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Legal Update
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Delaware Supreme Court Finds Fee-Shifting Bylaws Valid

A recent Delaware Supreme Court case, *ATP Tour Inc. v. Deutscher Tennis Bund*, No. 534, 2013 (Del. May 8, 2014),[1] held that fee-shifting bylaws, which shift attorneys fees and costs to unsuccessful plaintiffs in intra-corporate litigation, can be enforceable under the Delaware General Corporation Law (DGCL). As a result of the publicity generated by this case, many companies are wondering about the ramifications of this opinion and whether they, too, should be adopting a fee-shifting bylaw. The short answer is that it is too soon to tell.

The *ATP* opinion is likely to be controversial. As a result of the decision, there may be legislative or regulatory action taken to limit, or even preclude, the adoption of fee-shifting bylaws by public companies. Corporate governance rating organizations and proxy advisors may adopt policies that could potentially lower a company's corporate governance rating or give rise to recommendations against the election of directors for companies that adopt a fee-shifting bylaw. At present, it is unclear whether adopting a fee-shifting bylaw would affect director and officer insurance premiums, or if it would actually deter litigation. The desirability of adopting such a bylaw, as well as the preferred terms of such a provision, may be affected by future responses to the *ATP* decision. Therefore, companies should determine whether it may be more appropriate to wait to consider further developments in this area before deciding to adopt a fee-shifting bylaw.

The Delaware Supreme Court Decision

The *ATP* case arose in the context of a Delaware non-stock membership corporation that operates a professional men's tennis tour. ATP's members include tennis players and entities that own and operate tennis tournaments. Two members brought an antitrust and Delaware fiduciary duty suit over a change in the format and schedule of the tennis tour. The corporation prevailed in the litigation and then sought to recover fees from the plaintiffs under a fee-shifting bylaw. The US District Court for the District of Delaware certified four questions to the Delaware Supreme Court concerning the enforceability of the fee-shifting bylaw under state law.[2] The Supreme Court's opinion responded to these questions, but did not apply the law to the facts of the *ATP* litigation.

Specifically, the Supreme Court held that "a bylaw of the type at issue here is facially valid, in the sense that it is permissible under the DGCL, and that it may be enforceable if adopted by the appropriate corporate procedures and for a proper corporate purpose." The Supreme Court also held that the bylaw would be enforceable at least in a situation where the plaintiffs obtained no relief at all against the corporation. Although the Supreme Court noted that an improper purpose could render a legally permissible bylaw unenforceable in equity, it held that the intent to deter litigation would not invariably constitute an improper purpose and, therefore, would not necessarily render the provision unenforceable. Finally, the Supreme Court held that a bylaw

amendment adopted by a board of directors can be enforceable against members who joined before the amendment was adopted if directors have the power in the certificate of incorporation to amend bylaws. The Supreme Court concluded by stating that "under Delaware law, a fee-shifting bylaw is not invalid *per se*, and the fact that it was adopted after entities became members will not affect its enforceability."

Practical Considerations

APPLYING THE SUPREME COURT'S DECISION TO A STOCK COMPANY

The *ATP* decision involved a Delaware non-stock corporation, but the reasoning in the opinion seems applicable to stock corporations as well. The opinion suggests that Delaware stock corporations, including the many public companies that are incorporated in Delaware, can adopt fee-shifting bylaw amendments by action of their boards of directors. However, a board that is considering such a provision must recognize that its enforceability is likely to depend on the facts and circumstances involved.

The reason for adopting a fee-shifting bylaw may be a key factor in determining whether that bylaw is enforceable. A bylaw that is adopted when litigation with a shareholder is looming (or already in progress) may be harder to defend than a bylaw that is adopted at a time when the board of directors can discuss the benefit of deterring unwarranted lawsuits in the abstract.

Enforceability may also be affected by the breadth of the provision. The *ATP* provision has a very broad trigger for shifting legal fees to a claimant, making each claimant jointly and severally liable if it "does not obtain a judgment on the merits that substantially achieves, in substance and amount, the full remedy sought." A court might be more inclined to enforce a fee-shifting provision against a shareholder in a public company if the provision were narrower, for example, shifting fees only in a case where the shareholder lost or, in a derivative action, failed to properly plead demand futility. A provision that reflects a more neutral stance may be viewed with greater acceptance than a provision where the company seeks fee payment under most conceivable circumstances.

A public company board would also have to consider what kinds of actions would be subject to fee shifting: A derivative action? An individual or class action brought by a shareholder to challenge a merger or other transaction? A securities fraud case brought by purchasers of the company's stock?

Including securities fraud actions would likely raise the question of whether such clauses are enforceable under federal law. In the *ATP* litigation, the federal district court has indicated that it believes that federal law would preclude the fee-shifting provision from being enforced in a federal antitrust action. However, no definitive ruling has been made on that issue following the Supreme Court's *ATP* decision.

Companies incorporated outside of Delaware should carefully review the laws of their jurisdictions to determine if there are any statutory or case law principles that suggest that a fee-shifting bylaw may be unenforceable.

ADDITIONAL RAMIFICATIONS AND RESPONSES TO FEE-SHIFTING BYLAWS

Apart from the legal considerations outlined above, companies contemplating a fee-shifting bylaw should also consider a variety of practical issues. For example: How likely is it that such bylaws will in fact deter meritless litigation? Will they deter knee-jerk derivative actions? How about the lawsuits that are inevitably filed whenever a transformative transaction is announced? To the extent that such lawsuits typically end in a settlement, as opposed to a final disposition on the merits, a fee-shifting bylaw may not have as great a deterrent effect as the board may hope.

Another consideration is whether a forum selection bylaw should also be employed

(whether alone or in combination with a fee-shifting provision) to deter meritless lawsuits. In June 2013, the Delaware Chancery Court upheld forum selection bylaw provisions adopted by Chevron Corporation and FedEx Corporation, which required intra-corporate disputes to be litigated exclusively in Delaware.[3]

The likely reaction of investors, corporate governance rating organizations and proxy advisors is another practical consideration to keep in mind. Bylaw amendments trigger a Form 8-K filing, which would have to describe how the bylaws were amended. Public companies should expect adoption of a fee-shifting bylaw amendment to garner significant attention. If a decision is made to proceed with such an amendment, key officers and investor relations personnel must be prepared to respond to questions regarding the rationale and ramifications of the amendment. In fact, companies that decide to adopt fee-shifting bylaws may want to explain the reasons for the provision when the change is announced.

Public companies may face shareholder proposals to block their boards from adopting a fee-shifting bylaw provision or to repeal an existing fee-shifting bylaw. Shareholders only need to own at least $2,000 in market value, or 1 percent, of the stock of a public company for one year in order to be eligible to submit a shareholder proposal for inclusion in that company's proxy statement. It is possible that shareholders may be supported in such efforts by activists who may not be company shareholders. Because shareholders have the power to amend the bylaws, a shareholder proposal could be presented as a binding resolution that would not require further action by the board of directors. It is not clear that such a shareholder proposal would be successful, but unless the company is able to convince the Securities and Exchange Commission that there are grounds to exclude such proposal, it would bring the issue in front of the annual shareholders meeting.

If you have any questions about fee-shifting bylaws, please contact the author of this Legal Update, ***Laura D. Richman****, at* ***+1 312 701 7304****, or any of the lawyers listed below, or any member of our Corporate & Securities practice.*

Edward S. Best
+1 312 701 7100
ebest@mayerbrown.com

Scott J. Davis
+1 312 701 7311
sdavis@mayerbrown.com

Michael L. Hermsen
+1 312 701 7960
mhermsen@mayerbrown.com

William R. Kucera
+1 312 701 7296
wkucera@mayerbrown.com

Philip J. Niehoff
+1 312 701 7843
pniehoff@mayerbrown.com

Andrew J. Noreuil
+1 312 701 8099
anoreuil@mayerbrown.com

Michele L. Odorizzi
+1 312 701 7309
modorizzi@mayerbrown.com

Bruce F. Perce
+1 312 701 7985
bperce@mayerbrown.com

Elizabeth A. Raymond
+1 312 701 7322
eraymond@mayerbrown.com

Laura D. Richman
+1 312 701 7304
lrichman@mayerbrown.com

David A. Schuette
+1 312 701 7363
dschuette@mayerbrown.com

Jodi A. Simala
+1 312 701 7920
jsimala@mayerbrown.com

Marc F. Sperber
+1 312 701 7444
msperber@mayerbrown.com

Frederick B. Thomas
+1 312 701 7035
fthomas@mayerbrown.com

Endnotes

[1] Available at http://courts.delaware.gov/opinions/download.aspx?ID=205490.

[2] The four questions that the US District Court certified for the Delaware Supreme Court to decide are as follows:

1. Is the board of directors of a Delaware non-stock corporation permitted to adopt a bylaw that applies in the event that a member sues the corporation or another member or the corporation sues a member, obligating the claimant to pay for all fees, costs, and expenses of the opposing party if the claimant "does not obtain a judgment on the merits that substantially achieves, in substance and amount, the full remedy sought?"
2. Is such a bylaw enforceable against a member that obtains no relief at all on its claims against the corporation, even if it might be unenforceable if the member obtains some relief?
3. Is such a bylaw rendered unenforceable as a matter of law if any board members intended the adoption of the bylaw to deter legal challenges to other potential corporate action then under consideration?
4. Is such a bylaw enforceable against a member if it was adopted after the member joined the corporation, where the member had agreed to be bound by the corporation's rules "that may be adopted and/or amended from time to time?"

[3] See our Legal Update "Forum Selection Provisions Upheld by Delaware Chancery Court," dated July 10, 2013, available at http://www.mayerbrown.com/files/Publication/767c1ccc-3f76-42d7-b13c-28943398c1fe/Presentation/PublicationAttachment/f9bc22c2-c0a6-4e96-b8f4-2cda3ed94d10/130710-UPDATE-CS-CapMkts.pdf.