Corporate charters and bylaws serve many important functions with practical applications to corporate governance and M&A transactions. Among other things, (1) they establish procedural guidelines for corporate governance (stockholder meetings, board meetings, etc.); (2) in public companies, they can establish antitakeover protections; and (3) they define the relative rights and preferences of different classes of equity holders.

There are two overarching principles for drafting charters and bylaws.

First, charters and bylaws should be clear and precise to avoid later interpretive challenges. The ideal charter and bylaws would never need to be litigated because they would give all interested stakeholders a clear and indisputable road map at all times.

Second, charters and bylaws should be drafted to be consistent with all applicable state laws. Courts sometimes view charters and bylaws as contracts among the corporation and its shareholders. However, shareholders cannot go beyond certain basic statutory requirements in the charter and bylaws. Failing to be attentive to the applicable statutes while drafting charters and bylaws can result in carefully crafted and negotiated provisions being unenforceable. For example, under Delaware law, if a corporation has a staggered (or “classified”) board of directors, directors cannot be removed without cause. Accordingly, a charter provision permitting removal without cause of directors of a Delaware corporation that has a staggered board would likely be unenforceable. This is the case even in a small, privately held corporation where all of the shareholders have otherwise approved the concept of removal without cause. Even state corporation statutes that are generally similar to Delaware may have important exceptions and deserve a close read. Among other reasons, state legislatures in other states usually do not amend their corporation statutes as frequently as Delaware.

Beyond these two overarching principles for drafting charters and bylaws, there are a number of specific issues to bear in mind. This article summarizes ten of these issues. For more on charters and bylaws, see Chapter 6, “The Certificate of Incorporation,” Delaware Corporation Law and Practice and Chapter 9, “Bylaws,” Delaware Corporation Law and Practice.
This article is part of the “Speed Reading” series in which the authors highlight practical tips and recurring issues in M&A transactions. [Top 10 Due Diligence Issues in M&A Deals, 2010 Emerging Issues 5124; Top 10 Issues to Consider When Adopting a Rights Plan, 2010 Emerging Issues 5027; and Ten Issues to Spot in a Public Company Merger Agreement, 2010 Emerging Issues 4883.]

**1. Director and Officer Indemnification and Limitation on Liability.** It is usually desirable for charters and bylaws to include the most expansive D&O indemnity and liability-limiting provisions permitted under applicable state law. Directors and officers typically expect that they will have these protections and may be reluctant to serve in their absence, even for wholly owned and/or privately held subsidiaries. A well-crafted provision may go so far as to address directors’ and officers’ rights to advancement of expenses, as well as the extent of coverage of former directors and officers and/or non-management-level employees.

In the past few years, there has been some debate regarding the extent to which a corporation can amend its bylaws to eliminate indemnification rights of former directors. This issue arises starkly in hostile takeovers, where the target’s directors want to ensure that they will continue to be covered by the target’s pre-acquisition D&O indemnity provisions even if the buyer amends the charter or bylaws after it completes the acquisition. A number of corporations attempted to “cure” this risk for their directors by entering into separate indemnification agreements directly with the directors. These indemnification agreements cannot be unilaterally amended by the corporation. Now, however, it may not be necessary to use indemnification agreements for Delaware corporations. Delaware recently amended its corporation laws to clarify that a director’s right to receive indemnification or advancement pursuant to a company’s charter or bylaws generally may not be impaired or eliminated after the occurrence of the act or the omission that is the subject of the indemnification or advancement (unless the charter or bylaws expressly authorized such “ex post facto” amendments). For more on indemnification and insurance, see Chapter 16, “Indemnification,” Delaware Corporation Law and Practice, Chapter 20, “Indemnification,” Liability of Corporate Officers and Directors and Chapter 23, “Insurance: Director and Officer Liability,” Liability of Corporate Officers and Directors.

**2. Notice and Meeting Mechanics.** Setting aside the potential antitakeover impact of notice requirements and meeting mechanics (which we discuss below under number 4 below), these mechanics also serve an important non-takeover-related function: They
help to ensure that corporate governance, even at the largest, most diversified public companies, is conducted in an equitable and predictable fashion.

Notice and meeting mechanics must be drafted to work in practice. Any notice periods should be clearly stated and presented so that the corporation’s shareholders and, in the case of public companies, the market more generally are able to predict when important corporate governance deadlines will pass. Ambiguity in these provisions will not necessarily be resolved in favor of the corporation and can give rise to costly and lengthy litigation. When drafting these provisions for a public company, it may be advisable to consult with a proxy solicitor and/or the company secretary to ensure that the draft comports with how the corporation’s shareholder meetings are actually conducted, down to the details concerning how ballots are distributed and collected and who has authority to speak at shareholder meetings. For more on annual meetings and voting rights, see Chapter 3, “Stockholders’ Rights,” Corporate Governance: Law and Practice.

3. Voting Thresholds. Small nuances in drafting in a charter can make a big difference in the outcome of a shareholder vote. One such nuance is the provision that addresses what stockholder vote is required to approve a corporate action. Specifically, some charters provide that particular actions can be approved by “stockholders holding a majority of the shares outstanding”, whereas others provide that the actions can be approved by “stockholders holding a majority of the shares voted”. The latter standard would allow a corporate action to be approved by less than a majority of the outstanding shares. The distinction is important given the potential for low attendance (in person or by proxy) at a shareholder meeting, especially now that the NYSE has eliminated broker non-votes for several types of shareholder actions. Some state statutes dictate what minimum shareholder vote is required, but in most states supermajority voting requirements in the charter and bylaws can trump lower state law minimums.

A draftsperson also needs to consider whether a proposed voting threshold is workable in practice. For public companies, unanimity requirements realistically cannot be satisfied, and very high supermajority voting standards will make the outcome of a shareholder vote susceptible to control by a single shareholder (such as a hedge fund) that accumulates a large stake to gain hold-up value. In a private company, in contrast, unanimity or high supermajority standards may be desirable to ensure that all shareholders are given a voice in corporate governance matters.

4.Public Company Charters and Bylaws: Antitakeover Considerations. In the last decade, shareholder activists and proxy advisors like RiskMetrics have campaigned
successfully to get corporations to eliminate anti-takeover protections in their charters and bylaws. These changes have made it less likely that a company can withstand a hostile attack indefinitely. Even after these changes, however, charters and bylaws can still contain a number of procedural requirements that can buy a target’s board both (1) time to analyze and respond to a hostile offer and (2) leverage to negotiate a better deal for the target’s shareholders.

Takeover defenses are most potent when contained in a corporation’s charter (rather than the bylaws). This is because shareholders cannot unilaterally amend the charter under most states’ corporation laws: Board approval is also required. To eviscerate a protection contained in the charter, a hostile bidder not only needs to obtain the requisite shareholder vote, but also needs to persuade the legacy directors or conduct a proxy contest to remove and replace the legacy directors with its own designees. In contrast, shareholders can amend the bylaws unilaterally, without board approval, by bringing the bylaw amendment as a shareholder proposal at the company’s next annual meeting and obtaining the requisite shareholder vote in favor of the proposal.

There is ample room for creativity in designing takeover defenses in organizational documents, including the staggered board and supermajority voting provisions mentioned above. Some additional “old favorites” include:

- **Advance Notice Requirements.** Usually contained in the bylaws, advance notice provisions require shareholders to inform the corporation well in advance of a shareholder meeting whether the shareholders want to bring any proposals at the meeting and/or nominate directors for election at the meeting. These provisions give the corporation time to react to the proposal and the threat of a proxy contest, and to negotiate with the proponent to reach a compromise that will avoid a proxy fight. Under the SEC’s new proxy access rules, shareholders seeking to have their director nominees included in the company’s proxy will have to notify the company well in advance of the next annual meeting also, which in effect creates a de facto advance notice standard for such nominations. The new proxy access rules supersede existing advance notice provisions in a corporation’s bylaws with respect to nominations effected pursuant to Rule 14a-11 of the Exchange Act.

- **Shareholders’ Ability to Call a Special Meeting.** For takeover protection purposes, it is better that only the board (and not shareholders) have the
ability to call a special meeting of shareholders unilaterally. This forces hostile acquirers to either negotiate their offer with the board or wait until the next regularly scheduled annual meeting to try to change the bylaws, take over the board or take other actions that could promote their offer. In practice, however, many corporations recently have begun to adopt bylaws that allow shareholders holding a minimum amount of shares (e.g., 10% of the outstanding common shares) to call (or “requisition”) a special meeting.

- **Shareholders’ Ability to Act by Written Consent.** When shareholders can act by written consent, a small group of shareholders can surprise a company by taking corporate actions and delivering notice of the *fait accompli* to the company. This can be a very powerful tool for a hostile bidder because it allows large shareholders to take actions without calling a shareholder meeting and complying with the related procedural requirements. For U.S. public companies, it may even allow a shareholder to avoid having to comply with Exchange Act disclosure requirements if the shareholder does not solicit consents from other shareholders.

- **Cumulative Voting.** When a large shareholder has the right to cumulate its votes for directors, it is more likely that the shareholder will be successful in designating at least one director to the board. This can be a powerful tool where a shareholder is conducting a proxy contest to nominate a “short slate” of directors, rather than seeking to replace the entire board.

- **Opting Out Of State Takeover Laws.** Delaware’s business combination statutes restrict certain acquisitions by interested shareholders without prior board approval. However, corporations can opt out of the statute in their charters. A company’s failure to opt out of the protections of the statute will make it more difficult for a hostile acquirer to seize control of the company via a tender or exchange offer unless it also controls the board at the time it completes the transaction.

5. Amendment Provisions. Charters and bylaws are not intended to be static documents. Therefore, they should include provisions governing the procedures and approvals required for amendments. In most states, amendments to the charter require the approval of the board and the shareholders, whereas amendments to the bylaws can be approved by either the board or the shareholders. Many companies opt to include supermajority requirements for amendments to certain provisions, especially antitakeover
clauses. In private companies, a supermajority of the directors could also be a requirement (but this would be very unusual for a public company). In designing such a requirement, keep in mind how the supermajority requirement interacts with the quorum requirement for board meetings (i.e., could a shareholder’s designees hold up the approval of an amendment for which their vote is not required merely by boycotting a board meeting?). If the amendment clause requires a supermajority vote to amend other provisions of the charter or bylaws, make sure that the amendment clause itself cannot be amended by less than the requisite vote.

6. Stock Exchange Listing Requirements and Dodd-Frank. In addition to ensuring that charters and bylaws comply with state corporation laws, a draftsperson must ensure they comply with applicable stock exchange listing requirements and Federal laws (such as the recently enacted Dodd-Frank Act) that impose corporate governance requirements on corporations.

The NYSE listed company rules, for example, require that a listed company’s board have a majority of independent directors. Accordingly, the bylaws of the listed company should be drafted to provide for a sufficiently large board of directors that this requirement will be capable of being satisfied even if one or two large shareholders elect a non-independent director on the board. In addition, listed companies are required to have a nominating and corporate governance committee. The bylaws should contemplate both the existence of the committee as well as touch on the committee’s role in the process of nominating directors. A further example is that the NYSE listed company rules prohibit staggered boards that are divided into more than three classes, and requires that the classes be of approximately equal size and tenure and that directors’ terms of office should not exceed three years.

The Dodd-Frank Act gave the SEC express permission to adopt the new proxy access rules (see Section 4, above). It also imposes additional constraints on the composition of compensation committees that could be reflected in a public company’s bylaws. In the past year, legislators have proposed numerous other corporate governance reforms at both the state and federal level that, if adopted, could have an impact on how charters and bylaws are drafted in the future.

7. Board Designees/Board Observers. The organizational documents for private companies, especially those with private equity sponsors, often provide for certain shareholders to have allotted director positions or to have the right to appoint board ob-
servers. When drafting charters and bylaws that include such rights, be mindful of three considerations:

1. What fiduciary duties, if any, will one shareholder’s designees on the board have to the other shareholders? In other words, can a shareholder’s designees on the board vote in a manner that favors the designating shareholder at the expense of other shareholders? The extent to which a shareholder’s designees can disclaim their fiduciary duties to the corporation as a whole or other shareholders will depend on state law.

2. Can a shareholder’s board designees or board observers share information they receive in that capacity (e.g., board information packets) with the shareholder, its representatives or investors? Again, this may be an issue of state law because it can impinge on the directors’ duty of confidentiality to the corporation and its other shareholders.

3. What happens if a shareholder’s designee is removed or resigns from the board, or is otherwise unable to serve? In most cases, the organizational documents should provide that the designating shareholder would have the sole right to replace its director. Sometimes this right is memorialized in a separate shareholders’ agreement in which the other shareholders agree to vote in favor of each others’ designees (instead of in a charter or bylaws).

8. Certificates of Designation for Preferred Stock. Preferred stock is largely a creature of contract. As such, it is critical that the contract that defines the rights and preferences of preferred stock (known as a “certificate of designations” in Delaware and many other states) be drafted with precision.

Among other things, a certificate of designations should clearly address when the preferred stock has voting rights. We have on many occasions in connection with mergers and acquisitions encountered certificates of designations that contain some ambiguity concerning the rights of the holders of the preferred stock to veto the proposed transaction. Such ambiguity can arise when, for example, it is not clear that the preferred stock can be mandatorily converted into a like series of preferred stock of the acquiring or surviving company without the approval of the holders. In a stock-for-stock transaction, the acquirer must then determine whether to roll over the preferred stock anyway, try to buy it out prior to closing the transaction, or try to get approval of the holders of the preferred stock prior to closing the transaction. The latter two alterna-
tives can be costly (they give the preferred stock “hold up value”) and may delay the closing of the transaction.

Another example of an issue that arises frequently with preferred stock is the following: Certificates of designation for convertible preferred stock often contain complex anti-dilution adjustments. Sometimes the anti-dilution adjustments are so complex that it becomes unclear how they apply in transactions with unique structures. For example, a question may arise as to whether certain types of extraordinary dividends that may be paid in connection with a change of control transaction would trigger anti-dilution adjustments in addition to conversion or other rights for the preferred stock.

9. Authorized Stock. How much authorized stock a corporation has may seem like a very basic question, but it can have important implications. For a public company, if its charter provides for enough “headroom” (i.e., authorized stock above and beyond what is currently issued and outstanding), the corporation may be able to issue a substantial amount of stock as consideration in an M&A transaction without obtaining a shareholder vote (subject to the stock exchanges’ shareholder approval requirements for issuances of 20% or more of a corporation’s outstanding common stock). For example, if the corporation agrees to be acquired pursuant to a two-step acquisition (a tender offer followed by a merger), it may be in the corporation’s best interests to grant a “top-up” option to the buyer to ensure that the buyer will acquire 90% of the outstanding shares in the tender offer and will be able to complete the second step as a short form merger. The size of the “top-up” option will depend on how many authorized but unissued shares are available under the target’s charter. Such “headroom” can also come in handy for a corporation that is considering implementing a common-stock-based poison pill. Authorizing blank-check preferred stock can help to solve the latter concern for corporations in states that permit preferred-stock-based poison pills. The amount of stock issuable upon the exercise of employee stock options may also be a factor in determining how much stock should be authorized from the outset. In contrast to public companies, many private companies prefer to limit strictly the amount of authorized and unissued common stock. Such limits can provide shareholders with additional protection (above and beyond preemptive rights) from dilutive issuances. Whether public or private, every corporation needs to balance the dual concerns of (1) the need for flexibility in future capital-raising transactions and (2) the need to protect existing shareholders from a wayward board that may approve stock issuances that would not have been approved by shareholders if they were given an opportunity to vote.
10. **Dual-Class Structures.** It used to be quite common for family-owned corporations to go public with a dual-class capital structure. In other words, the controlling family might retain a class of super-voting common stock that was not publicly traded, while the general public would receive a class of lower-voting common stock that was listed on an exchange. This structure ensured that the founding family could continue to control the corporation while simultaneously allowing the corporation to access the capital markets.

Although less common today and occasionally a target of criticism by corporate governance advisors, such dual-class structures do continue to make sense for public companies in certain contexts. A good financial advisor should be able to help the corporation analyze the valuation discount, if any, that would be applied to the lower-voting class of stock by the market. The discount, if any, may be ameliorated through the inclusion in the charter of provisions such as a requirement that both classes share equally in the proceeds of any liquidation event or change of control transaction, a requirement that the board be comprised of a majority of independent directors, and/or a requirement that the super-voting shares convert into the lower-voting shares if and when transferred out of the founding shareholders' control.

Meanwhile, dual- and multi-class structures continue to be extremely common in private companies in which shareholders are able to negotiate different rights and preferences in connection with their investments. Among other things, for corporations in regulated industries like banking, dual-class structures may help shareholders to maintain economic rights that are proportional to the size of their capital investment while simultaneously navigating complex regulatory restrictions on voting and management rights.

In connection with implementing a dual-class structure, a draftsperson should consider the following issues, among others:

- relative voting rights, and the extent to which each class will vote as a separate class (i.e., have a veto in practice) on fundamental matters;
- relative dividend and liquidation rights;
- the extent to which either class can or must convert into shares of the other class upon the occurrence of certain events or the election of the holder;
- anti-dilution adjustments;
preemptive rights;

- rights to designate/elect directors separately;

- information rights and rights to attend and participate in meetings; and

- special protections for the lower-voting shares, such as the exit-price protection described above.

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It can be tempting to think of charters and bylaws as “off the shelf” documents that require little or no customization for the average company. In fact, however, the manner in which they are drafted can have a profound influence on the future of a corporation. The challenge is to imbue them with flexibility so that they can adapt organically to the needs of a corporation as it grows over time, takes on new shareholders and perhaps even goes public. It is not possible to anticipate every possible situation that will confront a corporation or its directors in the future, so the governing principles established in the charter and bylaws should be generic enough to apply to a wide range of circumstances, and should allow for amendments and other changes as needed to adapt to new situations.

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