

# THE ENFORCIBILITY OF FIXED-TERM EMPLOYMENT CONTRACTS THAT CONFLICT WITH CORPORATE BYLAWS

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## INTRODUCTION

Corporate bylaws commonly confer upon the board of directors the power to remove corporate officers from their positions without cause.<sup>1</sup> It is also fairly common, however, for corporations to hire officers under fixed-term employment contracts that make no reference to such bylaw provisions. The situation therefore can arise where a board of directors that is dissatisfied with the performance of an officer seeks to terminate his employment under a bylaw provision allowing for discharge at will, and the officer attempts to invoke the fixed-term employment provision of his contract to resist dismissal. How is such a dispute to be resolved?

First of all, most American jurisdictions have statutes in effect that reserve for directors the ultimate authority to dismiss corporate employees at will.<sup>2</sup> Therefore, as a general matter, a corporate employee can be dismissed regardless of the terms of his contract. However, these same statutes also generally preserve the right of an employee to recover damages if his dismissal is done in violation of his contractual rights.<sup>3</sup> An important question is thus squarely presented: Where a corporate employee has a provision in his contract calling for a specific term of employment, and this provision conflicts with a bylaw provision not referenced in the contract which gives the board of directors the power to terminate employees at will, does the

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1. Set forth below is a typical bylaw provision to this effect, drawn in this instance from the bylaws of Snelling & Snelling, Inc., a Delaware corporation:

*Removal.* Any officer or agent of the Corporation may be removed, with or without cause, by the Board of Directors whenever in the judgment of the Board the best interests of the Corporation will be served thereby.

2. See, e.g., 15 PA. CONS. STAT. § 1733 (2000):

Any officer or agent of a business corporation may be removed by the board of directors with or without cause. The removal shall be without prejudice to the contract rights, if any, of the person so removed. Election or appointment of an officer or agent shall not of itself create contract rights.

3. See, e.g., *id.* See also REV. MODEL BUS. CORP. ACT § 8.44(b) (1984), which states in part:

“An officer’s removal does not affect the officer’s contract rights, if any, with the corporation.”

employee have a right to damages if he is dismissed?

This question has been litigated fairly extensively for over 100 years across a number of jurisdictions,<sup>4</sup> and the cases are all over the map with regard to their results and the rationales followed to reach those results. The academic commentary unfortunately provides little assistance for understanding and resolving the tensions within this jurisprudence. I am not aware of any serious scholarly attempts to analyze the problem. All that is available are relatively superficial treatise discussions that do little more than describe the different positions that have been taken in the cases, and do not attempt to articulate a coherent theoretical framework for reconciling these differences.

In my opinion, in the event of such a conflict between express contractual terms and corporate bylaws the courts should favor the employee and allow the award of damages for wrongful termination under a wide range of circumstances, including some situations in which few if any courts have heretofore ruled in favor of the employee. As I will discuss below, this conclusion is supported both by basic agency law principles and by its favorable implications for promoting efficient resource allocation.

#### THE COMMENTARY AND CASES

Let me begin by demonstrating the ambivalence shown by the most widely consulted treatises concerning how to characterize the numerous and conflicting court decisions on this issue. First of all, the well-regarded corporation law treatise *Fletcher Cyclopedia of the Law of Private Corporations*<sup>5</sup> in its main text takes the position that the case law authority supports the directors' right to invoke the applicable bylaw to terminate a corporate officer from a fixed-term employment contract without liability: "An officer is chargeable with knowledge of its charter and of its bylaws adopted before his or her appointment, and the tenure of office is subject to their provisions."<sup>6</sup>

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4. See, e.g., the following cases (listed in chronological order, most recent cases first): *Nelson v. WEB Water Development Ass'n, Inc.*, 507 N.W.2d 691 (S.D. 1993); *Short v. Columbus Rubber and Gasket Co., Inc.*, 535 So.2d 61 (Miss.1988); *Hernandez v. Banco de las Americas*, 571 P.2d 1033 (Ariz. Ct. App. 1976); *Jennings v. Ruidoso Racing Ass'n*, 441 P.2d 42 (N.M. 1968); *Magnus v. Magnus Organ Corp.*, 177 A.2d 55 (N.J. Super. Ct. Ch. Div. 1962); *Dixie Glass Co. v. Pollak*, 341 S.W.2d. 530 (Tex. App. 1960); *Pioneer Specialties, Inc. v. Nelson*, 339 S.W.2d. 199 (Tex. 1960); *United Producers & Consumers Co-op v. Held*, 225 F.2d. 615 (9th Cir. 1955); *Cohen v. Camden Refrigerating & Terminals Co.*, 30 A.2d. 428 (N.J. 1943); *Dennis v. Thermoid Co.*, 25 A.2d. 886 (N.J. 1942); *Hill v. American Co-op. Ass'n*, 197 So. 241 (La.1940); *In re Paramount Publix Corp.*, 90 F.2d 441 (2d Cir. 1937); *Abberger v. Kulp*, 281 N.Y.S. 373 (N.Y. Sup. Ct. 1935); *Realty Acceptance Corp. v. Montgomery* 51 F.2d. 636 (3d Cir. 1930); *Walker v. Maas & Waldstein Co.*, 140 A. 286 (N.J. 1927); *Walker v. Maas*, 132 A. 322 (N.J. 1926); *Ginter v. Heco Envelope Co.*, 147 N.E. 42 (Ill. 1925); *Millar v. Grieb & Thomas, Inc.*, 120 A. 390 (Pa. 1923); *Cuppy v. Stollwerck Bros.*, 111 N.E. 249 (N.Y. 1916); *Reiss v. Usona Shirt Co.*, 159 N.Y.S. 1031 (N.Y. App. Div. 1916); *Selley v. American Lubricator Co.*, 93 N.W. 590 (Iowa 1903); *Darrah v. Wheeling Ice & Storage Co.*, 40 S.E. 373 (W. Va. 1901); *Jones v. Vance Shoe Co.*, 92 Ill. App. 158 (Ill. App. Ct. 1899); *Fowler v. Great S. Tel. & Tel. Co.*, 29 So. 271 (La. 1901); *Douglass v. Merchants' Ins. Co.*, 23 N.E. 806 (N.Y. 1890); *Martino v. Commerce Ins. Co.*, 15 Jones & S 520 (N.Y. 1881); *Hunter v. Sun Mut. Ins. Co.*, 26 La. Ann. 13 (La. 1874); *Queen v. Second Ave.*, 44 How. Pr. 281 (N.Y. Sup. Ct. 1872).

5. 1 WILLIAM MEADE FLETCHER ET AL., *FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § XXX (perm. ed. rev. vol. 1998).

6. FLETCHER, *supra* note 5, § 334 at 137.

However, the head note presented by the *Fletcher Cyclopedia* summarizing the first case cited purportedly in support of this proposition articulates exactly the opposite position: “Notwithstanding contrary provisions in bylaws or articles of incorporation fixing term of office of employees and officers of company, contract of employment entered into by board will be upheld, though in contravention thereof . . . .”<sup>7</sup>

The *American Jurisprudence (2d)*<sup>8</sup> treatise more openly acknowledges the split of judicial authority on this question, and takes a more nuanced position in its depiction of the major tensions within the case law:

According to some cases, persons who enter the employment of a corporation with either actual knowledge of the existence of a bylaw authorizing the removal of an officer, agent, or employee at any time, or with constructive notice of the bylaw by reason of being a stockholder in, or officer of, the corporation, or otherwise, are bound by it and must be presumed to have accepted employment subject to, it even though the employment purports to be for a specified period. In several cases, however, the mere fact that the bylaws of a corporation authorized the removal of officers, agents, or employees at any time, has not rendered invalid or unenforceable a contract of employment made by it for a specified period. A contract of employment for a specified period may operate as an amendment or rescission of a bylaw authorizing the removal of an officer or employee at any time, where such contract was made by a board of directors having power to amend or rescind the bylaws of the corporation. The contract of employment will not, however, override the bylaw, unless it fairly appears to have been intended to do so. A contract of employment for a specified period will not prevail over a bylaw authorizing removal at pleasure where the board of directors making the contract has no power to amend or rescind the bylaw (footnotes omitted).<sup>9</sup>

Finally, a 1943 *American Law Reports Annotated* Note that dealt specifically with this question also took the position articulated by the *Fletcher Cyclopedia* that the general rule is that such bylaws are incorporated by reference into the employment contracts, and that corporate employees are therefore subject to termination without liability at the discretion of the board of directors.<sup>10</sup> However, that Note also recognized in a sub-section titled “Contrary cases; special circumstances” that: “In several cases, however, the mere fact that the bylaws of a corporation authorized the removal of officers, agents, or employees at any time has been held not to render invalid or unenforceable a contract of employment made by it for a specified period.”<sup>11</sup>

The *ALR* Note in another section titled “Exceptions to, and limitations upon, general rule” also stated that:

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7. *Id.* at n.16 (citing *Realty Acceptance Corp. v. Montgomery*, 51 F.2d 636 (3d Cir. 1930)).

8. *American Jurisprudence, Second Edition* (1985).

9. 18B AM. JUR. 2D *Corporations* § 1432 (1985).

10. M.A.L., Annotation, *Bylaw of Corporation Authorizing Removal of Officer, Agent, or Employee at Anytime, as Affecting Contract of Employment for a Specified Period*, 145 A.L.R. 312 (1943) (“Generally, corporate bylaws are binding upon all the members of the corporation, as they are presumed to know them and to contract as members in reference to them”).

11. *Id.* at 315-16.

A contract for employment for a specified period has been held to operate as an amendment or rescission of a bylaw authorizing the removal of an officer or employee at any time, where such contract was made by a board of directors having power to amend or rescind the bylaws of the corporation.<sup>12</sup>

As I have noted above, and as the treatises recognize, there has developed a fairly extensive, but inconsistent case law concerning this issue.<sup>13</sup> One line of cases extending back into the 19th century emphasizes the principle articulated by all of the treatises quoted above that a person who contracts with a corporation is presumed to be aware of the corporation's bylaws, and that corporate employment contracts are therefore best regarded as implicitly incorporating by reference any limitations imposed by these bylaws upon the contractual rights expressly conferred.<sup>14</sup>

A second and somewhat more recent line of cases, however, emphasizes instead the principle recognized by the *AmJur 2d* and *ALR* annotation discussions quoted above that the corporation's board is presumed to be aware of the corporation's bylaws, and therefore any contracts the board authorizes that contain provisions that conflict with its bylaw authority are best regarded as implicitly repealing those conflicting bylaws, at least for the purpose of the contract at issue.<sup>15</sup> By far the best-known of these cases is *Realty Acceptance Corp. v. Montgomery*,<sup>16</sup> a Third Circuit opinion applying Delaware law that has been cited by a number of subsequent opinions that reached similar results.<sup>17</sup>

In *Realty Acceptance* the corporation's board sought to discharge its President from his five-year employment contract pursuant to a bylaw provision permitting removal of officers without cause. The Third Circuit court there ruled in favor of the officer's claim for damages, stating:

To read into a contract of employment for a definite period, expressly authorized by the board of directors, a by-law amendable by the majority of the board [allowing discharge without cause], and thus nullify the contract, would sacrifice substance and straightforwardness for form and procedure . . . . I am of the opinion and find that the contract made by the defendant pursuant to the express authority of its board of directors, which had express power to amend at will the by-laws of the defendant, modified, in its legal effect, all inconsistent by-laws and prevails over them.<sup>18</sup>

A sub-theme also developed by some opinions that lie within this second line of

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12. *Id.* at 316-17.

13. See Fletcher Cyclopedia, *supra* note 5.

14. See, e.g., *Jones*, 92 Ill. App. 158; *Selley*, 93 N.W. 590; *Hunter*, 26 La.13; *New Jersey ex rel. Walker*, 132 A. 322; *Walker*, 140 A. 286; *Cohen*, 30 A.2d 428; *Douglass*, 23 N.E. 806; *Queen*, 44 How. Pr. 281; *Abberger*, 281 N.Y.S. 373; *Darrah*, 40 S.E. 373.

15. See, e.g., *Nelson*, 507 N.W.2d 691; *Short*, 535 So. 2d 61; *Bossier v. Connell*, No. CIV. A. 8624, 1986 Del. Ch. LEXIS 511 (Del. Ch. Nov. 12, 1986); *Hernandez*, 571 P.2d 1033; *Jennings*, 441 P.2d 42; *Magnus*, 177 A.2d 55; *Dixie Glass Co.*, 341 S.W.2d 530; *United Producers & Consumers Co-op*, 225 F.2d 615; *Dennis*, 25 A.2d 886; *Hill*, 197 So. 241; *In Re Paramount Publix Corp.*, 90 F.2d 441; *Realty Acceptance Corp.*, 51 F.2d 636; *Cuppy*, 111 N.E. 249.

16. 51 F.2d. 636 (3d Cir. 1930).

17. See, e.g., *Nelson*, 507 N.W.2d 691; *Short*, 535 So.2d 61; *Bossier*, 1986 Del. Ch. LEXIS 511; *Hernandez*, 571 P.2d 1033; *Hill*, 197 So. 241; *Jennings*, 441 P.2d 42; *Keating v. K-C-K Corp.*, 383 S.W.2d 69 (Tex. Civ. App. 1964); *Magnus*, 177 A.2d 55.

18. 51 F.2d at 639.

cases is the limitation of the “implicit bylaw repeal” principle to instances where the bylaw is one that is within the authority of the board of directors to repeal, rather than one requiring a shareholder vote to amend or rescind.<sup>19</sup>

### DISCUSSION

The situation considered in this article can really only arise where the conflict between the fixed term of the employment contract and the removal-at-will bylaw provision is not addressed either in the original contract negotiations between the corporate officer and the corporation’s agents negotiating the contract on its behalf, or at the subsequent board of directors meeting by which the board ratifies the contract. In other words, the conflict almost by definition occurs only in situations where neither the officer nor the board becomes aware of the problem until dismissal is sought. Who is at fault here for overlooking this clash, and what implications should this culpability have for the resolution of the conflict?

One line of the cases takes as its central premise the view that the officer is the culpable party. He “should have known” of the bylaw provision when contracting with the corporation, and therefore his contract rights are subordinated to that provision. The other line of cases essentially rests upon the idea that the board of directors is the one that “should have known” about their bylaw, and thus has implicitly rescinded the applicable bylaw provision by agreeing to a contract with fixed-term employment provisions. Which of these lines of authority reflects the better view, and why?

The choice here can be clarified and illuminated if one first considers how basic principles of agency law apply to the situation. The board of directors of a corporation acts as an agent on behalf of its principal, the corporation. Under well-established legal doctrines agents can contractually obligate their principals by entering into contracts on their behalf within the scope of their agency authority.<sup>20</sup> The source of that authority can be either the actual authority conferred upon the agent by the principal,<sup>21</sup> apparent authority based upon representations made to that effect by the principal to third parties,<sup>22</sup> or inherent authority based upon the reasonable expectations that third persons have concerning the scope of authority conferred upon the agent in connection with his discharge of conventional agency roles.<sup>23</sup>

In most instances the board of directors of a corporation has the actual authority to amend or rescind all bylaw provisions except for those concerning core shareholder protections. This is so because in most jurisdictions the shareholders of corporations are left free under the applicable statutes to confer upon directors broad authority to amend, rescind or waive the bylaws concerning routine corporate operations, such as the bylaws conferring the right to terminate the employment of

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19. See, e.g., *Fowler v. Great Southern Tel. & Tel. Co.*, 29 So. 271, 272 (La. 1900).

20. RESTATEMENT (SECOND) OF AGENCY §144 (1993).

21. *Id.* §§ 7, 144.

22. *Id.* §§ 8, 159.

23. *Id.* § 8A.

officers or other agents without cause,<sup>24</sup> and most corporate articles of incorporation do confer that authority upon the board. Under these circumstances the only question arising under agency law in this context is whether the board should be deemed to have implicitly exercised this authority to waive or repeal a conflicting bylaw when it enters into a fixed-term employment contract.

I believe that economic efficiency concerns strongly support the “implicit bylaw repeal” position. There is an obvious parallel here with many other kinds of contractual disputes that arise from the parties’ failure to allocate the risk of a mutual mistake or of an unforeseen post-contractual contingency. There is now a very substantial collection of literature in support of filling such a contractual gap with an allocation of the risk of such an event to the party who would have been contractually allocated the risk had the parties foreseen the possibility and placed the risk on the party best able to prevent or insure against it, accompanied by the appropriate side payments needed to distribute the benefits of the efficient allocation of this particular risk in accordance with the relative bargaining power of the parties.<sup>25</sup> Such a default rule of risk allocation creates the economically efficient ex ante incentive structure for guiding parties’ decisions as to the degree of detail to which they will specify their obligations with regard to more remote contingencies.<sup>26</sup>

The frequently recurring problem with the application of this hypothetical bargain risk allocation principle is that it is often unclear which of the parties to a dispute was the preferred ex ante risk bearer with regard to the risk at issue.<sup>27</sup> However, in the corporate employment contract context the appropriate risk allocation seems unusually clear. The board of directors of a corporation is generally in a better position to take account of the corporation’s bylaws when negotiating employment contracts—particularly those bylaws that relate to the board’s core authority to make top-level personnel decisions—than are potential corporate employees. The board is certainly in at least as good a position to be aware of these bylaws as are even those bylaw-conscious existing senior corporate employees who are negotiating new contracts. The efficient allocation of the risk of unforeseen conflicts between contract terms and bylaw provisions will place the burden of an adverse resolution of such conflicts upon the board of directors, which is in the best position to become aware of this potential problem and prevent it from arising. Efficiency considerations thus call for *Realty Acceptance*-style “implied bylaw repeal”

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24. See, e.g., 15 PA. CONS. STAT. ANN. § 1504(a) (West 1995) (allowing the shareholders to vest in the board of directors the authority to adopt, amend or repeal all bylaw provisions except for those provisions listed in § 1504(b) as addressing shareholder protection concerns).

25. “The task for a court asked to interpret a contract to cover a contingency that the parties did not provide for is to imagine how the parties would have provided for the contingency if they had decided to do so.” RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* 104-05 (5th Ed. 1998). See also Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 *YALE L.J.* 87, 89-90 (1989); FRANK EASTERBROOK & DANIEL FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 15 (1991).

26. RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* 104 (1998).

27. “In many . . . cases economic analysis—at least of the casual sort employed by the judges and lawyers in contract cases—will fail to yield a definite answer, or even a guess, as to which party is the superior risk bearer.” Richard Posner & Andrew Rosenfeld, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 *J. LEG. STUD.* 83, 110 (1977).

rulings awarding damages for violation of fixed-term employment provisions.

I therefore recommend, on agency law and economic efficiency grounds, that courts embrace the “implied bylaw repeal” resolution of these contract-bylaw conflicts in favor of the corporation employee by ruling that corporation attempts to invoke those bylaw provisions, while generally effective to obtain dismissal under the applicable statutes, constitute a breach of the employment contract entitling the employee to appropriate damages. I oppose, however, limiting the application of that doctrine to those instances where the board of directors has the formal authority to amend or rescind the bylaw at issue, as some of the courts that have embraced the “implied bylaw repeal” doctrine have done in a rather superficial and uncritical fashion.<sup>28</sup>

My second conclusion here concerning the appropriate scope of this doctrine is also derived from agency law principles. As discussed above, boards of directors generally have the actual authority under their articles of incorporation to amend or rescind those bylaws relating to routine corporate operations. Given this fact, when dealing with boards of directors persons generally assume, without making further inquiry, those boards have the authority to explicitly or implicitly amend the bylaws as necessary to conform with corporation contractual commitments, except perhaps for those bylaws concerning core shareholder protections.

The doctrine of inherent authority is an elaboration of general estoppel principles that is designed to protect the reasonable (though incorrect) expectations of persons who deal with an agent as to the scope of the agent’s authority, under circumstances such as those here considered where those incorrect expectations arise from conventional understandings of agency roles, rather than from representations made by the principal. It is reasonable for persons entering into an employment contract with a corporation to assume that the board of directors, in ratifying the contract, has explicitly or implicitly repealed or waived any conflicting bylaws. Therefore, even in those relatively infrequent instances where the board of directors in fact lacks the actual authority to amend a bylaw provision relating to employment termination, and where no representations of such board authority that would create apparent authority have been made by the corporation, there still appears to be a sufficient “inherent authority” basis for estopping the corporation from invoking the bylaw to avoid liability for violating a fixed-term employment contract as a result of the board’s (formally unauthorized) attempt to implicitly repeal such a bylaw through ratification of a fixed-term employment contract.

### CONCLUSION

For the reasons discussed above, I recommend that where the board of directors of a corporation attempts to invoke a bylaw provision allowing termination at will to discharge a corporate employee from a fixed-term employment contract, such an act should be regarded as a breach of the employment contract entitling the employee to appropriate damages, even in those instances where the board lacks the

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28. See, e.g., *Realty Acceptance*, 51 F.2d at 639; *Fowler*, 29 So. at 272.

authority under the applicable articles of incorporation to amend or rescind the bylaw at issue.

The agency law and economic efficiency rationales underlying this conclusion are quite robust, and in my opinion also adequately support the general application of the “implied bylaw repeal” principle to protect other employee rights arising from the terms of employment contracts—such as, for example, commitments to fixed employee duties—that may conflict with other bylaw provisions conferring unrestricted discretion upon the board of directors. It should also for the same reasons be applied broadly to resolve similar conflicts that can arise between the terms of employment agreements and the internal governance rules in force for other types of business entities, such as partnerships, limited partnerships, and limited liability companies.