Delaware Supreme Court Okays One-Way Fee-Shifting Bylaws

Nathan A. Cook and Adam J. Levitt

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The Board of Insulated Corp. has just agreed to a merger by which Insulated Corp.'s controlling stockholder will cash-out all of the corporation's public stockholders and take the corporation private. Your client owns shares of Insulated Corp. stock and believes the merger price reflects only 50% of the true value of the stock. If your client is right, then she stands to gain $50,000 in increased merger consideration—and the class of public stockholders stands to gain $50,000,000. Sounds like a great case for breach of fiduciary duty, right? Not so fast.

Insulated Corp. is a Delaware corporation, and its Board has adopted a "one-way fee-shifting" bylaw. If your client commences an action for breach of fiduciary duty and does not "obtain a ***judgment on the merits*** that substantially achieves, in substance and amount, ***the full remedy sought***," then the bylaw provides that your client and arguably you and anyone else acting on your client's behalf will be jointly and severally liable for the defendants' attorneys' fees and other costs and expenses.

Your client has a maximum upside of $50,000 if she commences the litigation. Your client knows that this is a strong case for breach of fiduciary duty and that she will probably achieve some recovery. Yet, your client also knows that litigation is inherently uncertain and that stockholder-plaintiffs rarely obtain a "judgment on the merits" for "the full remedy sought." Due to the bylaw, there is a very real risk that your client will have to pay millions of dollars in attorneys' fees to the defendants. What had been a potentially great case for breach of fiduciary duty, which could have afforded a substantial recovery to not only your client but an entire stockholder class, is now a very unattractive proposition. By adopting the bylaw, the directors of Insulated Corp. have succeeded in living up to the company name—and insulating themselves from liability.

A. THE *ATP* DECISION

The scenario described above is now a realistic possibility for stockholders of Delaware corporations as a result of the Delaware Supreme Court's May 8, 2014 decision in *ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554 (Del. 2014). In *ATP*, the Delaware Supreme Court upheld as facially valid bylaws that impose liability on plaintiffs for defendants' attorneys' fees in the absence of substantially complete victory in fiduciary duty and other forms of intra-corporate litigation.

The decision arose in the context of a non-stock corporation, but commentators and practitioners have so far largely assumed that the ruling will apply to Delaware corporations, as well. The Court's reasoning suggests that fee-shifting bylaws that are unilaterally adopted by a board of directors ***after*** a stockholder purchases his or her shares will still be enforceable against that stockholder. The decision provides that the adoption of fee-shifting bylaws will be reviewed for inequitable conduct. Yet, the *ATP* decision also specifically acknowledges that fee-shifting bylaws, "***by their nature, deter litigation***" and holds that the adoption of a fee-shifting bylaw with the "intent to deter litigation" does not "necessarily render the bylaw unenforceable." Given this, equitable review of fee-shifting bylaws may be limited.

Finally, the form of fee-shifting bylaw held to be facially valid in *ATP* was "one-way" in the sense that the defendants in intra-corporate litigation would have no reciprocal obligation under the bylaw to reimburse the plaintiff for attorneys' fees. Instead, the reimbursement obligation was a one-way street, with all the risk on the plaintiff and all the benefit accruing to the defendants.[1]

B. PROPOSED LEGISLATION TO ADDRESS THE PROBLEM IS STYMIED

Within days of the Delaware Supreme Court issuing its decision in *ATP*, national law firms issued client alerts recommending that Delaware corporations give serious consideration to adopting one-way fee-shifting bylaws.[2]

The Delaware Corporation Law Council responded to the *ATP* decision by proposing a legislative amendment to the Delaware General Corporation Law. The proposal would have prohibited Delaware corporations from imposing monetary liability or responsibility for corporate debts on any stockholder through the corporation's certificate of incorporation or bylaws, except in certain very limited circumstances.[3] The effect of the amendment would have been to prohibit the adoption of one-way fee-shifting bylaws or charter provisions by Delaware corporations and to limit the application of *ATP* to non-stock corporations.

Historically, the Delaware General Assembly has routinely approved corporate legislation proposed by the Delaware Corporation Law Council. In this instance, that changed. Following lobbying and criticism that the proposal was adopted too quickly, the Delaware General Assembly instead approved a joint resolution calling for continued study of fee-shifting provisions in advance of the legislature's 2015 session.

C. CORPORATIONS ARE ALREADY ADOPTING THESE BYLAWS

In arguing that the Delaware General Assembly should delay addressing the *ATP* decision, critics of the proposed legislative amendment suggested that the joint resolution would adequately signal that Delaware corporations should not enact fee-shifting bylaws at this time. Yet, the "hypothetical" bylaw outlined at the beginning of this article is, in fact, not hypothetical at all. Already, at least three Delaware corporations have adopted versions of this one-way fee-shifting bylaw, with the requirement that stockholder-plaintiffs obtain a judgment on the merits that substantially achieves the full remedy sought.[4]

The expectation is that the number of Delaware corporations adopting one-way fee-shifting bylaws—and thereby insulating their directors and officers from liability for fiduciary misconduct—will continue to grow. All parties interested in ensuring that there is an adequate deterrent to fiduciary misconduct and that, once a breach of fiduciary duty occurs, the doors to the courthouse remain open to stockholders seeking to hold directors and officers to account, should strongly consider making their voices heard now.

ENDNOTES

1 The *ATP Tour* decision came to the Delaware Supreme Court as a series of certified questions from the Delaware federal district court, following remand from the Third Circuit Court of Appeals. The Third Circuit decision provided: "It is interesting to note that the by-law provision here imposes fees on a plaintiff who 'does not obtain a judgment ***on the merits*** that ***substantially*** achieves, in substance and amount, the ***full*** remedy sought.' This is not your average fee-shifting provision. Its language seems to suggest that a plaintiff would have to pay the defendant's fees even if the plaintiff receives a favorable settlement, because the plaintiff in such a case failed to 'obtain a ***judgment on the merits.***' Further, if a plaintiff prevailed at trial and won $10,000,000, but sought $20,000,000, this by-law theoretically could require the plaintiff to pay the defendant's fees because the judgment the plaintiff received arguably did not "'***substantially*** achieve[ ], in substance and amount, the ***full*** remedy sought.'" *Deutscher Tennis Bund v. ATP Tour Inc.*, 480 F. App'x 124, 128 (3d Cir. 2012).

2 *See, e.g.*, *Delaware Supreme Court Endorses "Fee-Shifting" Bylaw in Certified Question of Law*, Wilson Sonsini Goodrich & Rosati (May 12, 2014) ("[M]any boards of directors of private and public Delaware corporations should seriously consider adopting fee-shifting bylaws of their own.").

3 The synopsis to the proposed legislative amendment provided that the amendment was "intended to confirm and codify the limited liability nature of corporations by expressly stating that provisions in a certificate of incorporation or bylaw may not impose monetary liability on stockholders, except in the very limited circumstances already provided for in the Delaware General Corporation Law."

4 The three Delaware corporations are Echo Therapeutics, Inc., Hemispherx Biopharma, Inc., and The LGL Group, Inc.

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