approved by the dispersed shareholders.

are much more favorable to them and at the expense of the (minority) shareholders.<sup>127</sup> Through more active judicial monitoring, such abuses can be deterred.

Stronger judicial oversight will not operate in vacuum: it will operate together with the other policy tools, including director elections and shareholders amending or repealing board-adopted bylaws.<sup>128</sup> To the extent that the shareholders do not have a meaningful termination right, nor an effective pre-amendment notification right and also that approval mechanisms are costly to execute and subject to collective action and rational apathy problems, judicial oversight can become an effective check against directorial (or controlling shareholder's) abuse of power. It will function as a complementary mechanism to the others. Particularly when the directors have the delegated power to amend bylaws, while preserving the benefits of flexibility through delegation, it can mitigate the problems of externality and hold-up. Finally, because the judicial oversight mechanism taps into the existing corporate and contract law doctrines, it requires minimal change to the existing legal structure. The "proper" or "equitable" purpose test has been part of corporate law for a long time, and one could argue, this is also true of the "good faith" and "fair dealing" obligations.<sup>129</sup> By restoring and applying these common law-based doctrines, not only will the "contractarian" principle be applied in its truest form, but the corporate law doctrine can be harmonized with agency law principles.<sup>130</sup>

## Conclusion

Over the past decade, courts have more willingly applied the theory that the corporate charters and bylaws constitute a "contract" between the shareholders and the corporations and have upheld a number of bylaw provisions that were unilaterally adopted by directors. The focus of this paper is to examine this "contractarian" principle by, foremost, looking at the comparable issues under contract law. In particular, the paper highlights the fact that the right to unilaterally amend bylaws under corporate law is similar to the change-of-terms clauses under contract law; and, under contract law, the exercise of such discretion is subject to various (statutory and common law) restrictions, including the obligation to act in good faith and deal fairly with the counterparty. Notwithstanding the similarity, when we compare the rights of contracting parties with those of shareholders, the rights of the shareholders are insufficient on one key dimension: the right to terminate the shareholder-corporation relationship. The lack of meaningful termination (or opt out)

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<sup>127</sup> See *In re Delphi Financial Group Shareholder Litigation*, 2012 WL 729232 (Del. Ch. 2012) (controlling shareholder attempting to receive a control premium in a merger through a charter amendment by requiring the shareholders to simultaneously vote on the merger and the charter amendment).

<sup>128</sup> Coffee (1989) has argued that, whether we regard corporation as a nexus of contract, real entities, or artificial entities, the one immutable constant is "the institution of judicial oversight." See Coffee (1989) at 1621. One of us has argued how utilizing an open-ended standard can better allow contracting parties to police opportunism. See Albert Choi & George Triantis, *Completing Contracts in the Shadow of Costly Verification*, 37 *Journal of Legal Studies* 503 (2008).

<sup>129</sup> See *In re Delphi Financial Group Shareholder Litigation*, 2012 WL 729232 (Del. Ch. 2012) (noting that a charter amendment is subject to the good faith and fair dealing obligations).

<sup>130</sup> Under agency law, contract law principles will apply to interpret an agency agreement. See Restatement (Third) of Agency §8.07 cmt. b (stating that "contract law principles of general applicability govern whether such agreements are enforceable and how they are to be interpreted, among other questions.").

right, combined with the fact that the relationship between shareholders and directors (and minority shareholders and the controlling shareholder) is more hierarchical rather than horizontal, implies that the shareholders (or the minority shareholders) may be more vulnerable to managerial or controlling shareholders' opportunism.

In considering different mechanisms, the paper has argued that the policy goal should be to mitigate the problems of hold-up and opportunism while preserving the flexibility in amending corporation's organizational documents. With that in mind, the paper has examined various mechanisms, including optional redemption, more robust disclosure rights, shareholder voting, and judicial oversight. After considering the possibilities, the paper suggests that stronger judicial oversight may be better able to achieve the policy goal. By more vigorously applying the "proper" and "equitable" purpose test, or by imposing the good faith and fair dealing obligations borrowed from contract law, the paper has argued that the court can better deter both directors' and controlling shareholder's opportunism and guard against the problems of collective action and rational apathy. At the same time, unlike other costly, time-consuming, or possibly ineffective mechanisms, because courts with expertise can deter opportunistic amendments more quickly and at lower cost, the flexibility desired for shareholders and managers in ordering their private affairs can be better preserved.