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Paradigm Shift? The Delaware Supreme Court Allows Bylaw That Shifts Attorneys' Fees to Loser in Fiduciary Duty Litigation

By Jordan Eth, Michael G. O'Bryan and Mark R.S. Foster

Under the prevailing "American rule," shareholders and their counsel face little financial risk when they assert claims against directors and officers for breaches of fiduciary duty, typically following the announcement of a significant corporate transaction or disappointing corporate news. Winning plaintiffs (or at least their counsel) can get big paydays. Losers usually move on, having only lost some time and their own costs. That paradigm may begin to shift, however, after the Delaware Supreme Court's recent ruling in *ATP Tour, Inc. v. Deutscher Tennis Bund*, No. 534, 2013 (Del. May 8, 2014).

In *ATP*, the court ruled that Delaware law does not prevent the board of a Delaware non-stock corporation from enacting a fee-shifting bylaw that would require the unsuccessful plaintiff in intra-corporate litigation (including purported class action fiduciary duty claims) to pay the corporate defendants' litigation costs, including attorneys' fees. While typical stock corporations have not adopted fee-shifting bylaws similar to the one at issue in *ATP*, the ruling may pave the way for adoption and enforcement of similar fee-shifting bylaw provisions. That could force shareholders to carefully weigh the costs and benefits of litigating fiduciary duty claims.

BACKGROUND

In the *ATP* case, the Delaware Supreme Court analyzed a fee-shifting bylaw provision of ATP, a non-stock membership corporation that operates a men's professional tennis tour. The members of ATP consist of professional tennis players and entities that own and operate tennis tournaments. Litigation was triggered by the ATP board's decision to change the format and schedule of a tennis tour, downgrading certain tournaments. The tour operators whose tournaments were downgraded challenged the decision by filing suit in federal court against ATP and its directors for alleged breach of fiduciary duty (and for antitrust violations).

After trial, the federal court ruled in favor of defendants, who then sought recovery of their litigation expenses pursuant to the fee-shifting bylaw provision that ATP's board had adopted. The federal court recognized that the question of the bylaw's enforceability raised a novel question of first impression under Delaware law, and certified the question for consideration by the Delaware Supreme Court.

THE *ATP* DECISION

The Delaware Supreme Court upheld ATP's fee-shifting bylaw provision after analyzing the Delaware statutes and common law governing contracts. At the outset, the court stated that corporate bylaws are presumed to be valid. They are facially valid when authorized by the Delaware General Corporation Law (DGCL), consistent with the corporation's certification of incorporation, and not otherwise prohibited.

The court concluded that neither the DGCL nor any other Delaware statute prohibited a fee-shifting bylaw. The court stated that a fee-shifting bylaw satisfies the DGCL's requirement that bylaws "relate to the business of the corporation, the conduct of its affairs, and its right or powers or the rights or powers of its stockholders, directors, officers, or employees."

The court likewise concluded that the common law of contracts did not prohibit the bylaw. Because bylaws are contracts between corporations and their shareholders, the court explained, a bylaw provision can contractually bind shareholders to a fee-shifting provision: "a fee-shifting provision contained in a non-stock corporation's validly-enacted bylaw would fall within the contractual exception to the 'American Rule.'" The court also confirmed that such bylaws could bind shareholders who joined the corporation before adoption of the bylaw, if the directors were authorized in the company's certificate of incorporation to adopt bylaws (as is the case in most US public companies).

As the *ATP* court was only answering certified legal questions, it did not address whether the bylaw was enforceable in the case, an issue that must be decided by the federal court in Delaware, where the dispute is pending. Nevertheless, the *ATP* court provided guidance on how enforceability can be analyzed in future cases.

Whether a fee-shifting bylaw is enforceable in a given case will depend "on the manner in which it was adopted and the circumstances under which it [is] invoked." Even a valid bylaw will not be enforced, however, if it is "adopted or used for an inequitable purpose." The court observed that "an intent to deter litigation would not necessarily render the bylaw unenforceable in equity." On the other hand, the court suggested that an improper purpose might exist when there is evidence of entrenchment, obstruction of the shareholder franchise, oppression of minority shareholders, or other ulterior motives that could be deemed inequitable under the circumstances of a given case.

SIGNIFICANCE

Although the *ATP* decision addressed the validity of bylaw provisions adopted by non-stock corporations, there is reason to believe that the court's analysis should be equally applicable to stock corporations. For one, the decision expressly relied on provisions of the DGCL that are equally applicable to both types of corporations. If the court had intended its ruling to be confined to non-stock corporations, it could easily have expressly confined its ruling. Further, the reasoning in the *ATP* opinion is similar to the reasoning in the Delaware Court of Chancery's decision last year in *Boilermakers Local 154 Retirement Fund v. Chevron*, 73 A.3d 934 (Del. Ch. 2013), which held that stock corporations can adopt bylaws containing forum-selection provisions applicable to intra-corporate disputes. (See our client alert here).

The *ATP* decision offers the potential for fee-shifting bylaw provisions that take a variety of forms and apply in a variety of circumstances. On one end of the spectrum would be bylaw provisions that require the losing party to pay all expenses. As in *ATP*, that could be at the conclusion of the litigation following an adjudication on the merits. One could imagine a variant that requires payment of expenses after interim rulings, such as on motions to dismiss, or motions for a preliminary injunction, which are often the main event in many cases relating to mergers and acquisitions.

Alternative formulations of fee-shifting provisions might be less aggressive, perhaps to assuage concerns of activist investors or proxy advisory services who may fear that fee-shifting bylaws would deter meritorious shareholder litigation. For example, a bylaw could be drafted so that fee-shifting is triggered where the court makes a specific finding that the litigation fell below a specified threshold of merit, such as a suit lacking a "colorable basis." Or the fee-shifting provision could only apply where a shareholder pursues litigation in any jurisdiction other than the Delaware Court of Chancery. In this way, a fee-shifting bylaw could give teeth to a forum-selection bylaw that otherwise would have to be enforced by the company in motion practice, which can be expensive and drawn out.

Whether a board of directors can unilaterally amend the bylaws will depend as an initial matter on whether that power is expressly granted to the board by a given company's articles of incorporation. Moreover, whether a bylaw so adopted will be enforceable will depend on the circumstances under which it was adopted. Boards also will need to consider the potential reactions of their shareholders and of proxy advisory firms.

Regardless, the optimal time to adopt a fee-shifting bylaw (or forum-selection bylaw) is sooner rather than later. If the provision is adopted on a "clear day"—well in advance of litigation or the event triggering litigation—there is a greater likelihood that the provision will be found to be enforceable. Nevertheless, it could be proper to adopt the bylaw in connection with the negotiation of a significant corporate transaction such as a merger. In that circumstance, shareholder plaintiffs may be more likely to challenge the validity of the bylaw. Those challenges are to be expected in today's environment, where plaintiffs bring claims against virtually every public company acquisition transaction, but they may not be successful unless the plaintiffs unearth actual evidence demonstrating that board members acted with improper motives at the time of adoption.

CONCLUSION

Although *ATP* appears to offer a path to minimizing litigation risk, there are many open questions. Courts will be called upon to provide further clarity on the types of fee-shifting bylaws that are acceptable, what it might mean to "win" a complex, multi-stage lawsuit, the circumstances in which such bylaws are unenforceable, and the means by which a prevailing corporation seeks collection. Issues will arise about who will be responsible for payment of the fees, particularly in class actions. Notwithstanding that uncertainty, Delaware corporations and directors should welcome the *ATP* decision and consider adoption of fee-shifting and forum-selection bylaws. Adoption of either or both of these provisions could help level the playing field when it comes to litigation of claims based on alleged breaches of fiduciary duty.

Contact:

Jordan Eth
(415) 268-7126
jeth@mofo.com

Michael G. O'Bryan
(415) 268-6352
mobryan@mofo.com

Mark R.S. Foster
(415) 268-6335
mfoster@mofo.com

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