8-2-2020

Private Ordering and the Role of Shareholder Agreements

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Abstract

Corporate law has embraced private ordering -- tailoring a firm's corporate governance to meet its individual needs. Firms, particularly venture-capital backed start-ups, are increasingly adopting firm-specific governance provisions such as dual-class voting structures, arrangements to create stable shared control rights among a coalition of minority shareholders, and provisions that limit the permissible fora for shareholder litigation. Courts have broadly upheld these provisions as consistent with the contractual theory of the firm. Commentators too, while finding some governance provisions objectionable, nonetheless support a private ordering approach as facilitating innovation and enhancing efficiency.

Although most analyses of private ordering focus on provisions in a corporation's charter and bylaws, private corporations are increasingly turning to an alternative governance mechanism -- shareholder agreements. Shareholder agreements have largely escaped both judicial and academic scrutiny, but language in a handful of judicial opinions suggests that corporate participants have greater latitude to engage in private ordering through a shareholder agreement and even that shareholder agreements can be used to avoid otherwise-mandatory provisions of corporate law.

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This Article offers the first broad-based analysis of shareholder agreements, detailing the scope of issues to which they are addressed and identifying the challenges that they pose for corporate governance. Although shareholder agreements are a natural component of the small closely-held corporations that essentially operate as incorporated partnerships, they rely on principles of contract that are in tension with the fundamental structure of corporate law. This tension is particularly problematic for the increasing number of large privately-held corporations whose governance structures are shielded from the transparency and price discipline of the public capital markets.

The Article challenges the growing use of shareholder agreements and maintains instead that corporations should engage in private ordering exclusively through their charter and bylaws. It further critiques efforts to use shareholder agreements to evade statutory or common law limits on private ordering and argues that, to the extent such limits are undesirable, they should be the subject of legislative reform.

Introduction

Private ordering – tailoring a corporation's structure and governance mechanisms to meet firm-specific needs – is an important feature of corporate law.[1] New IPO companies like Facebook and Snap use dual or multi-class voting structures to protect a founder's ability to pursue his or her idiosyncratic vision while enabling public shareholders to share in the economic growth of the firm.[2] VC-funded firms like Trados implement negotiated board structures that balance control rights and veto power among shareholders with different incentives and skill sets.[3] A growing number of corporations are adopting provisions to increase board

[1] See Jill E. Fisch, *The New Governance and the Challenge of Litigation Bylaws*, 81 BROOKLYN L. REV. 1637, 1638 (2015) (defining private ordering as "the adoption of issuer-specific rules that are contractual in nature (as opposed to statutes, agency rules, or decisional law)").
[2] See, e.g., Dave Michaels, *Facebook, Snap and Other Firms Targeted by SEC Regulator's Attack on Dual-Class Shares*, WALL ST. J., Feb. 15, 2018 (describing Facebook and Snap as using multi-class voting structures to preserve founder control).
[3] See In re Trados Inc. S'holder Litig., 2009 Del. Ch. LEXIS 128, *3 (2009) (describing composition of Trados board of directors which included 4 representatives of venture capital firms, two Trados executives and one outside director).

accountability to shareholders such as majority voting[4] and proxy access.[5] Commentators defend private ordering based on its capacity to produce efficient firm-specific rules and to facilitate valuable experimentation and innovation in corporate governance.[6]

The standard tools by which corporations engage in private ordering are the certificate of incorporation or charter and the bylaws.[7] State corporation statutes allow corporations to tailor their charter and bylaws to meet their individual needs, and courts have taken a largely contractual approach to evaluating and interpreting these provisions.[8] As the Delaware Supreme Court recently explained, "Because corporate charters and bylaws are contracts, our rules of contract interpretation apply."[9] The permissible scope of the charter and bylaws – and thus the matters that corporations can address through private ordering – has been the subject of extensive judicial attention. For example, in March 2020, the Delaware Supreme Court made national headlines[10] when it upheld a

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[4] See Stephen J. Choi, Jill E. Fisch, Marcel Kahan & Edward B. Rock, *Does Majority Voting Improve Board Accountability?,* 83 U. CHI. L. REV. 1119, 1144 (2016) (empirically analyzing adoption of majority voting at S&P 1500 companies).

[5] See, e.g., Holly J. Gregory, Rebecca Grapsas & Claire Holland, *The Latest on Proxy Access*, HARV. LAW SCHOOL FOR. ON CORP. GOV., Feb. 1, 2019, https://corpgov.law.harvard.edu/2019/02/01/the-latest-on-proxy-access/ (reporting that 71% of S&P 500 companies had adopted a proxy access bylaw by the end of 2018, up from 1% in 2014).

[6] See, e.g., D. Gordon Smith, Matthew Wright, & Marcus Kai Hintze, *Private Ordering with Shareholder Bylaws*, 80 FORD. L. REV. 125, 174 (2011) (explaining that private ordering "enables each corporation to become a laboratory of corporate governance, experimenting with different models of shareholder participation and ultimately producing a diversity of governance forms and practices.").

[7] See, e.g., Megan Shaner, *Interpreting Organizational "Contracts" and the Private Ordering of Public Company Governance*, 60 WM. & MARY L. REV. 985, 988 (2019) ("With increasing frequency and creativity, the certificate of incorporation and bylaws of public corporations are being used as tools for restructuring key aspects of corporate governance.").

[8] See, e.g., Jill E. Fisch, *Governance by Contract: The Implications for Corporate Bylaws*, 106 Cal. L. Rev. 373, 377 (2018) ("the governing documents of the corporation—the charter and bylaws—operate and bind both managers and shareholders as if they had negotiated their terms and signed them, like a common law contract").

[9] Blackrock Credit Allocation Income Trust v. Saba Capital Master Fund, Ltd., 224 A.3d 964, 977 (Del. 2020).

[10] Alison Frankel, *Dela. Supreme Court: Companies can pick forum for shareholders' Section 11 claims*, REUTERS, March 18, 2020, https://www.reuters.com/article/legal-us-

charter provision providing actions arising under section 11 of the Securities Act of 1933 to be filed in federal court.[11]

Although most analyses of private ordering focus on charter and bylaw provisions, corporations are increasingly turning to an alternative governance mechanism -- shareholder agreements. Shareholder agreements have a long history in small closely-held corporations which typically operate as quasi-partnerships,[12] but their use has migrated into larger corporations such as venture-capital funded start-ups and even to public companies.[13] Despite their increased importance, shareholder agreements have received little attention.

The permissible scope and enforceability of shareholder agreements are uncharted territory Those commentators that have addressed the topic often claim that corporate participants can use shareholder agreements to evade otherwise-mandatory provisions of corporate law, a conclusion that is supported by language in some judicial decisions.[14] By and large, however, this language is dicta, and the actual

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[11] Salzberg v. Sciabacucchi, 227 A.3d 102 (Del. 2020).

[12] See, e.g., George D. Hornstein, *Judicial Tolerance of the Incorporated Partnership*, 18 L. & CONTEMP. PROBS. 435, 435 (1953). Close corporations are typically defined "by a blending of the roles of shareholder, officer, and director; the close personal relationships between the players; and the lack of market for reselling shares." Martin Edwards, *The Big Crowd and the Small Enterprise: Intracorporate Disputes in the Close-But-Crowdfunded Firm*, 122 PENN ST. L. REV. 411, 414 (2018).

[13] See Gabriel Rauterberg, *The Separation of Voting and Control: The Role of Contract in Corporate Governance*, working paper dated June 2020, at 5 (showing that "about 15% of companies that go public over the last five years do so subject to a shareholder agreement."). See also Sciabacucchi v. Liberty Broadband Corp., 2017 Del. Ch. LEXIS 93 (describing stockholders agreement between Liberty Media and Charter); Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 926 (Del. 2003) (describing voting agreement entered into by NCS officers in connection with Genesis Merger Agreement in their capacity as shareholders).

[14] See, e.g., Daniel T. Janis, *Venture Capital Shareholder Agreements—More Attention Now, Less Heartache Later,* BUS. L. TODAY, May 18, 2017, https://www.americanbar.org/groups/business_law/publications/blt/2017/05/03_janis/ ("Shareholder agreements give VCs extensive rights, far beyond the economics reflected in a company's charter); Rauterberg, *supra* note 13 at 13 (explaining that "[t]he essential function of shareholder agreements lies in the fact that they are not [] constrained" by the mandatory components of corporation statutes).

holdings are narrow and context-specific.[15] Critically, however, courts approach shareholder agreements differently, analyzing their validity according to principles of contract law rather than corporate law. Consistent with this approach, they treat shareholder agreements as personal waivers of a shareholder's individual rights,[16] governed by the general principle that private parties can validly waive common law, statutory and even constitutional rights by contract.[17]

The recent Delaware Chancery Court decisions in *Manti Holdings LLC v. Authentix Acquisition Co*. demonstrate the potentially expansive private ordering available through shareholder agreements.[18] In *Manti,* the court upheld a shareholder agreement waiving the common shareholders' statutory appraisal rights.[19] The court concluded that, because the parties were sophisticated, represented by counsel and received consideration, the shareholder agreement was a valid contract.[20] Although the petitioners argued that the Delaware appraisal statute, was a mandatory component of Delaware law that could not be subject to waiver, the court rejected this argument, concluding that nothing in the statute precluded petitioners from waiving their appraisal rights. Critically the court treated the shareholder agreement as personal rather than corporate, reasoning that it "did not restrict the appraisal rights of the

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[15] See, e.g., Rohe v. Reliance Training Network, Inc., 2000 Del. Ch. LEXIS 108, *58 n.49 (stating that "stockholders can bind themselves contractually in a stockholders agreement in a manner that cannot be permissibly accomplished through a certificate of incorporation."). Similarly, although Salamone v. Gorman, 106 A.3d 354 (Del. 2014) is often cited as support for the broad scope afforded to shareholder agreements, the court in that case explicitly concluded that the shareholder agreement in question did not "violate section 212(a) of the DGCL." *Id*. at 384.

[16] See, e.g., Klaassen v. Allegro Dev. Corp., 2013 Del. Ch. LEXIS 247, *79 ("By entering into the Stockholders' Agreement, Klaassen agreed voluntarily not to exercise his power as holder of a majority of the corporation's outstanding voting power to remove the Remaining Directors without cause.").

[17] See, e.g., Windmill Inns of Am., Inc. v. Cauvin, 299 Ore. App. 567, 576 (2019) quoting Assn. of Oregon Corrections Emp. v. State of Oregon, 353 Ore. 170, 183 (2013) ("The general rule in Oregon is that, although waivers of constitutional and statutory rights may be expressed through contract terms, those terms must clearly indicate an intention to renounce a known privilege or power.").

[18] Manti Holdings, LLC v. Authentix Acquisition Co., 2019 Del. Ch. LEXIS 307; Manti Holdings, LLC v. Authentix Acquisition Co., 2018 Del. Ch. LEXIS 318 (Del. Ch., Sept. 28, 2018)

[19] Manti Holdings, LLC v. Authentix Acquisition Co., 2019 Del. Ch. LEXIS 307

[20] Id.

classes of stock held by the Petitioners;"[21] rather the petitioners had simply agreed by contract "to forbear from exercising that right."[22]

Manti appears to sanction the growing trend of using shareholder agreements to engage in aggressive private ordering, a trend that is particularly significant in large private companies such as venture-capital funded start-ups, private equity owned firms, and "scaled" private companies.[23] The economic importance of shareholder agreements has grown as the number, size and age of private companies has increased.[24] In some cases, shareholder agreements continue in effect even after a company enters the public market.[25] Public companies that have substantial or controlling shareholders may also use shareholder agreements to allocate that control.[26]

This trend provides several reasons for concern. Simply put, shareholder agreements raise investor protection issues, including a lack of transparency, judicial oversight, and standardization. They allow unequal treatment of similarly-situated shareholders. And they sacrifice both the substantive and procedural predictability of the corporate form. Moreover, because the option of private ordering through shareholder agreements is far greater for private corporations than for public ones, they create an anomalous dichotomy in the scope of corporate law in an era in which the line between public and private corporations has

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[21] Manti Holdings, LLC v. Authentix Acquisition Co., 2018 Del. Ch. LEXIS 319, *11
[22] Id.
[23] Christopher B. Chuff, *Contracting Out of Appraisal Rights*, HARV. L. SCHOOL FOR. ON CORP. GOV., Oct. 23, 2018, https://corpgov.law.harvard.edu/2018/10/23/contracting-out-of-appraisal-rights/ (explaining that the *Manti* decision "brings further certainty to private equity and venture capital investors whose investments include drag-along rights with appraisal waivers").
[24] See, e.g., Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 HASTINGS L.J. 445 (2017) (explaining the regulatory factors that have led to a decline in the number of public companies as corporations remain private longer and raise substantial funding through the private capital markets).
[25] Rauterberg, *supra* note 13..
[26] See Sciabacucchi v. Liberty Broadband Corp., 2017 Del. Ch. LEXIS 93 (describing stockholders agreement between Liberty Media and Charter); Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 926 (Del. 2003) (describing voting agreement entered into by NCS officers in connection with Genesis Merger Agreement in their capacity as shareholders).

become increasingly blurred.[27] At the same time, they increase what is already a growing concern – the potential for highly-problematic governance practices in private companies. Notably, these are precisely those companies that are not subject to the disclosure requirements and discipline imposed by the public capital markets.[28]

Accordingly, this Article argues that shareholder agreements are inappropriate tools for private ordering and that firm-specific tailoring of governance rights in both public and private corporations should be restricted to the charter and bylaws. To be clear, this article is not challenging the role of shareholder agreements in the traditional close corporation – ventures that operate largely as incorporated partnerships – and the flexibility that they provide to participants in those firms.[29] Delaware and other states offer close corporation statutes with distinctive features, including greater contractual freedom, for corporations that both qualify and choose to be governed by their terms.[30] Rather, the Article is addressed to the substantial number of private companies that

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[27] See Donald C. Langevoort & Robert B. Thompson, "*Publicness" in Contemporary Securities Regulation After the JOBS Act*, 101 GEO. L.J. 337, 384 (2013) (explaining that the "boundary issues along the public--private divide are under theorized and, up until recently, left to resolution by reference to regulatory legacies from a time far different from today's trading markets."). See also Edwards, *supra* note 12, at 416 (describing equity crowdfunding as applying "a new tension to the already uneasy division between public and close corporations.").

[28] See, e.g., Renee M. Jones, *The Unicorn Governance Trap*, 166 U. PA. L. REV. ONLINE 165, 167-168 (2017) (observing that "in the absence of an impending IPO, Unicorn managers and investors lack sufficient incentives to develop governance structures and practices appropriate for enterprises of their scale.").

[29] See Harwell Wells, *The Rise of the Close Corporation and the Making of Corporation Law*, 5 Berkeley Bus. L.J. 263, 274 (2008) (observing that "The close corporation's distinguishing features sharply differentiate it from the public corporation").

[30] See, e.g., Tara J. Wortman, *Note, Unlocking Lock-in: Limited Liability Companies and the Key to Underutilization of Close Corporation Statutes*, 70 N.Y.U.L. REV. 1362 (1995) (estimating that only 5% of eligible firms elect statutory close corporation status); Notably, despite the availability of these statutes, they are not widely used. See id. at 1363 (examining "the possible reasons for the systematic underutilization of close corporation statutes by firms eligible for that status"). States also offer alternative business structures such as limited liability companies and limited partnership, in which freedom of contract takes precedence over the applicable statutory provisions. See, e.g., Peter Molk, *Protecting LLC Owners While Preserving LLC Flexibility*, 51 U.C. DAVIS L. REV. 2129 (2018) (describing and identifying potential concerns with the extensive contractual freedom provided to investors in LLCs).

do not share these characteristics, including venture capital-financed startups, companies owned by private equity funds, as well as established private companies with meaningful numbers of passive investors[31] – companies that, in a different legal and economic environment could have entered the public markets.[32] The number of large corporations that do not go public continues to increase, and their economic importance has increased as well.[33] These corporations exist along a broad spectrum of size and ownership structure and cannot be divided in a binary way between corporations in which mandatory rules are desirable as a policy matter and those in which they are not. For these corporations, this Article argues that a uniform approach to corporate law is both practical and normatively desirable.

The Article's premise is that corporate law provides a set of substantive and procedural rules that both define the corporation and govern the rights and powers of its constituencies. The use of the corporate form signals the application of these rules both to corporate participants such as officers, directors, and shareholders and to third parties that deal with the corporation. These rules provide predictability with respect to the corporation's operations, enhance the accuracy of investment pricing and facilitate the use of contracts.

Within these rules, a corporation's charter and bylaws are key. Together they form the corporation's governing documents; they set out the rights and responsibilities of officers, directors, and shareholders. Corporate law incorporates the concept of implicit consent; the terms of the governing documents are binding on all corporate participants, regardless of their individual sophistication, knowledge, and consent. Corporate law provides the procedures by which these documents may be altered and the features they can and cannot contain. Moving from the implicit contract of corporate law to the explicit contract of common

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[31] See, e.g., Carol Goforth, *Too Many Cooks Spoil the Cake, and too many Statutes Spoil the LLC: A Plea for Uniformity*, 46 Sw. L. Rev. 63, 69-70 2016) (defining closely held corporations and observing that "[c]ompanies that have not yet "gone public" in the sense of registering any of their equity interests with the Securities Exchange Commission may still be owned by such a widely diverse group of investors that they are not 'closely held' under this definition").

[32] See, e.g., de Fontenay, *supra* note 24 (explaining the regulatory factors that have led to a decline in the number of public companies as corporations remain private longer and raise substantial funding through the private capital markets).

[33] Jones, *supra* note 28 at 177.

law sacrifices the uniformity, universality and certainty that are fundamental values of the corporate form.

As a result, the article argues that corporations should engage in private ordering exclusively through their charter and bylaws, and the scope of shareholder agreements should be limited to matters that are truly individual in nature.[34] The distinction between private ordering and individual issues is informed by the types of issues that charter and bylaw provisions in public companies typically address, including director and officer fiduciary duties, inspection rights, appraisal rights, forum selection provisions and the procedures governing shareholder voting. Critically, shareholder agreements should not be used to restructure the scope of officer, director and controlling shareholder accountability. In addition, the article argues that shareholder agreements should be subject to the traditional hierarchy of governance tools, meaning that a shareholder agreement that is inconsistent with the statute, charter or bylaws, should not be enforceable.[35]

This analysis is in tension with the *Manti* decision which held that an appraisal waiver in a shareholder agreement could be valid even if the Delaware appraisal statute is understood to be a mandatory provision.[36] I do not argue that appraisal waivers are normatively undesirable; indeed, I make the case elsewhere that appraisal waivers such as the one in *Manti* are likely an efficient market-driven solution to

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[34] This Article focuses specifically on the use of shareholder agreements to address issues of corporate governance such as inspection rights, preemptive rights director appointment and removal rights, appraisal rights, restrictions on transferability and supermajority voting requirements. It is not addressed to contractual provisions that deal with the manner of payment, issues such as registration rights, or voting agreements that fall within the express contours of state corporation statutes. Gabriel Rauterberg offers a somewhat different taxonomy – differentiating between horizontal agreements as those among shareholders to which the corporation is not a party, and vertical agreements which involve commitments between the corporation itself and one or more shareholders. See Rauterberg, *supra* note 13, at 20.

[35] According to commentators, courts do not currently impose such a limitation. See, e.g., See Rauterberg, *supra* note 13 (arguing that "Delaware applies a fundamentally different paradigm of understanding to shareholder agreements than to the charter and bylaws, and this results in granting the former a wider span of freedom."); Wells, *supra* note 29 (arguing that "courts will permit [shareholder agreements] to establish governance structures that would not be countenanced in the charter or bylaws.").

[36] Manti Holdings, LLC v. Authentix Acquisition Co., 2019 Del. Ch. LEXIS 307, *9-10.

deficiencies in appraisal litigation.[37] Instead, this article argues that, to the extent that private ordering innovations conflict with mandatory features of corporate law, the appropriate solution is legislation explicitly expanding the permissible scope of private ordering. Delaware has consistently taken this approach, amending the statute to authorize private ordering in respond to evolving business needs through legislation authorizing, for example, proxy access bylaws, waivers of the corporate opportunity doctrine, and forum selection bylaws.[38] Notably, the legislature is particularly well suited to weigh the public policy considerations associated with retaining or eliminating a mandatory feature of the law. As with the appraisal waiver at issue in *Manti*, attempts by corporations to modify an existing mandatory feature of the law through innovative private ordering provisions – whether in the charter, bylaws or a shareholder agreement -- may be evidence that legislative reconsideration of that feature is appropriate.

The article proceeds as follows. Part I briefly summarizes the contractual approach to corporate law and the statutory and judicially-imposed limits on that freedom of contract through mandatory rules. Part II describes the increasing use of shareholder agreements and their limited consideration by the courts. Part III identifies the problems with using shareholder agreements to achieve private ordering in corporations. Part IV considers the implications of this analysis. It concludes that the identified problems are best addressed by requiring private ordering to take place through the charter and bylaws rather than through shareholder agreements. It further argues that states should respond to contractual innovation through legislation delineating the permissible scope of such provisions.

I. Contractual Freedom in Corporate Law

A. The Contractual Approach

Courts and commentators have widely embraced the contractual approach to corporate law both as a descriptive matter and a normative one.[39] This approach builds on an academic theory first advanced in the

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[37] See Jill E. Fisch, *Appraisal Waivers*, working paper dated July 6, 2020.
[38] See infra notes __ through __ and accompanying text.
[39] See, e.g., Fisch, *supra* note 8, at 374 (identifying the origins of contractual approach to corporate law).

economics literature[40] but that gained prominence in the legal literature thirty years ago with the publication of a symposium in the Columbia law review.[41] The economic theory is part of the literature on the theory of the firm, and argues that a corporation is best understood, not as an entity but as a nexus of contracts.[42] Accordingly, the contractual model views the officers, directors and shareholders of a corporation, as well as other corporate stakeholders, as using contract-like mechanisms to allocate their respective rights and responsibilities.[43]

Some supporters of the contractual approach argue that it has normative implications, specifically that corporate law should not adopt a one-size-fits all approach but should enable corporate participants to tailor the rules and structure of their enterprise to meet their needs.[44] Corporate law, these scholars claim, should facilitate the contracting process by accepting a wide-range of firm-specific terms and provisions. Although the law can furnish a default set of terms, it should be "enabling" in the sense that it allows individual firms to modify the

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[40] Ronald H. Coase, *The Nature of the Firm: Meaning*, in THE NATURE OF THE FIRM: ORIGINS, EVOLUTION, AND DEVELOPMENT 48, 56 (Oliver E. Williamson & Sidney G. Winter eds., 1993) ("The firm is essentially a choice of contractual arrangements."); Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310 (1976) (developing the nexus of contracts approach to the theory of the firm). The conception of the corporation as a contract can be traced back to Trs. of Dartmouth College v. Woodward, 17 U.S. 518 (1819). See, e.g., Henry N. Butler & Larry E. Ribstein, *Regulating Corporate Takeovers: State Anti-Takeover Statutes and the Contract Clause,* 57 U. CIN. L. REV. 611, 621 (1988) (describing "the Dartmouth College view of the corporation as a contract with the state").

[41] See generally Symposium: *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 et seq. (1989).

[42] Jensen & Meckling, *supra* note 40 at 310 ("Contractual relations are the essence of the firm, not only with employees but with suppliers, customers, creditors, etc. The problem of agency costs and monitoring exists for all of these contracts… .").

[43] See, e.g., Charles R. T. O'Kelley, *Coase, Knight, and the Nexus-Of-Contracts Theory of the Firm: A Reflection on Reification, Reality, and the Corporation as Entrepreneur Surrogate*, 35 SEATTLE U. L. REV. 1247, 1266-67 (2012) (explaining that the firm's nexus of contracts encompasses relationships among the firm's proprietor, investors, suppliers, lenders and employees).

[44] See, e.g., Jeffrey Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1551 (1989) (distinguishing between the positive implications of the nexus of contract theory and "normative contractarianism").

terms to meet their individual needs.[45] This firm-specific tailoring of corporate law rules is commonly termed private ordering.

Private ordering is defended on a variety of efficiency grounds.[46] It allows efficient customization in corporate structures by enabling rules to vary with firm-specific differences. It also allows innovation and experimentation and reduces the risk of regulatory error associated with mandatory regulation.[47] A firm's governance choices are also constrained by market discipline.

Corporate law generally facilitates private ordering. Most statutory provisions are structured as default rules that explicitly authorize individual corporations to modify the statutory default through a charter provision, a bylaw or, in some cases, a board resolution. For example, the Delaware statute provides that, as a default rule, corporations shall elect the board of directors on an annual basis.[48] The statute explicitly authorizes corporations to depart from this default and to adopt a staggered board.[49] The statute further instructs corporations that, if they choose to modify the statutory default and engage in private ordering, they must do so "by the certificate of incorporation or by an initial bylaw, or by a bylaw adopted by a vote of the stockholders."[50]

As this section illustrates, in many cases, the statutory text explicitly contemplates private ordering. The scope of private ordering is not, however, limited to topics in which there is specific statutory authorization. The governing documents of the corporation – the charter and bylaws – allow corporations to adopt a variety of firm-specific governance terms. The scope of issues that may be addressed through a firm-specific charter or bylaw provision is very broad. For example, the Delaware statute allows a corporate charter to contain "any provision for the management of the business and for the conduct of the affairs of the corporation," and "any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders, or any class of the stockholders, . . . if such provisions are

[45] See, e.g., Frank Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1446 (1989) ("The role of corporate law here, as elsewhere, is to adopt a background term that prevails unless varied by contract.").
[46] See Fisch, *supra* note 1 at 1639 (describing the advantages of private ordering).
[47] See *id.* (citing bylaws responding to board adoption and use of poison pills as an example of innovation through private ordering).
[48] 8 Del. §141(d).
[49] *Id.*
[50] 8 Del. §141(d).

not contrary to the laws of this State."[51] It further provides that the bylaws may address any subject, "not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees."[52]

The courts have upheld the power of corporations to address a variety of novel issues through bylaw and charter provisions. For example, in *Boilermakers*, the Delaware Supreme Court upheld the validity of forum-selection bylaws.[53] In *ATP*, the Court found fee-shifting bylaws to be facially valid.[54] And most recently, in *Salzberg*, the Court upheld the validity of a charter provision requiring the litigation of claims based on section 11 of the Securities Act of 1933 to be litigated in federal court.[55]

The rationale for these decisions is the contractual theory of the corporation.[56] As then-Chancellor Strine explained in *Boilermakers*, "the bylaws of a Delaware corporation constitute part of a binding broader contract among the directors, officers, and stockholders formed within the statutory framework of the DGCL."[57] Strine's reasoning in *Boilermakers* explains the rationale behind the contractual approach. As Strine explained, shareholder implicitly consent to the terms of the charter and bylaws when they make the voluntary decision to invest in a corporation.[58] Moreover, shareholders have the power to modify

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[51] 8 Del. § 102(b)(1). See Salzberg v. Sciabacucchi, 227 A.3d 102, 115 (Del. 2020) (describing § 102(b)(1)'s scope as "broadly enabling").
[52] 8 Del. § 109(b)
[53] Boilermakers Local 154 Retirement Fund v. Chevron Corp., 73 A.3d 934, 939 (Del. Ch. 2013).
[54] ATP Tour Inc. v. Deutscher Tennis Bund, 91 A.3d 554 (Del. 2014). Subsequently, the legislature amended the statute to prohibit fee-shifting charter and bylaw provisions.
[55] Salzberg v. Sciabacucchi, 227 A.3d 102.
[56] See, e.g., Airgas, Inc. v. Air Products & Chems., Inc., 8 A.3d 1182, 1188 (Del. 2010), citing Centaur Partners, IV v. Nat'l Intergroup, Inc., 582 A.2d 923, 928 (Del. 1990) (describing bylaws as "contracts among a corporation's shareholders").
[57] Boilermakers Local 154 Retirement Fund v. Chevron Corp., 73 A.3d 934 (Del. Ch. 2013). The Delaware legislature validated the former when, in 2015, it adopted legislation expressly authorizing issuers to adopt forum selection provisions in their charters and bylaws. 8 Del. § 115 (2015).
[58] See, e.g., *Boilermakers*, 73 A.3d at 939 ("the bylaws of a Delaware corporation constitute part of a binding broader contract among the directors, officers, and stockholders formed within the statutory framework of the DGCL"). Strine further observed that shareholders also consent to the possibility that the board will unilaterally

contract terms with which they disagree, either by amending the bylaws or removing and replacing the directors.[59] In addition to providing a justification for upholding charter and bylaw provisions that adopt firm-specific governance terms, the contractual approach also offers a methodology for interpreting those provisions bylaws – they are to be interpreted using contract principles.[60]

The contract analogy in corporate law is imperfect, however.[61] Certain elements of corporate law are generally understood to be beyond the scope of permissible private ordering.[62] Commentators term these elements "mandatory corporate law."[63] Although at least in the United States, most of corporate law is flexible and enabling, the law imposes limits on freedom of contract.[64] As Chancellor Allen explained "[corporate law] is not, however, bereft of mandatory terms . . . . Generally, these mandatory provisions may not be varied by the terms of the certificate of incorporation *or otherwise*."[65]

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amend the bylaws when they invest in a corporation in which the board has been given the authority to do so. *Id*. at 958.

59 *Id*. at 956-57.

60 See BlackRock Credit Allocation Income Trust v. Saba Capital Master Fund, Ltd., 224 A.3d 964, 977 (Del. Jan. 13, 2020) ("Because corporate charters and bylaws are contracts, our rules of contract interpretation apply").

61 See also Fisch, supra *note* 8 at 377 (challenging the contract metaphor because shareholders' power to adopt and amend bylaws is more limited than that of the board); Memorandum in Support of Motion to Dismiss of Proposed Intervenors California Public Employees' Retirement System and Colorado Public Employees' Retirement Association, dated May 31, 2019, The Doris Behr 2012 Irrevocable Trust v. Johnson & Johnson, Civil Action No. 19-08828 (MAS)(LHG), at 22 (D.N.J.) (explaining that corporate law does not involve the "mutual manifestation of assent" that is a required component of contract law).

62 See, e.g., John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989); Jeffrey N. Gordon, *supra* note 44.

63 See Bernard S. Black*, Is Corporate Law Trivial? A Political and Economic Analysis,* 84 NW. U.L. REV. 542, 543 (1990) (using term "mandatory corporate law" to refer to corporate law rules that are not "waivable by contract among the relevant parties").

64 Jurisdictions outside the United States rely more heavily on mandatory corporate law. See, e.g., Jens Dammann, *The Mandatory Law Puzzle: Redefining American Exceptionalism in Corporate Law*, 65 HASTINGS L.J. 441 (2014) (distinguishing US law, which is primarily enabling, from European law, which involves more mandatory terms); see also Katharina Pistor et al., *Innovation in Corporate Law*, 31 J. COMP. ECON. 676 (2003) (comparing the corporate law of ten jurisdictions and describing Delaware as an "outlier . . . on the flexible end of the spectrum").

65 In re Appraisal of Ford Holdings, 698 A.2d 973, 976 (1997) (emphasis added).

The scope of private ordering may be limited in two ways. One way is through express limitations in the statutory text. For example, 8 Del. § 102(f) prohibits fee shifting charter provisions in connection with internal corporate claims, and 8 Del. §109(b) does the same for bylaws.[66] Similarly, 8 Del. § 102(b)(7) authorizes contractual limitations on the scope of director fiduciary duties but does not permit a waiver of the duty of loyalty or the obligation to adhere to the statutory limits on the payment of dividends.[67]

The second limit is implicit. Corporation statutes prohibit charter and bylaw provisions that are "contrary to the laws of this state."[68] As then-Vice Chancellor Strine explained in *Jones Apparel*, "contrary to the laws of this State" means charter provisions that 'transgress a statutory enactment or a public policy settled by the common law or implicit in the General Corporation [Law] itself.'"[69] Courts have generally interpreted this language to mean that some provisions in the corporation code are mandatory and cannot be modified through private ordering.[70]

As Chancellor Allen explained in *Ford Holdings*:

> Under Delaware law, for example, a corporation is required to have an annual meeting for the election of directors; is required to have shareholder approval for amendments to the certificate of incorporation; must have appropriate shareholder concurrence in the authorization of a merger; and is required to have shareholder approval in order to dissolve. Generally, these mandatory

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[66] See 8 Del. § 102(f) ("The certificate of incorporation may not contain any provision that would impose liability on a stockholder for the attorneys' fees or expenses of the corporation or any other party in connection with an internal corporate claim, as defined in §115 of this title"); 8 Del. § 109(b) ("The bylaws may not contain any provision that would impose liability on a stockholder for the attorneys' fees or expenses of the corporation or any other party in connection with an internal corporate claim, as defined in §115 of this title").

[67] See Siegman v. Tri-Star Pictures, Inc., 1989 Del. Ch. LEXIS 56, *25 (denying motion to dismiss a claim alleging that such a charter provision was invalid).

[68] 8 Del. § 102(b)(1).

[69] Jones Apparel Group v. Maxwell Shoe Co., 883 A.2d 837, 843 (Del. Ch. 2004).

[70] See *id.* at 846 (explaining that the court will "invalidate a certificate provision [that vitiates or contravenes] a mandatory rule of our corporate code").

> provisions may not be varied by terms of the certificate of incorporation or otherwise.[71]

The legal basis by which courts determine which aspects of corporate law are mandatory is not entirely clear. Courts have been guided in part by the statutory text. If a statute section contains the word "shall", for example, some courts have read that language as mandatory. Thus the court in *H-M Wexford* explained that the requirements of section 228(c) concerning the validity of written consents were mandatory because "The word "shall" is a mandatory term."[72] Similarly, the court in *Speiser v. Baker* emphasized the language of § 211 which states that a corporation "shall" hold an annual meeting.[73]

Courts have also looked to the policy behind the statute, reasoning that the statute sets up certain core components of the rights and responsibilities of directors and shareholders that are not subject to firm-specific modification. One of the areas in which courts have applied this policy to limit private ordering is with respect to shareholders' rights to remove directors. Accordingly, the *Rohe* court concluded that a corporate charter could not restrict the right of shareholders to remove directors of a non-classified board without cause based in part on the fact that the removal right was a "fundamental element of shareholder authority" that could not be eliminated by the charter."[74] The court in *Frechter v. Zier*, applied a similar rationale to invalidate a bylaw providing that shareholder could only remove directors by a 2/3 vote.[75] Notably, the court in Frechter explicitly rejected the argument that, in order to qualify as a mandatory provision, a statute section must contain the words shall or must.[76] It seems likely

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[71] Matter of Appraisal of Ford Holdings, Inc. Preferred Stock, 698 A.2d 973, 976 (Del. Ch. 1997).

[72] H-M Wexford LLC v. Encorp, Inc., 832 A.2d 129, 152 (Del. Ch. 2003).

[73] Speiser v. Baker, 525 A.2d 1001 (Del. Ch. 1987).

[74] Rohe v. Reliance Training Network, Inc., 2000 Del. Ch. LEXIS 108. See also In re VAALCO Energy, Inc. Stockholder Litigation C.A. No. 11775-VCL (Del. Ch. Dec. 21, 2015) (reaching the same conclusion).

[75] Frechter v. Zier, 2017 Del. Ch. LEXIS 14, *5-6 ("Under the plain language of the statute, I find that the Removal provision is inconsistent with Section 141(k).").

[76] See id. at *7. But see Siegman v. Tri-Star Pictures, Inc., 1989 Del. Ch. LEXIS 56, *21 (rejecting challenge to charter provision providing the board with the exclusive authority to fill vacancies on the board and newly-created directorships, based on the permissive character of § 223).

that courts would take a similar view with respect to a charter or bylaw that attempted to divest shareholders of their power to amend the bylaws, although the provisions that require such a supermajority vote to do so appear to be valid.[77]

A similar rationale applies in other areas. The court in *Kurz* concluded that directors could not adopt a bylaw that would have the effect of enabling them to remove a fellow director.[78] Although the text of the Delaware statute does not explicitly define or impose fiduciary duties on corporate officers and directors, commentators have widely reasoned that public policy reasons bar charter or bylaw provisions that limit or eliminate the duty of loyalty.[79] Thus, the court in *Siegman v. Tri-Star Pictures* held that the Delaware statute barred a charter provision purporting to limit director liability under the corporate opportunity doctrine.[80] In *Jones Apparel*, the court recognized that, although Delaware law affords shareholders and managers broad power to engage in private ordering through charter provisions but nonetheless questioned

[77] Chesapeake Corp. v. Shore, 771 A.2d 293 (Del. Ch. 2000)

[78] Kurz v. Holbrook, 989 A.2d 140, 157 (Del. Ch. 2010) ("For 89 years, Delaware law has barred directors from removing other directors."),

[79] The extent to which corporate law permits the waiver of fiduciary duties has been debated extensively. See Gabriel Rauterberg & Eric Talley, *Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers*, 117 COLUM. L. REV. 1075, 1077 n.8 (2017) (citing commentators arguing that duty of loyalty is a mandatory component of corporate law). This conclusion has support in the statutory text. See section 102(b)(7). Accord Neubauer v. Goldfarb, 108 Cal. App. 4th 47, 57 (2003) (holding that "waiver of corporate directors' and majority shareholders' fiduciary duties to minority shareholders in private close corporations is against public policy"). Amir Licht has argued that transaction costs and information asymmetries counsel provide a justification for precluding fiduciary duties from being fully contractable and suggests that permitting fiduciary duty waivers would "lead to suboptimal 'market for lemons' equilibrium at the societal level." Amir N. Licht, *Motivation, Information, Negotiation: Why Fiduciary Accountability Cannot be Negotiable*, in RESEARCH HANDBOOK ON FIDUCIARY LAW 159, 179 (2018). But see Rauterberg & Talley, *supra* at 1077 (arguing that the perception that the duty of loyalty is mandatory is no longer true in light of the adoption by Delaware and other states of statutory provisions permitting corporations to waive the corporate opportunity doctrine).

[80] Siegman v. Tri-Star Pictures, Inc. No. 9477, 1989 WL 48746, at *7-8 (Del. Ch. May 30, 1989). The Delaware legislature subsequently overturned *Siegman* by statute. See 8 Del. § 122(17) (2017).

whether a charter provision that divested the board of its statutory power to approve a merger or amend the charter would be valid.[81]

Although commentators have debated the normative question of whether corporate law should provide unlimited freedom of contract, one potential answer to the debate is the existence of alternative business forms that allow greater contractual freedom.[82] Delaware, for example, provides alternative entity structures, the limited partnership and limited liability company, that are fully contractual. Both statutes explicitly state that they are intended to give the maximum possible effect to principles of freedom of contract.[83] Similarly, Delaware and other states allow statutory close corporations in which the participants are explicitly granted greater contractual freedom than in the traditional corporation.[84] Accordingly, it can be reasonably argued that business participants that desire greater contractual freedom than is available under corporate law can choose a different business form. Indeed, a number have chosen to do so, and courts have upheld provisions in LLCs and LPs that, for example, broadly eliminate managers' fiduciary duties.[85]

II. Private Ordering Through Shareholder Agreements

The mandatory features in corporate law limit the scope of private ordering that corporate participants can obtain through charter and bylaw provisions. As noted in Part I, the charter and bylaws must be consistent with the statute and, although the statute does not impose many limits on private ordering, courts continue to invalidate provisions

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[81] Jones Apparel Group, Inc. v. Maxwell Shoe Co., 883 A.2d 837, 849 n.30 (Del. Ch. 2004)

[82] But see Leo E. Strine, Jr. & J. Travis Laster, *The Siren Song of Unlimited Contractual Freedom*, in RESEARCCH HANDBOOK ON PARTNERSHIPS, LLCS, AND ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS 11 (Mark Lowenstein & Robert Hillman eds., 2014) (questioning the value of unlimited contractual freedom for non-corporate business forms).

[83] See, e.g. DLLCA §18-1101 ("It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability agreements It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability agreements").

[84] See Wells, *supra* note 29, at 286, 295 (explaining why corporate law's "statutory norms" were a poor fit for close corporations and response of a body of common and statutory law specific to the close corporation).

[85] See Molk, *supra* note 30.

that transgress tfhose limits. This Part considers an alternative tool for implementing private ordering – the shareholder agreement. As subpart IIA explains, the use of shareholder agreements in private corporations is pervasive. Despite limited judicial guidance on the permissible scope of shareholder agreements, parties appear to be using them in ways that go beyond the limits that courts have imposed on the charter and bylaws.[86] As a result, shareholder agreements appear to offer a vehicle for evading mandatory corporate law.

A. The Rise of Shareholder Agreements

Shareholder agreements have their origin in close corporations, small family businesses that are run, in many cases, as incorporated partnerships.[87] In close corporations, shareholder agreements are used to provide predictability and stability,[88] and their use dates back many years.[89] Participants in close corporations frequently use shareholder agreements to designate specific individuals to serve as directors or officers, to limit the authority of directors, and to increase shareholder control over operational decisions.[90] These uses which operated in tension with the statutory authority of the board of directors, often led early courts to view them with skepticism.[91] As a result, a number of state legislatures enacted close corporation statutes that explicitly authorized greater contractual freedom among the participants in corporations that elected to be governed their terms.[92]

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[86] See *supra* note __ and accompanying text.
[87] See *supra* note 12 (describing close corporations).
[88] See, e.g., Galler v. Galler, 32 Ill. 2d 16, 27-28 (1964) (explaining that in a close corporation, "often the only sound basis for protection is afforded by a lengthy, detailed shareholder agreement securing the rights and obligations of all concerned").
[89] See, e.g. Faulds v. Yates, 420 Ill. 416, 420 (Ill. 1870). (upholding shareholder agreement to choose the company's officers and directors).
[90] Wells, *supra* note 29 at 298.
[91] See, e.g., Manson v. Curtis, 223 N.Y. 313 (N.Y. 1918) (invalidating shareholder agreement that violated statutory requirement that corporation be managed by the board of directors); McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934) (invalidating shareholder agreement that selected corporate officers and determined their salaries as stripping the board of its power to do so),.
[92] See, e.g., 8 Del §350 ("A written agreement among the stockholders of a close corporation holding a majority of the outstanding stock entitled to vote, whether solely among themselves or with a party not a stockholder, is not invalid, as between the parties to the agreement, on the ground that it so relates to the conduct of the business

Today, however, the use of shareholder agreements is not limited to small businesses. Shareholder agreements are a critical feature of corporate governance in private corporations -- corporations that vary substantially in size, age, and ownership.[93] Private corporations include venture capital-financed start-ups, private equity-funded firms including corporations that previously traded in the public markets, and established private companies with substantial shareholder bases and varying degrees of investor liquidity.[94] The most visible of these are the Silicon Valley unicorns.[95] Shareholder agreements are also used, in some cases, in public companies.[96]

Shareholder agreements address a variety of issues and take a variety of forms.[97] They may specify the process by which directors will be elected or designate specific individuals to serve as directors, provide shareholders with preemptive rights or registration rights, designate the scope of shareholders' inspection rights and identify those shareholders who can exercise such rights.[98] They typically include detailed

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and affairs of the corporation as to restrict or interfere with the discretion or powers of the board of directors.").

[93] See, e.g., Elizabeth Pollman, *Startup Governance*, 168 U. PA. L. REV. 155 (2019) (explaining that venture capital-funded "startups are different from both public corporations and traditional closely held corporations").

[94] See Goforth, *supr*a note 31 (describing these as companies that have not yet gone public). A variety of secondary markets have developed to enable trading in the stock of private companies. See, e.g., Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 VAND. L. REV. 1 (2012) (describing legal issues presented by VC secondary markets).

[95] Unicorns are private companies with a valuation of $1 billion or more. Jennifer S. Fan, *Regulating Unicorns: Disclosure and the New Private Economy*, 57 B.C. L. REV. 583, 584 (2016).

[96] See Rauterberg, *supra* note 13 (detailing frequency of shareholder agreements that continue in effect after a company's IPO); Helena Masullo, *Shareholder Agreements in Publicly Traded Companies: A Comparison between the U.S. and Brazil*, 12 BRAZILIAN J. INT'L L. 402, 404 (2015), https://ssrn.com/abstract=2770776 (presenting study that challenges "the conventional wisdom that shareholder agreements are not used in U.S. public corporations").

[97] Common shareholder agreements in the start-up context include voting agreements, stock purchase agreements and investor rights agreements. See National Venture Capital Association, Model Legal Documents, https://nvca.org/model-legal-documents/. This article will refer to these documents collectively as shareholder agreements.

[98] See generally Corp. Law Comm. of the Ass'n of the Bar of the City of N.Y., *The Enforceability and Effectiveness of Typical Shareholders Agreement Provisions*, 65

provisions that apply in the context of a merger such as drag-along rights and appraisal waivers.[99] In some cases, they include limitations on or waivers of the right to bring litigation, including litigation alleging breaches of fiduciary duties.[100]

Private corporations are not required to file shareholder agreements with state or federal regulators.[101] As a result, it is not possible to ascertain the full range of shareholder agreements in existence or their terms.[102] Some guidance on their use is available, however. The National Venture Capital Association posts a variety of model forms of shareholder agreements.[103] The Corporation Law Committee of the Association of the Bar of the City of New York published a report in 2010 summarizing typical provisions in shareholder agreements and providing guidance as to their likely enforceability.[104] Many provisions are commonplace in such agreements despite a paucity of case law on their enforceability.[105] Gabriel Rauterberg has collected data from shareholder agreements filed in connection with the IPO process and estimates and reports, based on this data, that roughly 55% of pre-IPO companies were governed by a shareholder agreement.[106] Rauterberg also finds a significant number of shareholder agreements that continue in effect even after a company goes public.[107]

BUS. LAW. 1153 (2010) (describing common types of issues addressed by shareholder agreements and evaluating their enforceability).

[99] *Id*.

[100] Shareholder agreements may specify a forum for litigation of shareholder disputes or select arbitration in lieu of litigation. See, e.g., *id.* at 1201-02 (discussing considerations in drafting arbitration provisions); Pinto Tech. Ventures, L.P. v. Sheldon, 526 S.W.3d 428 (Tex. May 19, 2017) (upholding forum selection provision in shareholder agreement). They may also purport to waive shareholders' litigation rights. Cf. Neubauer v. Goldfarb, 108 Cal. App. 4th 47, 57 (2003) (holding that, under California law, shareholder agreement purporting to waive shareholders' right to sue for breach of fiduciary duty was void).

[101] Rauterberg, *supra* note 13 at 4

[102] See *id*. at 19 (examining shareholder agreements filed by newly-public firms in connection with their initial public offerings and inferring from this data, that "private companies, even mature ones, are routinely subject to shareholder agreements.").

[103] National Venture Capital Association*, supra* note 97.

[104] Corp. Law Comm. of the Ass'n of the Bar of the City of N.Y., *supra* note 98, at 1172-94.

[105] See, e.g. *id*. at 1182 (explaining that "case law concerning the enforceability of drag-along rights is scarce")

[106] Rauterberg, *supra* note 13, at 19.

[107] *Id.*

Shareholder agreements play an important role with respect to the governance of venture-capital funded starts-ups. Their main purpose is to provide VC investors with greater control over the corporation than that associated with their economic interest.[108] As a result, they may provide major shareholders with veto rights over corporate transactions, determine the composition of the board of directors, facilitate the coordination of minority shareholders into control groups, and provide financial rights with respect to structural changes.[109]

Shareholder agreements also govern the rights of employee-shareholders.[110] A substantial percentage of employee compensation in large privately-held companies takes the form of stock and stock options.[111] Shareholder agreements may be used in this context to compel employees to sell their shares in a merger or to give the employee the right to join a sale by the majority shareholder of its shares.[112] They can set the terms of sale when an employee leaves the company.[113] They may also affect the rights of employee-shareholders by limiting their information rights, litigation rights or their ability to seek appraisal.[114] By way of example, a shareholder of Juul, a privately-

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[108] See, e.g., Janis, *supra* note 14 ("The ultimate purpose of a shareholder agreement is to provide a VC with rights above and beyond what it would have simply by virtue of its overall percentage ownership of the company.").

[109] See also John F. Coyle, *Altering Rules, Cumulative Voting, and Venture Capital*, 2016 UTAH L. REV. 595, 606-8 (2016) (explaining how participants in California corporations can use shareholder agreements to eliminate the statutorily required cumulative voting).

[110] See *Shareholder's agreement: Employee equity*, SparkUp, June 15, 2017, https://medium.com/@SparkUp/shareholders-agreement-employee-equity-9704b94c83e3

[111] See Yifat Aran, *Making Disclosure Work for Start-up Employees*, 2019 COLUM. BUS. L. REV. 867, 880-881 ("a growing number of employees have started accepting compensation agreements in which equity grants represent a significant proportion of their pay"); Anat Alon-Beck, *Unicorn Stock Options—Golden Goose or Trojan Horse?* 107 COLUM. BUS. L. REV. 107 (2019) (describing historical practice by start-ups of compensating their employees largely with stock options). As Alon-Beck notes, these employees face delayed liquidity as start-ups remain private for extended periods of time. *Id*. at 112.

[112] *Id.*

[113] *Id.*

[114] See, e.g. Roy Shapira, *Corporate Law, Retooled: How Books and Records Revamped Judicial Oversight*, __ CARDOZO L. REV. __ (forthcoming 2020) (describing efforts by start-up companies to limit employee use of inspection rights through shareholder agreements).

held corporation, who received stock pursuant to employee stock options, filed suit against Juul's directors alleging various breaches of fiduciary duty.[115] In connection with that litigation, the shareholder sought to exercise his statutory inspection rights.[116] Juul filed a declaratory judgment action, asserting that the stockholder had waived his inspection rights pursuant to the shareholder agreement that he executed in order to receive the option grant.[117] As discussed in subpart B below, the extent to which courts will enforce such a waiver is unclear.

B. Enforcement of Shareholder Agreements

As noted above, historically, courts viewed shareholder agreements with suspicion.[118] In a number of early cases, courts held that, as a matter of common law, shareholder agreements were "unenforceable as they were against public policy."[119] Corporate law shifted from this early position, however, to accept shareholder agreements both through a change in the common law and as a result of statutory provisions expressly authorizing the use of shareholder agreements.[120]

The common law evolution toward a general acceptance of shareholder agreements reflected three principles. First, as noted above, early cases typically involved the use of shareholder agreements in close corporations. In that context, many courts recognized both that close corporations differed substantially from large public companies and that shareholder agreements were a legitimate way of meeting their

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[115] Daniel Grove v. Adam Bowen, et al., Case No. CGC-20-582059 (Super. Ct. CA), Jan. 7, 2020, https://www.bloomberglaw.com/product/blaw/document/X2DHAOPV58K9EU98UFDA50UR7DJ/download?fmt=pdf

[116] See Hailey Konnath, *Juul Says Investor Waived His Right to Inspect Its Books*, LAW360, Jan. 9, 2020.

[117] JUUL Labs, Inc. v. Daniel Grove, Docket No. 2020-0005 (Del. Ch. Jan 06, 2020),

[118] See *supra* notes __ through __ and accompanying text. See also Rainer Kulms, *A Shareholder's Freedom of Contract in Close Corporations - Shareholder Agreements in the USA and Germany*, 2 EUR. BUS. ORG. L. REV. 685 (2001).

[119] *Id.* at 686.

[120] See, e.g. Oceanic Exploration Co. v. Grynberg, 428 A.2d 1, 7 (Del. 1981) (explaining that, although historically the law had viewed contractual arrangements that interfered with stock ownership with suspicion, "The desire for flexibility in modern society has altered such restrictive thinking").

distinctive needs.[121] Second, recognition of shareholder agreements was consistent with the general principle of freedom of contract.[122] Third, courts in many cases reasoned that shareholder agreements were personal, not corporate in nature. As a result, even a shareholder agreement that was arguably inconsistent with a mandatory corporate law could be understood as simply a personal agreement not to invoke that rule.[123]

In addition, corporation statutes validated some types of shareholder agreements.[124] Both the Delaware statute and the MBCA expressly authorize voting agreements among shareholders and provide that they are specifically enforceable.[125] The statutes do not limit voting agreements to close corporations, and, although the statutes originally required that voting agreements be publicly disclosed and limited their duration to ten years, subsequent amendments removed these limits. Based on these statutes, courts have broadly upheld shareholder voting agreements[126] as long as their terms are sufficiently clear.[127]

The Delaware statute does not explicitly address other forms of shareholder agreements,[128] but MBCA § 7.32 authorizes shareholder

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[121] See, e.g., 9 BUSINESS ORGANIZATIONS WITH TAX PLANNING § 114.01 (Matthew Bender 2020) (describing "the evolving law of shareholder agreements in close corporations").

[122] See Frank H. Easterbrook & Daniel R. Fischel, THE ECONOMIC STRUCTURE OF CORPORATE LAW 237 (1991) (explaining that freedom of contract is particularly appropriate in the context of close corporations).

[123] See, e.g., Manti Holdings, LLC v. Authentix Acquisition Co., 2018 Del. Ch. LEXIS 319, *11.

[124] Close corporation statutes went further and authorized corporate participants to vary or eliminate a variety of standard corporate law requirements through shareholder agreements. See, e.g., George J. Siedel, Close Corporation Law: Michigan, Delaware and the Model Act, 11 Del. J. Corp. L. 383, 393-96 (1987) (describing such provisions in the Michigan close corporation statute).

[125] Del. Gen. Corp. L. 218(b), MBCA §7.31.

[126] See, e.g., Salamone v. Gorman, 106 A.3d 354, 383 (Del. 2014) (explaining that a "Voting Agreement acts as a contractual overlay [of Section 212(a)] pursuant to 8 Del. C. § 218(c)").

[127] See, e.g., Rohe v. Reliance Training Network, Inc., 2000 Del. Ch. LEXIS 108 ("although Delaware law provides stockholders with a great deal of flexibility to enter into voting agreements, our courts rightly hesitate to construe a contract as disabling a majority of a corporate electorate from changing the board of directors unless that reading of the contract is certain and unambiguous.")

[128] Other state statutes also recognize shareholder agreements and impose various procedural requirements. See, e.g., Booker v. Humphreys, 73 Va. Cir. 543, 551 (2007)

agreements that address a variety of issues beyond voting, including agreements that limit the discretion of the board of directors, govern corporate distributions, and establish who shall serve as directors or officers.[129] The statute imposes a variety of procedural requirements.[130] Notably, it expressly authorizes shareholder agreements that conflict with other provisions in the statute, stating that an agreement that complies with § 7.32 is valid "even though it is inconsistent with one or more other provisions of this Act."[131] Although § 7.32 is not part of a separate close corporation statute, it appears to have been contemplated to play an analogous role because it originally provided that shareholder agreements authorized by its terms would cease to be effective if the corporation went public.[132] In 2017, the ABA eliminated this restriction however, and the current form of the provision is not limited to private companies.[133]

As noted above, this Article focuses on the validity and enforceability of shareholder agreements outside the close corporation context. Close corporation statutes create a separate body of corporation law that expressly reflects the quasi-contractual nature of the close corporation. At the same time, the Article rejects the proposition that the legal treatment of shareholder agreements should depend on whether a corporation has accessed the public capital markets.[134] Because

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(refusing to enforce shareholder agreement that did not comply with the Virginia statutory requirements that it be in writing and signed by all the shareholders). Various sections of the Delaware statute implicitly reference shareholder agreements. See Bonanno v. VTB Holdings, Inc., 2016 Del. Ch. LEXIS 24, *47 (describing the statute's "distinct itemization of shareholder agreements as a class of documents that, in addition to corporate charters and bylaws, fall within the given regulatory ambit").

[129] MBCA §7.32. Delaware law contains no similar provision.

[130] MBCA §7.32 (b) & (c). Rauterberg, *supra* note 13 at 24 n.89.

[131] MBCA §7.32 (a). Some commentary suggests public policy limits in the statute would preclude a shareholder agreement under the Act that purported to eliminate director fiduciary duties. See Warren F. Griffin, Jr., *Fiduciary Duties of Officers, Directors, and Business Owners,* https://www.davismalm.com/wp-content/uploads/2019/08/Griffin_CH8_Fiduciary_Duties.pdf at 38-30.

[132] See MBCA § 7.32 (d) (2005) (providing that "[a]n agreement authorized by this section shall cease to be effective when shares of the corporation are listed on a national securities exchange or regularly traded in a market maintained by one or more members of a national or affiliated securities association.").

[133] Rauterberg, *supra* note 13 at 24 n.89.

[134] See Langevoort & Thompson, *supra* note 27 at 339 (observing that the public-private divide has been undertheorized and questioning the extent to a corporation's

corporations have the ability to opt into the contractual framework of close corporation statutes, it is reasonable to treat privately-held corporations that either do not qualify for close corporation status or have chosen not to avail themselves of those statutes to be subject to the same corporate law that applies to public companies.[135]

Few cases have considered the enforceability of shareholder agreements outside the close corporation context.[136] Two potentially conflicting principles apply. On the one hand, corporate law imposes a hierarchy of corporate authority in which the statute is supreme, the terms of the charter must comply with the statute, the terms of the bylaws are limited by the charter, and a shareholder agreement is not valid if it conflicts with any of the foregoing.[137] As a result, a shareholder agreement that conflicts with the statute should be invalid.[138]

On the other hand, shareholder agreements (unlike corporate charters and bylaws) are explicit contracts. "When parties have ordered their affairs voluntarily through a binding contract, Delaware law is strongly inclined to respect their agreement, and will only interfere upon a strong showing that dishonoring the contract is required to vindicate a

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regulatory treatment should be based on the extent to which it has accessed the public capital markets).

[135] See, e.g. Abregov v. Lawrence, 2020 Cal. App. Unpub. LEXIS 1826, *7 (holding that the rules governing the enforceability of shareholder agreements are different for statutory close corporations than for other corporations).

[136] In addition, a number of the cases deal with the rights of preferred stockholders, and those rights are considered primarily contractual. See, e.g., In re Appraisal of Ford Holdings, 698 A.2d 973, 977 (Del. Ch. March 20, 1997) ("the relation between the holder of the preferred and the corporation is contractual").

[137] As the Delaware Chancery court explained, "The by-laws must succumb to the superior authority of the charter; the charter if it conflicts with the statute must give way; and the statute, if it conflicts with the constitution, is void." Gaskill v. Gladys Belle Oil Co., 16 Del. Ch. 289, 296 (1929). See also Pierre Schroeder, et al. v. Philippe Buhannic, et al., C.A. No. 2017-0746-JTL, order (Del. Ch. Jan. 10, 2018) at 8, https://delawarecounselgroup.com/wp-content/uploads/2018/02/pierre-schroeder-et-al.-v.-Philippe-Buhannic.pdf (explaining that a shareholder agreement is invalid if it conflicts with the statute). See also Manti Holdings, LLC v. Authentix Acquisition Co., 2019 Del. Ch. LEXIS 307, *9 (Del. Ch. August 14, 2019) (describing and rejecting petitioners' argument that corporate law consists of "a hierarchy, in which the DGCL resides at the top, followed by a corporation's certificate of incorporation, then its bylaws, and then other contracts (such as the SA at issue here)").

[138] Pierre Schroeder, et al. v. Philippe Buhannic, et al., C.A. No. 2017-0746-JTL, order (Del. Ch. Jan. 10, 2018) at 8, https://delawarecounselgroup.com/wp-content/uploads/2018/02/pierre-schroeder-et-al.-v.-Philippe-Buhannic.pdf

public policy interest even stronger than freedom of contract."[139] As the Delaware Supreme Court explained, this approach is "in keeping with the goal of Delaware law to "ensure freedom of contract and promote clarity in the law [and thus] facilitate commerce."[140]

If shareholder agreements are contractual, can they be used to circumvent mandatory provisions of corporate law?[141] Outside of corporate law, courts generally accept the premise that private parties may, by contract, waive statutory, and even constitutional rights.[142] Several courts suggest that the same analysis applies to shareholder agreements,[143] at least so long as the waiver of statutory rights in a shareholder agreement is "clear and unmistakable."[144]

One example is statutory inspection rights. In several cases, courts have held that corporations cannot eliminate shareholder

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[139] ev3, Inc. v. Lesh, 114 A.3d 527, 529 n. 3 (2014), quoting Libeau v. Fox, 880 A.2d 1049, 1056-57 (Del. Ch. 2005), aff'd in pertinent part, 892 A.2d 1068 (Del. 2006)

[140] Salamone v. Gorman, 106 A.3d 354 (Del. 2014). Moreover, Delaware is not alone in broadly upholding shareholder agreements based on the policy of freedom of contract. See, e.g., George Bellas, *What's the Purpose of a Shareholders' Agreement*, https://www.bellas-wachowski.com/whats-the-purpose-of-a-shareholders-agreement.html ("Illinois has a strong history of upholding shareholders' agreements pursuant to the underlying policy regarding freedom of contract."); Galler v. Galler, 32 Ill.2d 16 (1964).

[141] See Rohe v. Reliance Training Network, Inc., 2000 Del. Ch. LEXIS 108, *58 (Del. Ch. July 21, 2000) ("stockholders can bind themselves contractually in a stockholders agreement in a manner that cannot be permissibly accomplished through a certificate of incorporation").

[142] See G. Richard Shell, *Contracts in the Modern Supreme Court*, 81 CALIF. L. REV. 431, 475-480 (1993) describing U.S. Supreme Court's analysis of private parties' power to waive various statutory and constitutional protections).

[143] See Manti Holdings, LLC v. Authentix Acquisition Co., 2019 Del. Ch. LEXIS 307, *10 n. 29 (Del. Ch. August 14, 2019) (citing cases). See also Bonanno v. VTB Holdings, Inc., 2016 Del. Ch. LEXIS 24 (allowing enforcement of provision in shareholder agreement waiving shareholders' right to litigate in Delaware courts, despite explicit statutory language prohibiting such a waiver in a corporate charter or bylaw).

[144] See, e.g., Windmill Inns of Am., Inc. v. Cauvin, 299 Ore. App. 567, 576; accord Kortum v. Webasto Sunroofs Inc., 769 A.2d 113, 125 ("There can be no waiver of a statutory right unless that waiver is clearly and affirmatively expressed in the relevant document"); Cf. Manti Holdings, LLC v. Authentix Acquisition Co., 2019 Del. Ch. LEXIS 307, *11 (finding that shareholder agreement "clearly and unambiguously waives appraisal rights;")

inspection rights through a charter or bylaw provision.[145] Nonetheless, as the Juul litigation shows,[146] corporation are seeking to do so through shareholder agreements.[147] Although the courts have not expressly upheld these provisions, dicta in several cases suggests their potential willingness to uphold such waivers as enforceable.[148] Another example is appraisal rights, which the *Manti* court held could be waived pursuant to a shareholder agreement.[149]

One argument is that shareholder agreements are different from charter or bylaw provisions in that they are personal waivers of statutory rights, that is, they do not eliminate shareholder inspection rights but merely constitute the agreement of an individual signatory to the agreement not to exercise those rights. Thus the *Manti* court reasoned that although the shareholders waived their right to appraisal rights, the

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[145] See e.g., State ex rel. Cochran v. Penn-Beaver Oil Co., 34 Del. 81, 88 (1926) (holding that a charter provision that "permits the directors to deny any examination of the company's records by a stockholder is unauthorized and ineffective,"); Rainbow Navigation, Inc. v. Pan Ocean Navigation, Inc., 535 A.2d 1357, 1359 (Del. 1987) ("The shareholders' right of inspection can only be taken away by statutory enactment"); BBC Acquisition Corp. v. Durr-Fillauer Medical, Inc., 623 A.2d 85, 90 (a shareholder's inspection rights "cannot be abridged or abrogated by an act of the corporation."
[146] Konnath, *supra* note 116.
[147] See, e.g., Shapira, *supra* note 114 ("explaining that "a burgeoning practice among growing start-ups is to sign employees on an inspection rights waiver before granting said employees stock options"); George Geis, *Information Litigation in Corporate Law,* 71 ALA. L. REV. 407, 427 (2019) ("Corporations are even starting to include conditions in employee stock grants that require workers to waive future shareholder inspection rights"); Rolfe Winkler, *Startup Employees Invoke Obscure Law to Open Up Books,* WALL ST. J., May 24, 2016, https://www.wsj.com/articles/startup-employees-invoke-obscure-law-to-open-up-books-1464082202 (quoting executive compensation attorney Richard Grimm as stating that "Some companies are now pushing employees to waive their right to inspect the books as a condition for receiving stock awards").
[148] See e.g., Kortum v. Webasto Sunroofs Inc., 769 A.2d 113, 125 (Del. Ch. 2000) (observing that the shareholders agreement "does not expressly provide for a waiver of statutory inspection rights [and] there can be no waiver of a statutory right unless that waiver is clearly and affirmatively expressed . . . ."); Schoon v. Troy Corp., 2006 Del. Ch. LEXIS 123, *7 (rejecting argument that shareholder's section 220 rights were defined by the stock purchase agreement where "[t]he agreement did not in any way, explicitly or implicitly, contractually limit the information that must be provided to Steel in the exercise of its statutorily protected inspection rights under Section 220.").
[149] Manti Holdings, LLC v. Authentix Acquisition Co., 2018 Del. Ch. LEXIS 319.

waiver did not have the effect of altering the terms of the petitioner's stock.[150]

The problem with this analysis is that these shareholder agreements address corporate governance rather than merely an individual shareholder's rights. A shareholder's agreement that limits the authority of shareholders to remove sitting directors, limits the potential accountability of the board. An agreement to waive inspection rights prevent shareholders from overseeing the corporation's financial condition and responding to potential problems. An agreement to forsake appraisal rights affects the terms of future transactions. In this sense, shareholder agreements affect not merely the rights of non-signatory shareholders but also the rights of the corporation's officers, directors and non-shareholder stakeholders.

Moreover, if all shareholders must agree to the terms of the shareholder agreement as a condition of acquiring stock, it is misleading to characterize the agreement as purely personal. If the agreement requires them to waive their statutory rights, then no shareholder is capable of exercising those rights and, as a practical matter then, the corporation has eliminated them. Thus, in *Manti*, if all shareholders waive their appraisal rights, the common stock effectively has no appraisal rights. To the extent the elimination of statutory appraisal rights is inconsistent with public policy, the prospect of obtaining this result through a contractual waiver appears problematic.

To be sure, some shareholder agreements are more limited in scope. In *Alter Bioscience*, the court considered a covenant in a shareholder agreement waiving the plaintiffs' right to sue.[151] The plaintiffs argued that enforcement of the covenants would essentially insulate the defendants from claims of breach of fiduciary duty and were therefore void as against public policy.[152] In evaluating and rejecting this claim, the court observed that, in the case before it, the agreements only bound the plaintiffs; other shareholders were able to sue and were,

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[150] *Id*. at *11 ("The SA, in other words, did not restrict the appraisal rights of the classes of stock held by the Petitioners")
[151] In re Altor Bioscience Corp., C.A. No. 2017-0466-JRS (Del. Ch. May 15, 2019) (TRANSCRIPT).
[152] Katherine Henderson, Amy Simmerman, & Brad Sorrel, *Appraisal Claim Waivers and Deal Covenants*, HARV. L. SCHOOL FORUM ON CORP. GOV., Aug. 26, 2019, https://www.wsgr.com/publications/PDFSearch/harvard-082619.pdf

in fact, asserting similar claims to those the plaintiffs sought to assert.[153] Consequently, the court concluded that enforcement of the agreements against the plaintiffs was not contrary to public policy.[154] The conclusion, however, is overly facile. To the extent that minority or disempowered shareholders waive their rights, the fact that other shareholders have the technical ability to assert these claims does not ensure accountability.

An additional challenge is that, as noted above, the case law provides limited guidance on the extent to which statutory provisions are mandatory or enabling. The *Manti* court confronted this question. As the court explained:

> I note that the DGCL does not explicitly prohibit contractual modification or waiver of appraisal rights, nor does it require a party to exercise its statutory appraisal rights. Thus, such modification or waiver serves to supplement the DGCL, and is not inconsistent with, nor contrary to, the DGCL.[155]

The court's treatment of this issue reflects the lack of certainty by the courts regarding how to distinguish between mandatory and enabling statutory provisions. Specifically, does the absence of statutory language that expressly authorizes private ordering imply that the provision in question is mandatory?

The court's analysis in *Bonanno* went further.[156] *Bonanno* concerned the enforceability of a New York forum selection provision in a shareholder agreement. Notably, 8 Del. § 115 expressly prohibits charter and bylaw provisions that adopt an exclusive non-Delaware forum for the litigation of internal corporate claims. Nonetheless, as the *Bonanno* court noted, the statute does not forbid such provisions in

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[153] Katherine Henderson, et al., *Delaware Court Addresses Private Company Deal Issues*, WILSON SONSINI ALERT, Aug. 13, 2019, https://www.wsgr.com/en/insights/delaware-court-of-chancery-addresses-significant-issues-regarding-private-company-deal-litigation.html.
[154] *Id*.
[155] *Manti* at *11.
[156] Bonanno v. VTB Holdings, Inc., 2016 Del. Ch. LEXIS 24, *47

shareholder agreements.[157] Accordingly, the court concluded that the shareholder agreement did not contravene public policy.[158]

Although *Manti* dealt with common stock, several cases have emphasized that the scope of what is mandatory may be different for preferred stock.[159] The rationale of these courts is that preferred stockholders' rights are primarily contractual rather than statutory. Thus the court in *Ford Holdings*, although observing that 8 Del. §262 is a mandatory provision of Delaware corporate law, nonetheless concluded that the rights of preferred stockholders could nonetheless be modified by contract.[160] The court expressly conditioned its holding on the fact that "preferred stock is a very special case."[161] Similarly the court in *Metromedia* explained that the "proposition of contract interpretation for preferred stock is interwoven with a stockholder's statutory right of appraisal."[162] As a result, the court concluded that a contractual provision establishing the fair value of the preferred stock was not inconsistent with either the language or the policy of section 262.[163] In *Fletcher International Ltd. v. ION Geophysical Corp*., the court applied similar reasoning to conclude that the contractual duties owed to preferred stockholders in the case supplanted any fiduciary duty claims that might result in additional remedies.[164]

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[157] The court noted that, although shareholder agreements are not referenced in the statutory text, a synopsis included with the bill stated "Section 115 is not intended, however, to prevent the application of any such provision in a stockholders agreement or other writing signed by the stockholder against whom the provision is to be enforced" Id. at *46 n.131, citing Del. S.B. 75 syn., 148th Gen. Assem. (2015). Accord Salzberg v. Sciabacucchi, 227 A.3d 102, 117 n. 65 (Del. 2020).

[158] *Bonanno*, 2016 De. Ch. Lexis, at *48,

[159] See Hintmann v. Fred Weber, Inc., 1998 Del. Ch. LEXIS 26 (Del. Ch. 1998) (questioning whether the reasoning in *Ford Holdings* could be used to limit the rights of common, as opposed to preferred, stockholders).

[160] In re Appraisal of Ford Holdings., Inc. Preferred Stock, 698 A.2d 973, 976 (Del. Ch.1997) (explaining that "Among the[] mandatory provisions of Delaware law is Section 262"); id. at 975 ("insofar as preferred stock is concerned, the provisions of Section 262 may be modified by provisions of the certificate of rights,").

[161] Id. at 977.

[162] In re Appraisal Metromedia Int'l Grp., Inc., 971 A.2d 893, 899 (Del. Ch.2009).

[163] Id. at 900

[164] Fletcher Int'l, Ltd. v. ION Geophysical Corp., 2010 Del. Ch. LEXIS 125, *26 (holding that asserted fiduciary duty claims "arise out of and are superfluous to the breach of contract claims").

III. The Problems with Shareholder Agreements

A. Shareholder Agreements and the Corporate/Contract Paradigm

As Part I explained, courts generally describe corporate law as "contractual." The contract analogy is imperfect, however. As William Bratton and Michael Wachter recognize, the law has struggled to reconcile "two great private law paradigms, corporate law and contract law."[165] Shareholder agreements sit uneasily between these two paradigms. On the one hand, they purport to function as contracts and, as such, have been subjected to legal analysis based on principles of contract law. On the other hand, the powers and rights that they address are the product of corporate law.[166]

There are fundamental differences between the two paradigms. Contract law is party-based. In general, contracts only affect the legal rights of signatories to the contract, contract law explicitly disclaims, in most cases, the ability to create rights or obligations with respect to third parties.[167] Contracts provide the primary source of rights and responsibilities between the parties thereto and, to the extent that statutory provisions and public policy considerations limit the permissible scope of contract terms, those limitations are minimal. Contracts are self-defining in terms of their scope – they determine the duration of the obligations they impose, the manner in which the contract can be modified[168] and the circumstances under which the contract may be terminated.[169]

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[165] William Bratton & Michael Wachter, *A Theory of Preferred Stock*, 161 U. PA. L. REV. 1815, 1820 (2013).

[166] See also David Ciepley, *Beyond Public and Private: Toward a Political Theory of the Corporation,* 107 AM. POL. SCI. REV. 139 (2013) (describing corporations as neither public nor private but "corporate.")

[167] See, e.g., Pinto Tech. Ventures, L.P. v. Sheldon, 526 S.W.3d 428, 445 (Tex. May 19, 2017) (concluding that non-signatories to a shareholder agreement lacked the power to enforce its terms).

[168] See, e.g., *id.* at 443 (holding that signatory to a shareholder agreement was bound by changes to that agreement pursuant to its terms).

[169] The potential for termination is a key distinction between shareholder agreements and charter and bylaw provisions. A charter or bylaw continues in effect unless and until it is amended or removed. Shareholder agreements may provide for formal termination of the contract or revocation of individual shareholders' agreement to its terms. Contractual silence on these points need not eliminate the potential for

Consent is a central component of contract law.[170] Contract law "requires that the parties have an understanding of the terms to which they have agreed."[171] A binding contract requires affirmative assent; silence or inaction is not generally sufficient.[172] The requirement of consent limits the ability of one party unilaterally to modify the contract.[173] And, where a contract purports to waive a party's statutory or constitutional rights, that waiver must be explicit.

Corporate law, by contrast, is structural. Statutes prescribe the necessary formalities to form a corporation and, once those formalities are complied with, establish the corporation as a distinct legal entity.[174] Corporate law also specifies the resulting entity's specify critical features.[175] State law identifies the key participants in a corporation – the officers, directors and shareholders – and allocates rights and responsibilities among those parties based on status, not agreement. The board of directors, for example, has primary authority to operate the corporation. Shareholders have the right to elect directors. The board and the shareholders must act jointly to undertake certain actions such as amending the charter or approving a merger. Although many features of

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revocation. Thus in *Roam-Tel Partners*, the Chancery court held that, in a short-form merger, absent prejudice to the company, a stockholder could revoke his prior waiver of appraisal rights in a shareholder agreement so long as the revocation occurred within the statutory period prescribed for perfecting those rights. Roam-Tel Partners v. AT&T Mobility, C.A. 5745-VCS (Del. Ch. December 17, 2010).

[170] See, e.g., Blake D. Morant, *Law, Literature, and Contract: An Essay in Realism*, 4 MICH. J. OF RACE & L. 10 (1998) (consent is "a mandatory requisite of any valid agreement"). Rnady E. Barnett, *The Sound of Silence: Default Rules and Contractual Consent*, 78 VA. L. REV. 821 (1992) (describing importance of consent in contract theory and identifying circumstances under which parties may be understood to consent to contractual default rules).

[171] Atalese v. U.S. Legal Servs. Grp., L.P., 219 N.J. 430, 99 A.3d 306, 313 (N.J. 2014)

[172] See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 69 cmt. a ("Acceptance by silence is exceptional.")

[173] See, e.g., Badie v. Bank of Am., 67 Cal. App. 4th 779, 790 (1998); Discover Bank v. Shea, 362 N.J. Super. 200, 204–07 (2001).

[174] See Ciepley, *supra* note 166 at 141 (explaining that a corporation relates to outside parties "as an independent contracting individual, with property and liability wholly separate from its members"); *Id.* at 144 (identifying "asset lock-in, entity-shielding, and limited liability" as features that "preserv[e] the corporation as a separate contracting individual").

[175] *Id*. at 141.

the relationship among these participants can be modified by contract, some cannot.[176]

Corporation statutes both supply default rules that govern the rights and responsibilities of corporate participants and specify the mechanism by which those default rules can be modified. Most corporation statutes, for example, explicitly provide that statutory amendments are binding upon existing corporations.[177] Statutes typically require the joint agreement of the board of directors and the shareholders to approve charter amendments and, in some cases, require the vote even of a class of shareholders that does not otherwise have voting rights to approve amendments that would adversely affect the rights of that class. Statutes typically provide default rules regarding the power to amend the bylaws and specify how a corporation can modify that default rule.[178]

Unlike contract law, corporate law explicitly addresses the rights of third parties – most importantly through the principle of limited liability, which provides entity-level treatment for corporate obligations in tort and contract. Limited liability means that corporate participants – including officers, directors and shareholders – are not personally liable for the corporation's obligations to third parties. Other aspects of corporate law also affect third party interests such as statutory provisions that limit the conditions under which a corporation may pay dividends. Commentators increasingly argue that corporate law includes responsibilities to stakeholders such as employees, customers and suppliers,[179] and a majority of states have adopted constituency statutes

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[176] See, e.g., *Boilermakers*, 73 A.2d at 955–56 (describing the shareholders' power to amend the bylaws under Delaware law as "indefeasible" and sacrosanct").

[177] See Nelson Ferebee Taylor, *Evolution of Corporate Combination Law: Policy Issues and Constitutional Questions*, 76 N.C.L. REV. 687, 724-30 (1998) (describing such provisions as standard). For example, 8 Del. § 394 reserves to the legislature the right to amend the statute and provides that such amendments shall be part of the charter of every corporation so long as they do not take away a remedy or liability that has "been previously incurred").

[178] See, e.g., Tex. Bus. Orgs. Code Ann. § 21.057(c) (West 2015) ("A corporation's board of directors may amend or repeal bylaws or adopt new bylaws unless: (1) the corporation's certificate of formation or this code wholly or partly reserves the power exclusively to the corporation's shareholders . . . .").

[179] See, e.g., Business Roundtable, *Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans'*, Aug. 19, 2019, available at https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans (stating

that explicitly authorize directors to consider stakeholder interests in making corporate decisions.[180]

Finally, corporate law operates under the principle of implied consent rather than explicit consent. Shareholders invest in a corporation with the constructive knowledge of the rules of the game – the binding effect of the statute, charter and bylaws.[181] They invest with the knowledge that those rules can be changed and, by investing, consent to changes that conform to the corporate law mechanisms for changing these rules, including the adoption of new statutes, and amendments to the charter and bylaws.[182] This consent is necessarily implicit, but it is nonetheless binding. A shareholder cannot be heard to complain about the board's adoption of a bylaw pursuant to a charter that gives the board the power to amend the bylaws, even if the shareholder lacked knowledge of the relevant charter provision. The role of implied consent highlights "the tension between corporate law principles - which generally impute to members of the corporation knowledge and acceptance of corporate bylaws - and the law of contracts, which requires consent to be bound."[183]

It is efficient for corporate law to incorporate implied consent because it means both that shareholders implicitly consent to the authority delegated to the board of directors to make operational decisions and that shareholder decisions can be made by majority vote. Minority interests neither have the power to block a decision with which they disagree nor the right to exit the corporation as a result of that disagreement. These features allow passive investors to finance

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that corporations should be run for the benefit of all stakeholders – customers, employees, suppliers, communities and shareholders.).

[180] Christopher Geczy, et al. *Institutional Investing When Shareholders are not Supreme*, 5 HARV. BUS. L. REV. 73, 95 (2015) (reporting that, as of publication date, 33 states had constituency statutes).

[181] See, e.g., Boilermakers Local 154 Retirement Fund v. Chevron Corp., 73 A.3d 934, 939-40 (Del. Ch. 2013) (reasoning that shareholders invested with constructive notice that state law and a company's "certificates of incorporation gave the boards the power to adopt and amend bylaws unilaterally" and that such bylaws "are binding on the stockholders.")

[182] See Verity Winship, *Shareholder Litigation by Contract*, 96 B.U.L. REV. 485, 497-498 (2016) ("Unlike in other contracting contexts, the rationale is not that shareholders have consented to the terms, but rather that they have consented to the corporate governance structure that gave rise to them.").

[183] Kirleis v. Dickie, McCamey & Chilcote, P.C., 560 F.3d 156, 162-163 (3d Cir. 2009).

corporations in a manner that would not be possible through formal multi-lateral contracts.

B. The Significance of Corporate Law in Analyzing Shareholder Agreements

Although, as indicated above, some courts have relied primarily on contract law in analyzing the validity of shareholder agreements, this analysis is incomplete to the extent it does not also incorporate corporate law principles. Shareholder agreements are increasingly used as tools of private ordering, to create, waive and modify the rights and responsibilities of corporate participants – rights and responsibilities such as the responsibility of the board of directors to run the corporation or the right of shareholders to exercise inspection or appraisal rights, that are the product of corporate law.

Although they are used as a tool of private ordering, shareholder agreements lack the structural protections of charter and bylaw provisions. They are not a part of the corporation's formal governing documents. The legal principles that apply in case of conflict between the shareholder agreement and those documents are unclear. They are not created or modified according to corporate law procedures, and the doctrine of implied consent does not apply. Perhaps most problematically, shareholder agreements govern the signatories' rights in an individualized manner. Not all shareholders may be signatories to the same shareholder agreements and, even among signatories, not all may be bound. Similarly, corporate participants who are not parties to a shareholder agreement may not be able to enforce it.[184] As a result, unlike a charter or bylaw provision, a shareholder agreement may cause shareholders with the same economic interest to have different rights.[185]

These features go a long way to explaining why the use of shareholder agreements is more common in private companies than in publicly-traded firms. Small private companies often fail to operate according to the formalities of corporate law, and the relationships

[184] See, e.g., Pinto Tech. Ventures, L.P. v. Sheldon, 526 S.W.3d 428, 443-44 (Tex. Sup. 2017) (refusing to allow enforcement of forum selection provision in shareholders' agreement by non-signatories).

[185] See, e.g., Henry v. Phixios Holdings, Inc., 2017 WL 2928034 (Del. Ch. July 10, 2017) (finding that shareholder was not bound by a shareholder agreement when he acquired stock without knowledge of transfer restrictions contained in that agreement).

among the parties are often highly personal.[186] Many corporate participants fill multiple roles in the close corporation, which is also typified by substantial shareholder participation in management.[187] The contract paradigm thus dominates as a practical, if not a legal matter. It is unsurprising that close corporation statutes, which are designed specifically for this type of business, explicitly authorize broad use of shareholder agreements.[188]

Many private corporations operate very differently from the prototypical close corporation, however. They have centralized management, hundreds of shareholders many of whom are passive investors, and shares that are frequently traded, albeit not in the public markets.[189] There are currently close to 600 so-called "unicorns," private corporations with a valuation of $1 billion or more.[190] Modifications to the federal securities laws have made it easier for these companies to grow and access capital from a wide range of sources without becoming public companies.[191] As commentators have observed, private companies are not subject to mandatory disclosure requirements limiting the ability of both shareholders and regulators to exercise oversight.[192] There are reasons to believe that large private companies systematically

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[186] See Manuel A. Utset, *A Theory of Self-Control Problems and Incomplete Contracting: The Case of Shareholder Contracts*, 2003 UTAH L. REV. 1329 1405-6 (2003) (describing the "deformalization" of the close corporation and arguing that corporate formalities can serve as important self-regulation mechanisms).

[187] Carol Goforth, *Proxy Reform as a Means of Increasing Shareholder Participation in Corporate Governance: Too Little, but not Too Late*, 43 AM. U.L. REV. 379, 435 n. 349 (1994) ("In most close corporations, the shareholders play a significant role in management.").

[188] Many privately-held corporations, however, do not qualify to use close corporation statutes and, of those that qualify, a substantial percentage do not elect close corporation status. See *supra* note 30.

[189] See, e.g., Langevoort & Thompson, *supra* note 27 at 349-50 (describing the growth of platforms that facilitate the trading of private company stock).

[190] As of July 11, 2020, Crunchbase listed 601 companies in the Crunchbase Unicorn List. See *The Crunchbase Unicorn List,* https://www.crunchbase.com/lists/the-crunchbase-unicorn-list/1e409c7c-010c-4997-a41e-e2d273437da4/identifiers. (last visited July 11, 2020).

[191] See De Fontenay, *supra* note 24 (describing regulatory factors leading to the growth of large private companies).

[192] See Rauterberg, *supra* note 13 at 4 (terming private companies "the dark matter of the corporate universe.").

have poor governance practices relative to their publicly-traded peers, a problem Renee Jones terms the "Unicorn Governance Trap."[193]

The use of shareholder agreements in this context raises particular concerns.[194] One is the lack of transparency associated with private ordering via shareholder agreements.[195] Private companies are not subject to SEC-mandated disclosure, providing a degree of insulation from public oversight.[196] Whether the extent of that insulation is efficient or not, statutory inspection rights partially fill the gap by affording shareholders some level of access to corporate information. This information can provide a variety of benefits including reducing agency costs and exposing business practices that are socially harmful or even illegal.[197]

Shareholder agreements, however, are commonly used to limit shareholder inspection rights, further reducing the accountability of managers and controlling stockholders. Similarly, shareholder agreements are themselves opaque. Corporate charters, even in private firms, are publicly available,[198] and it is generally understood that shareholders have a near-absolute right to inspect the current bylaws of the corporation without relying on any statutory inspection rights.[199] By

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[193] Jones, *supra* note 33. See also

[194] See *id.* at 170 (explaining that unicorns are "insulated both from the investor control that typifies private company governance and the public scrutiny and oversight that accompanies an IPO").

[195] Corporate charter and bylaw provisions "are available for the public to inspect while the shareholder agreement is typically private, shared only by the parties involved." LegalNature.com, https://www.legalnature.com/guides/articles-of-incorporation-and-shareholder-agreements-whats-the-difference.

[196] See Langevoort & Thompson, *supra* note at 361 (arguing that existing limitations on required disclosure are arbitrary and further observing that disclosure is a public good that provides benefits to parties other than shareholders).

[197] See *id.* at 367 (identifying potential benefits to increased disclosure).

[198] See Fan, supra note 95 at 611 (observing that "Although anyone can obtain a corporation's certificate of incorporation from the Secretary of State of Delaware, there is a fee, and the certificate of incorporation does not include significant information about the company.").

[199] See, e.g., 13 P.L.E. CORPORATIONS § 110 (2019)("explaining that "The statute does not refer expressly to the bylaws because the shareholders have an absolute right to be supplied with a copy of the currently effective text of the bylaws without going through this statutory procedure regarding inspection"); 14 NY JUR. BUSINESS RELATIONSHIPS § 386 (2) ("While the right of a stockholder to examine the bylaws of the company is not absolute but rests in the discretion of the court, a strong case will be required to deny an inspection since the bylaws constitute a part of the contract between the stockholder

contrast, shareholder agreements have the legal status of contracts and, as such, they do not need to be disclosed to non-signatories or filed with the state.[200]

The absence of disclosure limits the ability of shareholders to ascertain both the economic and the governance rights of their fellow shareholders. Because provisions in shareholder agreements may afford some shareholders different economic rights from others, a shareholder cannot readily determine the value of his stock or options without access to their terms. As Gornall and Strebulaev demonstrate empirically, contractual rights that are "virtually invisible to employees under the current disclosure regime, have a dramatic influence on the value of the common stock "[201] Nonetheless, existing law does not require the disclosure of such rights if they are based on shareholder agreements.[202]

Shareholder agreements further undermine both the transparency of corporate ownership and the operation of shareholders' governance rights.[203] A key component of corporate governance is collective shareholder action. Shareholders can, through the voting process, elect and remove directors, amend the bylaws and approve structural changes such as mergers. The corporate charter and bylaws establish mechanisms for shareholder voting such as the process for calling a shareholder meeting, the quorum requirement for such a meeting to be valid, and the voting threshold necessary to effect certain corporate decisions. Corporation statutes also afford shareholders the right to inspect a shareholder list, so that they can ascertain who has control of

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and the corporation, and the stockholder should be permitted to know the extent and terms of the stockholder's and the corporation's obligation to each other"). But see Rauterberg, *supra* note 13 at 4 (observing that private companies "are not required to publicly disclose any instrument of governance beyond filing their charter with the Secretary of State").

200 A public corporation may be required to disclose a material shareholder agreement to which it is a party under the federal securities laws. See Rauterberg, *supra* note 13 (describing disclosure requirement).

201 Aran, *supra* note 111 at 911-12, citing William Gornall & Ilya A. Strebulaev, *Squaring Venture Capital Valuations with Reality*, 135 J. FIN. ECON. 120 (2020).

202 Aran, *supra* note 111.

203 Even in public companies, the reallocation of control rights is fraught and frequently generates litigation. See Zohar Goshen & Assaf Hamdani, *Corporate Control, Dual Class and the Limits of Judicial Review*, 120 COLUM. L. REV. 941, 942-45 (2020) (describing efforts by Google, Facebook, IAC and CBS to reallocate control rights and subsequent litigation).

the corporation, solicit the support of their fellow shareholders and price the risks associated with changes in stock ownership.[204]

A shareholder agreement may, for example, create a control block by obligating certain shareholders to vote together.[205] A shareholder agreement may provide some shareholders with the power to select or remove corporate officers, undermining the powers of the board of directors, Indeed, the terms of a shareholder agreement may have the effect of enabling participants in a corporation to evade the otherwise-applicable thresholds for corporate decisions. For example, a corporation statute may require a merger to be approved by a majority of the outstanding shares.[206] A shareholder agreement may, through the application of drag-along rights, require some shareholders to approve a merger at the behest of their fellow shareholders, allowing, in some circumstances, shareholders with a minority of the voting power to effectuate a transaction.[207]

The absence of formal disclosure requirements coupled with the fact that shareholder agreements, unlike charters and bylaws, only bind signatories, also makes it possible for a corporation to distinguish among shareholders and to provide different shareholders, even those holding the same class of stock, with different rights and powers. Substantial shareholders and those with significant bargaining power may be able to contract for rights that are not shared by other shareholders. These rights can include typical shareholder rights such as inspection rights, the opportunity to observe board meetings or participate in operational decisions, or rights with respect to the sale or liquidity of their shares. By contrast, small shareholders may be forced to give up significant rights in order to invest. Some of these shareholders may lack the sophistication to understand the implications of the contracts that they are forced to sign. Employees who receive stock or options as a

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204 Randall S. Thomas, *Improving Shareholder Monitoring of Corporate Management by Expanding Statutory Access to Information*, 38 ARIZ. L. REV. 331, 340 (1996) (Describing shareholders' statutory inspection rights and explaining that "shareholders' qualified rights to obtain a stocklist and inspect corporate books and records are accepted in every state.").

205 See Rauterberg, *supra* note 13.

206 See, e.g., 8 Del. §251.

207 See, e.g., Shannon Wells Stevenson, Note: *The Venture Capital Solution to the Problem of Close Corporation Shareholder Fiduciary Duties*, 51 DUKE L.J. 1139, 1161 (2001) (explaining how a minority shareholder can use drag-along rights to effect a sale of the company over the objection of other shareholders).

substantial component of their compensation are likely to be particularly vulnerable.

These differential rights differ markedly from the standard corporate law principle that the rights of shareholders are not personal but run with the shares, and that the rights associated with a share of stock do not based on the ownership of that share. Corporate law is predicated on the proposition of equal treatment of shareholders,[208] it and requires not merely that differential treatment be based on a different financial instrument, but that the terms of that instrument be formalized in the corporate charter.

Moreover, because the enforceability of shareholder agreements depends on contract principles, signatories to a shareholder agreement may differ in the extent to which they are bound, depending on their individual circumstances. Shareholders are not all similarly-situated and, even in a private corporation, there are substantial differences between the knowledge and sophistication of a venture capital fund, a sovereign wealth fund, and a former employee – yet all may be shareholders. When a shareholder's consent involves the waiver of statutory rights, contract law enforcement requires that the consent be knowing, voluntary and uncoerced, a requirement that courts may view differently depending on individual shareholder circumstances. For example, a shareholder agreement between a VC fund and the entrepreneur that purports to waive certain shareholder rights might be enforced while the same provision in an employment agreement or option agreement over which a prospective shareholder has limited bargaining power may not. At oral argument of a motion to dismiss in *Mathieson v. Digital Ocean*,[209] VC Parsons expressed some concern about the validity of such a contractual waiver of shareholder rights in an employee stock option agreement. Describing the agreement as potentially a contract of adhesion, VC Parsons questioned whether the employees' assent to the terms of that agreement constituted a knowing and voluntary waiver of his statutory rights.[210]

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[208] See, e.g., Victor Brudney, *Equal Treatment of Shareholders in Corporate Distributions and Reorganizations*, 71 CALIF. L. REV. 1072, 1074 (1083) (terming the proposition of equal treatment of shareholders as "part of the received learning about publicly held corporations")

[209] Civil Action No. 11185-VCP (Aug. 27, 2015).

[210] See *id*., transcript at 29 ("I don't know where on that spectrum it is, and it seems conceivable to me that it might make a difference in the enforceability of this waiver.").

Private ordering through shareholder agreements also creates complexity. As noted above, there is limited case law on the validity of specific provisions in shareholder agreements.[211] Because they are not public, they do not provide similar network effects as charter and bylaw provisions which enable firms to see and copy innovative efforts at private ordering by their peer firms. Decisions such as *Boilermakers* and *ATP* provide clear guidance to market participants on the validity of innovative charter and bylaw provisions and enable new governance practices to diffuse broadly.[212]

In contrast, cases analyzing shareholder agreements demonstrate that their provisions vary substantially, creating interpretive uncertainty. In addition, the cases repeatedly caution that their analysis is context-specific, meaning that other corporate participants cannot readily rely on those decisions as to the validity of their own contracts. In addition to the complexity associated with their validity, shareholder agreements make it necessary to create, interpret and integrate multiple documents to ascertain the scope of various corporate participants' rights and authority. As the National Venture Capital Association website demonstrates, it is common practice for a single corporation to use a number of different shareholder agreements, each of which addresses different elements of the shareholders' relationship with his or her fellow shareholders and the corporation.[213] Separate agreements may address voting issues, rights associated with share ownership include preemptive rights, redemption rights and registration rights, and rights and responsibilities in connection with a merger. To add to the complexity, not every shareholder is a signatory to every shareholder agreement.

The use of shareholder agreements also creates the potential for opportunism. Shareholders who relinquish their rights pursuant to a

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[211] See, e.g. *id.*, transcript at 27 (observing, in trying to assess the validity of a provision in a shareholder agreement waiving inspection rights "what's holding me up on that issue to some regard, No. 1 is we don't have any case that quite deals with it squarely. We've had some that have recognized the principle, but then for some reason or another have held that it wasn't clear and affirmative or they have not found a waiver.").

[212] See, e.g. Smith, et al., *supra* note 6 at 188 (explaining how private ordering through shareholder-adopted bylaws can "create laboratories of corporate governance that benefit the entire corporate governance system"). Roberta Romano & Sarath Sanga, *The Private Ordering Solution to Multiforum Shareholder Litigation*, 14 J. EMPIR. LEGAL STUD. 31, 32-33 (2017) (documenting diffusion of forum selection bylaws).

[213] National Venture Capital Association, *supra* note 97.

shareholder agreement need not be told the extent to which other shareholders are receiving similar treatment.[214] The corporation or the majority shareholder can negotiate contracts providing an opportunity to buy out minority shareholders on different and less-favorable terms. More problematically, VC funds and controlling stockholders may view legal uncertainty as a basis for overreaching, choosing to include aggressive provisions in shareholder agreements despite the absence of any legal authority, in the hope or expectation that the inclusion of these terms will deter counterparties from asserting their rights.[215] The potential for unequal bargaining power coupled with the general obstacles to shareholder rights litigation in private companies compounds this problem.[216] These factors may explain the widespread use of shareholder agreements despite their uncertain legal status.[217]

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[214] See, e.g., James D. Cox, *Corporate Law and the Limits of Private Ordering*, 93 WASH. U. L. REV. 257, 269 (2015) (observing that the board, officers and controlling stockholders "can act opportunistically to pursue self-interested ends, the effects of which only they can be fully aware").

[215] See *id.* (noting that such players "enjoy important, and likely unerodable, strategic advantages" in a system of private ordering). Aggressive efforts to limit shareholder rights through shareholder agreements may be similar to the aggressive use of contractual waivers in other instances of unequal bargaining power such as employer/employee and business/consumer. See, e.g., Heather Bromfield, *Comment: The Denial of Relief: The Enforcement of Class Action Waivers in Arbitration Agreements*, 43 U.C. DAVIS L. REV. 315, 333 (2009) ("Lack of contractual mutuality runs rampant in situations of unequal bargaining power, such as consumer contracts and employee agreements").

[216] Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 1001 (2006) (describing the potential reputational costs of litigating against VCs, including future limits on the ability to obtain funding from VCs or work at a VC-funded firm); cf. Jeffrey M. Leavitt, *Burned Angels: The Coming Wave of Minority Shareholder Oppression Claims in Venture Capital Start-up Companies*, 6 N.C. J.L. & TECH. 223, 228 (2005) (predicting future wave of litigation by "burned" angel investors but observing that filed cases were limited and none survived pre-trial settlement).

[217] Commentators generally argue that corporate participants prefer corporate participants typically prefer predictable legal rules upon which they can rely in planning business transactions. See, e.g., Stephen J. Massey, *Chancellor Allen's Jurisprudence and the Theory of Corporate Law*, 17 DEL. J. CORP. L. 683, 688 (1992) (describing "the necessity that corporate law provide a sufficient level of stability and predictability to allow corporate planners to have a high level of confidence as to the law that courts will apply to their transactions."); Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle,* 1 J.L. Econ. & Org. 225, 227 (1985) (explaining that efficient corporate law reduces the transaction costs of organizing and operating a business).

Analyzing shareholder agreements from a purely contractual perspective, as courts have done, fails to account for any of these concerns that, from a corporate law perspective, are highly problematic. At the same time, the cases fail to identify a rationale for letting corporate participants create a tool for private ordering that is independent of the statutory framework. The existing statutory framework provides explicit procedures governing the scope, adoption and amendment of the charter and bylaws that structure their use for private ordering; the justification for bypassing them in favor of private contract is unclear.

Because public corporations cannot readily use shareholder agreements for private ordering,[218] allowing them to be used in private companies also creates an illogical disparity, a disparity that is exacerbated if courts conclude that shareholder agreements can be used in ways that charter and bylaw provisions cannot. Although there may be a justification for allowing the type of close corporations that operate as incorporated partnerships to depart from the structure and formalities of general corporate law, the difference between public and private companies is no longer binary. As noted above, there are an increasing number of privately-held corporations whose size, economic impact and ownership structure resemble those of public companies and might have gone public but for various regulatory and capital market developments. Avoiding the disclosure requirements associated with the public capital markets has contributed to poor quality corporate governance at some of these companies, and to the extent that shareholder agreements reduce accountability and transparency, they have the potential to exacerbate those shortcomings.[219]

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[218] Despite Gabriel Rauterberg's recent scholarship demonstrating significant use of shareholder agreements in public companies, Rauterberg, *supra* note 13, this use is far more limited than in the private company context, largely because of the fact that public trading, by its nature, makes it impossible for all shareholders to be signatories to a shareholder agreement and therefore bound by its terms.

[219] See Jones, *supra* note 28 at 167-68 ("in the absence of an impending IPO, Unicorn managers and investors lack sufficient incentives to develop governance structures and practices appropriate for enterprises of their scale."); David F. Larcker & Brian Tayan *Governance problems in private companies – Uber Governance Gone Wild: Epic Misbehavior at Uber Technologies*, STANFORD CLOSER LOOK SERIES, Dec. 11, 2017, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3087371(describing governance failures at Uber prior to its IPO).

Finally, shareholder agreements undermine the uniformity and predictability associated with the corporate form. There is a public value having corporate law apply to all corporations – public and private. The need for managerial accountability, the mechanisms for addressing shareholder collective action problems, concerns about conflicts of interest, and the challenges of ensuring that shareholders enter and exit the business on fair terms, are not categorically different depending on whether a corporation's securities are traded in the public capital markets. The value of a single body of corporate law is increased by the freedom that business entities possess to choose a more contract-based alternative legal structure such as a statutory close corporation or LLC. To the extent that an entity has chosen corporate law, its choice should reflect a willingness to be bound by the rules of the corporate form, including its mandatory features.

These arguments apply specifically to private ordering efforts. By situating private ordering within the charter and bylaws, all corporations benefit from innovations.[220] The visibility of firm-specific provisions enables participants in other corporations, scholars and regulators to evaluate their validity and efficiency, creates network externalities, and fosters standardization. Commentators can analyze the policy implications of a bylaw that purports to limit the scope of managerial fiduciary duties. The capital markets can price the impact of a forum selection bylaw. These benefits lower the transaction costs and increase the likely efficiency of firm-specific private ordering.

IV. The Implications of this Analysis

A. Limiting Private Ordering Through Shareholder Agreements

This Article has argued that, to the extent courts have afforded corporate participates greater latitude to engage in private ordering through shareholder agreements than in the charter and bylaws, that latitude is inappropriate. The implications of this article's analysis of shareholder agreements goes further, however. The relative

[220] As noted above, corporate charter and bylaw provisions "are available for the public to inspect while the shareholder agreement is typically private, shared only by the parties involved." LegalNature.com, https://www.legalnature.com/guides/articles-of-incorporation-and-shareholder-agreements-whats-the-difference

disadvantages of shareholder agreements from a corporate law perspective suggest that they should be affirmatively disfavored relative to the charter and bylaws, the traditional tools of firm-specific private ordering. In other words, even a shareholder agreement which implements a provision that would clearly be permissible if contained in a charter or bylaw is problematic in that it is opaque, may not apply to all shareholders equally, depends for its enforceability on shareholder-specific attributes such as knowledge and sophistication, and cannot be modified through traditional corporate law mechanisms such as the vote of a majority of directors or shareholders.

This Article therefore argues that courts should limit the enforcement of shareholder agreements. Rather than allowing private contracts to substitute for the corporation's formal organizational documents, courts should require that corporations engage in private ordering exclusively through the charter and bylaws. This approach would reinforce the corporation's status as an independent legal entity that operates not by means of multi-lateral contracts but according to a set of legal principles that include both substantive rules and the procedures by which those rules are tailored or modified. Shareholder agreements should be presumptively invalid to the extent they address rights or powers that could alternatively be addressed in a charter provision or bylaw and should be permissible only when they are limited to matters that involve shareholders acting in an individual investor capacity.

The distinction between private ordering and contracts that deal with shareholders in their individual capacity can be ascertained with reference to the types of issues that are typically addressed through charter and bylaw provisions. These issues include the scope of director and officer fiduciary duties, inspection rights, appraisal rights, forum selection provisions and the procedures governing shareholder voting. Shareholder agreements could continue to be used to deal with issues such as the payment for or financing of stock transactions as well as proxies and other individual contractual allocations of voting rights.[221]

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[221] Although the contractual allocation of voting rights presents some of the concerns identified in this Article, corporate law has a long tradition of allowing shareholders freedom to assign their voting rights by contract, a tradition that stems, in part, from the recognition that, in exercising their voting rights, shareholders act in a quintessentially individual capacity. Indeed, the Delaware courts have expressly "recognized a shareholder's right to act selfishly in exercising its voting power [and that shareholders]

This Article does not propose to apply this legal standard to shareholder agreements that are used in statutory close corporations. As the legislative provisions concerning such entities reflect, close corporations operate quite differently from other corporations. The premise behind close corporation statutes is both to recognize that difference and to make explicit the fact that such corporations, by virtue of electing statutory close corporation status, are to be governed by a different set of legal rules than those applicable to other corporations.

B. Facilitating Innovation Through Private Ordering

To the extent that, under current law, shareholder agreements afford corporate participants greater latitude to engage in private ordering than charter and bylaw provisions, the approach advocated by this Article restricts private ordering. This result may be criticized as limiting valuable corporate innovation. Shareholder agreements enable early-stage companies the flexibility to adjust corporate law rules to meet their needs and do so through a mechanism that is confidential and easily created and modified. More significantly, forcing private ordering into the charter and bylaws prevents corporate participants from contracting around mandatory provisions of corporate law.

The debate over the extent to which corporate law should incorporate mandatory features as opposed to being subject to complete freedom of contract is beyond the scope of this Article. Assuming, however, that some constraints on private ordering are desirable as a matter of efficiency or public policy, the question is whether shareholder agreements should be able to avoid those constraints. This Article argues that they should not. If mandatory corporate law rules are desirable, either as a matter of public policy or to protect the rights of minority shareholders or other stakeholders, those same considerations should mitigate against the enforcement of shareholder agreements that are inconsistent with those rules. By the same token, to the extent that shareholder agreements are valuable tools for innovative private ordering, the flexibility they provide should not be limited to private companies that have the option of using shareholder agreements rather than the charter or bylaws.

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are under no obligation to vote their shares in the best interests of the corporation." Jill E. Fisch, *Standing Voting Instructions: Empowering the Excluded Retail Investor,* 102 MINN. L. REV. 11, 47-48 (2017).

The solution is to formalize the mechanism by which corporations engage in private ordering. Because corporation statutes are broadly enabling, corporations have extensive power to adopt firm-specific charter and bylaw provisions within the express contours of the existing statutory framework. The power to do so is found both in specific statutory provisions such as those that prescribe the tools for adopting a classified board, and the general grant of authority to adopt firm-specific charter and bylaw provisions.

Functionally, under this statutory framework, private ordering innovation operates as a tripartite process. In the first instance, corporate participants identify a potentially beneficial issue that can potentially be addressed through firm-specific private ordering. To the extent they believe that the innovation is permitted under existing law, they can implement it through a charter or bylaw. To the extent that they believe existing law does not currently permit the provision, they can seek legislation. If the validity of an innovative charter or bylaw is subsequently challenged, courts can evaluate the degree to which the provision is in tension with the statute and public policy. Judicial approval of the provision is likely to lead to broader adoption, but even then, the provision will be subject to the discipline of market forces, and some innovative provisions will not be successful. Finally, state legislatures can evaluate the courts' analysis and ratify or overturn the courts' conclusions by statute.

Importantly, as this process reveals, and experience further demonstrates, private ordering innovation need not await legislative action. Corporations can and do adopt novel charter and bylaw provisions, and courts evaluate the validity of these provisions in the absence of clear statutory guidance. More to the point, innovation in private ordering is facilitated if both public and private corporations use the same governance mechanisms because the transparency of public company charters and bylaws reduces information costs, facilitates standardization and provides a vibrant mechanism for evaluating the costs and benefits of innovation through the discipline of both shareholder oversight and capital market discipline.[222]

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[222] See, e.g., Matthew D. Cain, Jill E. Fisch, Sean J. Griffith & Steven Davidoff Solomon, *How Corporate Governance is Made: The Case of the Golden Leash*, 164 U. PENN. L. REV. 649, 695 (2016) (detailing the power of both Institutional Shareholder Services and the Wachtell Lipton law firm in influencing firm behavior with respect to the adoption of an innovative corporate governance bylaw).

Formal legislative action operates as a safety valve with respect to this process. State legislatures can evaluate the policy rationale for taking a mandatory versus enabling approach. From a comparative institutional perspective, they are particularly well-suited to engage in this analysis.[223] Legislatures can readily access the information necessary to determine the potential costs and benefits of innovation.[224] Unlike courts, legislatures control their agendas and need not wait for litigation to evaluate the validity of a provision. Finally, legislatures can assess the interests of those likely to be affected by an opt-out or waiver, interests that may not be represented in the litigation context. As a result, they can identify the private ordering approach most protective of those interests. For example, the legislature might determine that corporations should be allowed to limit director liability for breaches of the duty of care through private ordering, but that the risk that directors will act out of self-interest if permitted to adopt such limitations unilaterally means that they should be limited to charter provisions that require shareholder approval.

The history of private ordering innovation in corporate law is replete with illustrations of this process at work. Corporations adopted innovative charter and bylaw forum selection provisions in response to the explosion in multi-forum litigation challenging mergers. The validity of these provisions was uncertain until the Delaware court's *Boilermakers* decision, after which their adoption increased dramatically.[225] The Delaware legislature subsequently endorsed forum selection provisions and provided clarification as to their permissible scope.[226]

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[223] See generally Neil K. Komesar, IMPERFECT ALTERNATIVES: CHOOSING INSTITUTIONS IN LAW, ECONOMICS, AND PUBLIC POLICY (1994). (developing analysis of comparative institutional advantage).

[224] Roberta Romano explains, for example, the variety of legislative responses in the late 1980s, to the crisis in the market for D&O insurance as "an excellent case study of the successful operation of federalism as a laboratory for legal reform." Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 YALE J. ON REG. 209, 221 (2006). See also Edward P. Welch & Robert S. Saunders, *Freedom and its Limits in the Delaware Corporation Law*, 33 DEL. J. CORP. L. 845, 854 (2008) (describing Delaware legislature's adoption of §102(b)(7) in response to the D&O insurance crisis).

[225] See Romano & Sanga, *supra* note 212 (documenting the spread of forum selection provisions after the Boilermakers decision).

[226] See Fisch, *supra* note 1, at 1669-71 (describing legislation authorizing forum selection charter and bylaw provisions).

The corporate opportunity doctrine is a component of the common law duty of loyalty.[227] Courts adopted various tests to determine when the doctrine had been breached, and the variety and complexity of the tests led the doctrine to become "unpredictable and over complicated."[228] To reduce possible corporate opportunity doctrine litigation, Tri-Star Pictures amended its charter to limit the liability of its directors for potential breaches. The court in *Siegman v. Tri-Star Pictures* held that, because the charter provision could limit liability for a breach of the duty of loyalty, it was potentially invalid.[229] The Delaware legislature responded by adopting 8 Del. §122(17), which authorizes corporations to adopt corporate opportunity doctrine waivers in their charters. The legislation responded to a broad-based market demand and, subsequent to its enactment, corporations broadly adopted such waivers.[230] Many states followed Delaware's lead and adopted similar legislation.[231] Moreover, at least one empirical study has found market reactions to the adoption of such waivers to be favorable.[232]

Finally, as institutional investors became more active in corporate governance, they sought ways to overcome collective action problems and increase shareholder access to the corporate proxy machinery. One of the tools for doing so was proxy reimbursement bylaws – bylaws that entitled shareholders to reimbursement of their expenses in conducting a

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[227] Eric Talley & Mira Hashmall, *The Corporate Opportunity Doctrine*, USC Gould Sch. L. (Feb. 2001), https://weblaw.usc.edu/why/academics/cle/icc/assets/docs/articles/iccfinal.pdf.

[228] Martha M. Effinger, *Comment: A New Corporate Statute: Adding Explicit Procedures to Maryland's Corporate Opportunity Waiver Provision*, 48 U. BALT. L. REV. 293, 300 (2019).

[229] Siegman v. Tri-Star Pictures, Inc., 1989 Del. Ch. LEXIS 56, *26 ("Thus, at least one scenario (and perhaps others) could plausibly be constructed where Article Sixth would eliminate or limit the liability of Tri-Star directors for breach of their fiduciary duty of loyalty - - a result proscribed by § 102(b)(7)").

[230] See Talley & Rauterberg, *supra* note 79 at 1079 (stating that "hundreds of public corporations in our sample – and well over one thousand in the population – have disclosed or executed waivers").

[231] See Effinger, *supra* note 228 at 305 ("many states have followed by adopting corporate opportunity waivers"). Notably, not every state's approach is identical to Delaware's. For example, Georgia allows corporate opportunity doctrine waivers in both the charter and the bylaws. See Georgia § 14-2-870.

[232] Talley & Rauterberg, *supra* note 79 at 1081 (reporting results of an event study finding that "market reactions [to the adoption of a waiver] appear to be favorable, resulting in an average positive abnormal stock return hovering around one percent in the days immediately surrounding the announcement date").

proxy contest if the context was successful. In *CA v. AFSCME*, the Delaware Supreme Court struck down a proxy reimbursement bylaw on the basis that it interfered with the board's statutory authority to determine how corporate money should be spent.[233] The legislature overturned the decision, adopting a statutory provision that explicitly authorized proxy reimbursement bylaws.[234]

These examples suggest that requiring corporations to use their charters and bylaws to implement private ordering will not stifle innovation. To the contrary, the use of formal governance tools facilitates the transparency of governance innovation, leads to clarification of the law and permits the spread of provisions that have the potential to enhance corporate value or facilitate their operations. Channeling innovation through charter and bylaw provisions, provisions that can be adopted by public companies and whose validity can be clarified through litigation and legislation has led to their widespread use. At the same time, waivers and innovations that have been implemented through shareholder agreements – such as appraisal waivers and limits on shareholder inspection rights – have not been standardized and remain of uncertain validity.

Conclusion

This Article has explored the role of shareholder agreements as substitutes for the corporate charter and bylaws in adopting firm-specific private ordering. It has situated shareholder agreements on the boundary between the contract law and corporate law paradigms and argued that their use highlights the limitations of viewing the two paradigms as analogous. Structuring corporations by contract differs from the quasi-contractual tailoring available through the corporate charter and bylaws, and the use of shareholder agreements to do so sacrifices important components of corporate law and structure.

These issues are of concern as the number and size of private companies continue to grow. Because private companies are not subject to federally-mandated disclosure requirements or capital market discipline, they are particularly vulnerable to poor corporate governance

[233] CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 239–40 (Del. 2008).

[234] 8 De. 8, § 113. See Jill E. Fisch, *Leave it to Delaware: Why Congress Should Stay Out of Corporate Governance*, 37 DEL. J. CORP. L. 731, 763 (2013) (describing legislation authorizing both proxy reimbursement and proxy access bylaws).

practices that reduce the accountability of officers, directors and controlling shareholders and potentially sacrifice the interests of minority shareholders and other stakeholders. The opacity and uncertainty associated with shareholder agreements and the risk that they will be used as tools to depart from the standardization associated with the corporate form increase this potential.

This analysis indicates that courts may be overly willing to rely on principles of freedom of contract to uphold and enforce shareholder agreements. That approach is misguided. Instead, this Article argues that shareholder agreements should be disfavored as tools of private ordering, and courts should limit their enforcement to circumstances in which the agreement deals exclusively with a shareholder's individual interests. Although the Article applauds corporate participants' continued efforts to use private ordering to innovate, such innovation should rely on the corporate law instruments – the charter and bylaws – rather than private contract.