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Corporate Litigation:

Litigation Fee-Shifting Bylaws Facially Valid in Delaware

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Last month, the Delaware Supreme Court ruled that a board-approved provision in a non-stock corporation's bylaws shifting legal expenses in intra-corporate litigation to unsuccessful claimants can be valid in Delaware. Although *ATP Tour v. Deutscher Tennis Bund*[1] pertained to a non-stock corporation, the decision has provoked an outpouring of debate because its reasoning applies equally to stock corporations. Some have warned that widespread adoption by Delaware corporations of fee-shifting bylaws could upend intra-corporate litigation by deterring even meritorious stockholder claims. At the same time, advisers to Delaware stock and non-stock corporations have paused to analyze *ATP Tour* and evaluate whether it is in the best interest of corporations and their stockholders to adopt fee-shifting bylaws.

Delaware legislation has already been proposed that would limit the applicability of *ATP Tour* to non-stock corporations and mandate that no charter or bylaw provision may impose monetary liability on stockholders of Delaware stock corporations except under traditionally limited circumstances. If the Delaware General Assembly approves the legislation before the end of the current session (June 30), these amendments would become effective on Aug. 1, 2014. This column examines this fluid situation and offers practical guidance to boards and their advisers.

Fee-Shifting Bylaws

The "American rule" regarding attorney fees and costs in litigation provides that each party is responsible for its own attorney fees and costs, absent a statute,

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contract or other equitable basis for an exception. The chief objection to fee-shifting bylaws has been the likely chilling effect on even meritorious claims, and the argument has been ably made by many commentators. A stockholder plaintiff, however, receives the benefit (and frequently a direct incentive payment) from any judgment or settlement obtained in litigation prosecuted on a contingency basis by well-financed attorneys. A cogent argument can be made that expenses incurred by the company in defending itself and indemnified managers against a lawsuit that lacked reasonable basis should in fairness be borne by the plaintiff, not the company and ultimately the stockholders.

ATP's members included two tennis federations which, upon joining ATP, had "agreed to be bound by ATP's Bylaws, as amended from time to time." Thereafter, ATP's board of directors amended the company's bylaws to provide that if any current or prior member initiates a claim against the corporation and "does not obtain a judgment on the merits that substantially achieves, in substance and amount, the full remedy sought," each initiating party must pay all of the corporation's "fees, costs and expenses of every kind and description…that the parties may incur in connection with" the claim.

The federations then sued and lost a fiduciary duty and antitrust lawsuit against ATP in federal court, and ATP moved to recover its legal fees and costs. The district court asked the Delaware Supreme Court to address the enforceability under Delaware law of the fee-shifting provision in ATP's bylaws.

The Delaware Supreme Court's response stated that, assuming a board-adopted fee-shifting bylaw is not precluded by the company's corporate charter, such bylaws are facially valid because they do not violate the Delaware General Corporation Law (DGCL) or any other Delaware statute, and they are within the DGCL §109(b)'s requirement that bylaws must "relat[e] 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."[2] Fee-shifting bylaws, the court added, are not repugnant to any common law principle. The court observed that the "American rule" may be modified by contracting parties, and since "corporate bylaws are 'contracts among a corporation's shareholders,' a fee-shifting provision contained in a non-stock corporation's validly-enacted bylaw would fall within the contractual exception to the American Rule."

Having determined that fee-shifting bylaws are facially valid, the court continued that whether a specific bylaw would be enforceable "depends on the manner in which it was adopted and the circumstances under which it was invoked," cautioning that facially valid bylaws "will not be enforced if adopted or used for an inequitable purpose." Because the court responded to certified questions of law, it did not expound on this potential limitation by determining the enforceability of the specific fee-shifting provisions at issue in the underlying federal case. The court removed an obvious potential challenge from the table, however, by noting that a board's intent to deter litigation is "not invariably an improper purpose," as "[f]ee-shifting provisions, by their nature, deter litigation."

Finally, the court held that the fact that ATP's fee-shifting bylaw was adopted after the claimants became members of ATP did not affect the bylaw's enforceability. The court explained that the DGCL permits a corporation to, "in its certificate of incorporation, confer the power to adopt, amend or repeal bylaws upon the directors." Thus, where the certificate of incorporation empowers the board to adopt bylaws, stockholders are bound unless the stockholders vote to repeal the bylaws.

Practical Considerations

Doctrinally, *ATP Tour* is sound. *ATP Tour* has important parallels to last year's Delaware Court of Chancery decision approving the facial validity of bylaws designating Delaware as the exclusive forum for litigation relating to the corporation's internal governance (e.g., stockholder derivative suits, fiduciary duty class actions, DGCL suits, and suits pertaining to the relationships among or between the corporation and its current officers, directors and stockholders). The central premise in *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*,[3] was that bylaws "constitute part of a binding broader contract among the directors, officers, and stockholders formed within the statutory framework of the DGCL." Stockholders, by purchasing and maintaining shares, "have assented to a contractual framework established by the DGCL and the certificates of incorporation that explicitly recognizes that stockholders will be bound by bylaws adopted unilaterally by their boards."

As in *Chevron*, *ATP Tour* referenced the presumed validity of corporate bylaws, focused on the broad range of permissible bylaws under DGCL §109(b), cited precedent indicating that contractual clauses achieving what the respective bylaws

sought to achieve are valid and enforceable, and held that if directors are authorized by the certificate of incorporation to adopt and amend bylaws, "stockholders will be bound by bylaws adopted unilaterally by their boards." Nevertheless, *ATP Tour's* perceived potential to facilitate arguably the most significant change to intra-corporate litigation in decades has provoked a firestorm among legal practitioners and commentators, and swift legislative response.

Despite consensus that parties can by contract abrogate the American rule, *ATP Tour's* ruling has elicited vociferous objection from some that widespread adoption of fee-shifting bylaws by publicly held companies will have a game-changing chilling effect on stockholder lawsuits—regardless of merit. Conversely, fee-shifting bylaws could provide a useful deterrent against non-meritorious lawsuits—a widely acknowledged problem in corporate America. Now that the Delaware Supreme Court has approved fee-shifting bylaws, boards of directors and their advisers naturally are asking: "Should we adopt a fee-shifting bylaw?"

As a threshold matter, since directors do not have inherent power to amend the corporation's bylaws, only a board expressly authorized by the certificate of incorporation to adopt and amend bylaws unilaterally can follow the ATP Tour model. If so empowered, directors should approach consideration of whether a fee-shifting bylaw is in the best interest of the company and its stockholders disinterestedly, with care and informed deliberation.

There are manifold considerations a board should weigh before adopting such a bylaw. First, it is essential to heed ATP's admonition that "inequitable action does not become permissible simply because it is legally possible." While adoption of fee-shifting bylaws with an intent to deter litigation does not render the bylaws unenforceable, the validity of board-adopted fee-shifting bylaws will depend on the specific facts and circumstances surrounding their adoption.

Because the ATP Tour court did not apply its approval of the facial validity of fee-shifting bylaws to any set of facts, corporations have limited guidance regarding the factual circumstances under which adoption of fee-shifting bylaws would be permissible. That said, common sense strongly suggests that fee-shifting bylaws are more likely to be upheld if they are adopted by the board only after a careful survey of the historic litigation landscape (for the company, its industry, etc.), its results and associated expenses, and certainly at a time the company is not involved in or reasonably anticipates stockholder litigation.

Second, Delaware companies should bear in mind that stockholders do not lack recourse if the majority does not want fee-shifting; *ATP Tour's* determination that fee-shifting bylaws are facially valid in Delaware does not restrict stockholders' right to repeal board-adopted bylaws. Additionally, as the Delaware Court of Chancery observed in *Chevron*, "because the DGCL gives stockholders an annual opportunity to elect directors, stockholders have a potent tool to discipline boards who refuse to accede to a stockholder vote repealing" a fee-shifting provision.[4]

Third, *ATP Tour* does not represent a guarantee that fee-shifting bylaws will always be upheld. In *ATP Tour*, for example, the court noted that in the underlying litigation, the district court "effectively ruled that 'federal law preempts the enforcement of fee-shifting agreements when antitrust claims are involved,'" though, on appeal, the U.S. Court of Appeals for the Third Circuit held that the district court should have determined whether the fee-shifting provision in ATP's bylaws was "enforceable as a matter of Delaware law before reaching the federal preemption question." Thus, even in *ATP Tour* itself the fee-shifting provision may ultimately be determined to be preempted by federal law. Similarly, unless a corporation's bylaws also include a forum-selection provision, there is no guarantee that intra-corporate litigation will be brought in Delaware; in litigation brought outside of Delaware, a court may apply the law of its state and could find the fee-shifting provision to be unenforceable or interpret the provision to apply reciprocally regardless of its wording.

Finally, the managers of Delaware corporations should consider the potential "public relations" ramifications of adopting fee-shifting bylaws. The first public companies to adopt such bylaws should be prepared to face criticism by the media and should consider that proxy advisory firms may express their disapproval of fee-shifting bylaws, which could, in turn, influence the vote of a number of the companies' institutional investors.

Given the complexity of the various legal, reputational, and practical considerations involved, boards contemplating the adoption of fee-shifting bylaws should consult extensively with experts. Significantly, directors should seek the advice of outside legal counsel regarding whether, given the facts involved, they should adopt fee-shifting bylaws and, if so, how best to craft such bylaws.

Experienced advisers may craft tailored fee-shifting bylaws with a substantially reduced chilling effect on meritorious stockholder lawsuits. For example, a fee-

shifting provision could apply only if the plaintiffs do not pass the motion to dismiss stage; this could deter frivolous lawsuits, while not discouraging meritorious ones. It may also be prudent for companies to seek the views of their largest institutional stockholders before taking any action regard fee-shifting bylaws.

The situation is fluid. The Corporation Law Section of the Delaware State Bar Association has approved proposed amendments to the DGCL that would-limit *ATP's* holding to non-stock corporations. Specifically, new §331 to the DGCL would prevent the certificate of incorporation or the bylaws of any corporation from imposing monetary liability or responsibility for any debts of the corporation on any stockholder of the corporation, except as permitted by DGCL §§102(b)(6) and 202 (§202 permits transfer restrictions imposed by charter, bylaw or stockholder agreement that could result in stockholder monetary liability).

The proposed legislation also would amend DGCL §102(b)(6), which permits a certificate of incorporation to include a provision imposing personal liability for the debts of the corporation on stockholders to a specified extent under specified conditions, to clarify that any such provision may impose liability "based solely on…stock ownership," and not on any other status or action of the stockholder. The proposed amendments would not disturb the rule that stockholders may be liable for corporate debts when liability arises from the stockholder's acts or omissions, such as tortious conduct or a guarantee of corporate debt.

The categorical approach of proposed §331 may reflect the rush to initiate a legislative counter to the public company implications of *ATP*, but its one-size approach raises a fair question: whether any legislation addressing fee-shifting should better reflect the realities of intra-corporate litigation. Stockholder litigation comes in materially different contexts—e.g., deal litigation, corporate setbacks, governance disputes—and sound policy considerations support allowing public companies to authorize fee-shifting that takes context into account. Fee-shifting based on certain objectively identifiable criteria, such as the stage at which a case is dismissed, deserves consideration. For now, public companies will likely want to wait until the Delaware General Assembly votes on the proposed amendment and the governor acts before reaching any final conclusions about fee-shifting.

Endnotes:

1. 2014 WL 1847446 (Del. May 8, 2014).

2. Id. at * 3 (quoting 8 Del. C. §109(b)) (brackets in original).

3. 73 A.3d 934 (Del. Ch. 2013).

4. Chevron, 73 A.3d at 956-57.

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