Legal Backgrounder

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Is Delaware High Court Ruling an Ace for Merging Companies Served with Shareholder Suits?

by Greg Brower and Casey Perkins

Shareholder lawsuits challenging corporate mergers have risen sharply in recent years, effectively imposing a "merger tax" on most large corporate deals. In fact, more than 97 percent of all merger transactions in 2013 were the subject of litigation alleging a breach of fiduciary duty or other wrongdoing by the various parties to the deal.[1] Because such litigation can threaten the closing of a transaction, these suits rarely progress even to the motion to dismiss stage before they are resolved with a quick "disclosures only" settlement which includes the payment of the plaintiff class's attorneys' fees. The average amount paid, although decreasing recently, is still around $500,000. The U.S. Chamber of Commerce has described this increasingly common occurrence "extortion by litigation."[2] As companies look for ways to avoid this all too frequent, but almost always meritless litigation, Delaware's highest court may have devised a potential solution.

The Delaware Supreme Court's Recent *ATP Tour* Decision. In *ATP Tour, Inc. v. Deutscher Tennis Bund, et al.*[3] ("*ATP Tour*") the Delaware Supreme Court recently decided that Delaware corporate law did not prevent a corporate board from inserting into its bylaws a fee-shifting provision that requires the losing party in an intra-corporate lawsuit to pay the attorneys' fees incurred by the prevailing party. Traditionally, the so-called "American Rule" provides that each party to a lawsuit must pay its own attorneys' fees whatever the outcome of the suit, unless the parties have contracted for some other arrangement. Indeed, the Court in *ATP Tour* reasoned that "[i]t is settled that contracting parties may agree to modify the American Rule and obligate the losing party to pay the prevailing party's fees."[4] Moreover, the unanimous decision held that deterring litigation is a permissible reason for adopting such a bylaw.[5]

The parties to the case included ATP Tour, Inc. (ATP), a Delaware "membership" (*i.e.*, non-stock or private) corporation that operates the major global professional men's tennis tour. Two of ATP's member entities, Deutscher Tennis Bund (DTB) and Qatar Tennis Federation (QTF), sued ATP in federal court in Delaware after ATP's board voted to change the tour schedule and format in a way that DTB and QTF did not like. The suit alleged antitrust and fiduciary duty claims.

Following a jury trial, the federal district court in Delaware granted ATP's motion for judgment as a matter of law on some of the claims, and the jury later found for ATP on the remaining claims. As the prevailing party, ATP then moved to recover its attorneys' fees pursuant to a fee-shifting bylaw that provides for the prevailing

[1] Matthew D. Cain & Steven M. Davidoff, *Takeover Litigation in 2013* (Ohio State Public Law Working Paper No. 236, 2014).
[2] Andrew J. Pincus, *The Trial Lawyers' New Merger Tax: Corporate Mergers and the Mega Million-Dollar Litigation Toll on Our Economy*, U.S. Chamber Institute for Legal Reform (2012).
[3] Case No. 534, 2013, 2014 WL 1847446, ___ A.3d ___, (Del. May 8, 2014).
[4] *Id*. at *3.
[5] *Id*. at *4.

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party in such a suit to recover its fees from the losing party or parties. The district court denied the motion on federal preemption grounds.

ATP appealed the denial of its fees motion to the United States Court of Appeals for the Third Circuit which held that the district court should have decided whether the corporate bylaw at issue was enforceable as a matter of Delaware law before considering the preemption question. *Deutscher Tennis Bund v. ATP Tour Inc.*[6] On remand, the district court certified the question to the Delaware Supreme Court.[7]

The Delaware Supreme Court held that under the Delaware General Corporation Law (DGCL), a fee-shifting bylaw, like the one at issue, is facially valid:

> A fee-shifting bylaw, like the one described in the first certified question, is facially valid. Neither the DGCL nor any other Delaware statute forbids the enactment of fee-shifting bylaws. A bylaw that allocates the risk among parties in intra-corporate litigation would also appear to satisfy the DGCL'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. The corporate charter could permit fee-shifting provisions, either explicitly or implicitly by silence. Moreover, no principle of common law prohibits directors from enacting fee-shifting bylaws.[8]

The Court went on to explain:

> Because corporate bylaws are 'contracts among a corporation's shareholders,' a fee-shifting provision contained in a non-stock corporation's validly-enacted bylaws would fall within the contractual exception to the American Rule. Therefore, a fee-shifting bylaw would not be prohibited under Delaware common law.[9]

Thus, in *ATP Tour*, the Court clearly held that, at least in the context of a private company, the adoption of a fee-shifting bylaw is something that can be contracted for between the company and its shareholders, and nothing in Delaware's corporate law prohibits such a contractual provision.

***ATP Tour's* Applicability to Public Companies**. The obvious question that arises from the Delaware Court's holding in the context of a "member" or private company is whether the same reasoning can be extended to a "stock" or public company. In other words, under Delaware law, can a publicly-traded company adopt a bylaw that would impose a fee-shifting rule upon the parties to an intra-company lawsuit?

This question has generated considerable debate since the *ATP Tour* decision was issued on May 8th. Corporate attorneys have generally reacted positively to the idea that public companies might benefit from a broad reading of the decision, seeing fee-shifting bylaws as an effective way to deter unmeritorious shareholder litigation. Indeed, former chief judge of the Delaware Chancery Court William B. Chandler III, who is now a partner with a law firm that typically represents corporations in shareholder litigation, observed that "any way that companies see to stem the litigation epidemic is likely to be very attractive."[10] Within days of the decision, several corporate law firms issued alerts recommending that clients consider adopting fee-shifting bylaws of their own.[11]

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[6] 480 Fed. Appx. 124, 128 (3rd Cir. 2012).
[7] *Deutscher Tennis Bund v. ATP Tour Inc.*, Civil Action No. 07-178, 2013 WL 4478033 at *1 (D. Del. Aug. 20, 2013).
[8] *ATP Tour*, 2014 WL 1847446 at *3.
[9] *Id*.
[10] Liz Hoffman, *Why Shareholder Suits May Prove Costly*, WALL ST. J., May 18, 2014, http://online.wsj.com/news/articles/SB10001424052702304908304579565850165670972.
[11] John Delikanakis and Jennifer Luiña, *Legal Alert – Fee Shifting Bylaw Facially Valid Under Delaware Law*, SNELL & WILMER L.L.P. (May 19, 2014), www.swlaw.com/publications/view/id/2240; *Client Alert – Delaware Supreme Court Holds Fee-Shifting Bylaw*

On the other hand, lawyers who represent shareholders in class-action suits against companies were just as quick to criticize the potential application of the *ATP Tour* decision beyond the narrow context of private company intra-corporate litigation. Plaintiffs' lawyers argue that if the decision is interpreted to allow public companies to adopt fee-shifting bylaws, important shareholder litigation would be significantly undermined, allowing corporate misconduct to go unchecked. These lawyers contend that no shareholder will be willing to be a named plaintiff in such a case if there is a possibility of having to pay the company's fees in the event that the suit is not successful.

Legislative Fix Proposed. Indeed, the plaintiffs' bar is already pursuing a preemptive legislative fix. Within a week of the *ATP Tour* decision, the Corporation Law Council of the Delaware State Bar Association proposed legislation that, if passed by the Delaware General Assembly, would statutorily limit the *ATP Tour* decision to non-stock corporations. The proposed new section of the DGCL would read as follows:

> Notwithstanding any other provision of this chapter, neither the certificate of incorporation nor the bylaws of any corporation may impose monetary liability, or responsibility for any debts of the corporation, on any stockholder of the corporation, except to the extent permitted by Sections 102(b)(6) and 202 of this title.[12]

If passed, this legislation would answer the question debated since the *ATP Tour* decision with a clear "no." If the proposed legislation is not adopted, Delaware public companies will be free to consider the option of adopting a fee-shifting bylaw.[13]

Even if public companies have the option of adopting a fee-shifting bylaw, it may not always be the right option. Adoption of such a bylaw would almost certainly cause a negative reaction by shareholders, corporate governance advocates, and advisory firms, and would likely lead to litigation and/or attempts to oust supportive directors. Thus, as with any corporate decision, a careful weighing of the pros and cons would govern the outcome on a company-by-company basis. But, shouldn't public companies at least have that option?

Corporate Bylaws under Delaware's *Chevron* Decision. In evaluating whether the *ATP Tour* decision should logically be expanded to the public company context, it is helpful to look back to another recent Delaware decision concerning public company bylaws. In *Boilermakers Local 154 Retirement Fund, et al. v. Chevron Corporation, et al.*,[14] Delaware's Chancery Court was faced with a challenge to "forum selection bylaws" adopted by the boards of two public companies incorporated in Delaware. In deciding that such bylaws are not facially invalid as a matter of Delaware corporate law, the court focused on the legal relationship between a public company and its stockholders:

> As our Supreme Court has made clear, the bylaws of a Delaware corporation constitute part of a binding broader contract among the directors, officers, and stockholders formed within the statutory framework of the DGCL. This contract is, by design, flexible and subject to change in the manner that the DGCL spells out and that investors know about when they purchase stock in a Delaware corporation. The DGCL allows the corporation, through the certificate of incorporation, to grant the directors the power to adopt and amend the bylaws unilaterally.[15]

Facially Valid, Cooley LLP (May 19, 2014), http://www.cooley.com/delaware-supreme-court-holds-fee-shifting-bylaw-facially-valid; Peter Allan Atkins et al., *Fee-Shifting Bylaws: The Delaware Supreme Court Decision in ATP Tour, Its Aftermath and the Potential Delaware Legislative Response to the Decision*, Skadden, Arps, Slate, Meagher & Flom LLP (May 22, 2014) http://www.skadden.com/insights/fee-shifting-bylaws-delaware-supreme-court-decision-atp-tour.

[12] Peter Allan Atkins et al., *supra* n. 11.

[13] It appears that the Delaware legislature has postponed, for now, consideration of this proposed legislation until 2015.

[14] 73 A.3d 934 (Del. Ch. 2013).

[15] *Id*. at 939.

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The point of *Chevron* is that where a public company's certificate of incorporation authorizes its board to amend its bylaws, investors should be presumed to know that fact when they purchase their stock. The court explained as follows:

> In other words, an essential part of the contract stockholders assent to when they buy stock… is one that presupposes the board's authority to adopt binding bylaws consistent with 8 Del. C. section 109. For that reason, our Supreme Court has long noted that bylaws, together with the certificate of incorporation and the broader DGCL, form part of a flexible contract between corporations and stockholders, in the sense that the certificate of incorporation may authorize the board to amend the bylaws' terms and that stockholders who invest in such corporations assent to be bound by board-adopted bylaws when they buy stock in those corporations.[16]

As for the *Chevron* plaintiffs' position that stockholders' rights may not be regulated by board-adopted bylaws, the court explained that this argument "misunderstands the relationship between the corporation and stockholders established by the DGCL, and attempts to revive the outdated 'vested rights' doctrine, which is inconsistent with the fundamental structure of Delaware's corporate law." *Id.*

Thus, *Chevron* and *ATP Tour* together make it clear that Delaware law is intended to give broad leeway to corporations, private and public, to adopt bylaws not otherwise prohibited by law, and that duly adopted bylaws are presumed to be part of the contract between the company and the member or shareholder. This means that publicly-traded companies and their shareholders ought to be able to freely contract for the details of their relationship, including details such as where disputes between them will be litigated, and whether the losing party in such litigation should have to pay the legal fees of the prevailing party. Such contracts are part of the fundamental structure of the corporate law of Delaware—or, it seems, of any other state for that matter.

Legislative Action Is Unnecessary. The question raised by *ATP Tour* is not whether the Delaware General Assembly can modify Delaware's corporate law. It obviously can here, where no constitutional rights are at issue. The real question is whether it should. As both the *Chevron* and *ATP Tour* decisions make clear, Delaware corporations and their stockholders have a relationship grounded in contract principles, and stockholders are presumed to be aware of and are bound by the terms of their contract. Whether the terms of that contract include the selection of a forum for future litigation or an agreement to a fee-shifting arrangement for litigation, the contract should be enforceable. Moreover, current Delaware corporate law, while allowing for unilateral board adoption of bylaws, also provides that stockholders can overturn such decisions.[17] Against this legal backdrop, it seems that a legislative reaction to *ATP Tour* is unnecessary.

Conclusion. Returning to the problem of "extortion by litigation," *ATP Tour* opens the door to some relief as fee-shifting bylaws have the potential to deter such litigation. Indeed, the *ATP Tour* decision makes clear that deterring litigation is a permissible reason for adopting such a bylaw. Fee-shifting bylaws, like forum-selection bylaws, are, under traditional corporate law principles, matters of contract, and even public companies and their shareholders should be able to agree to such terms in furtherance of what the Delaware Supreme Court has deemed to be a legitimate corporate objective. After all, fee-shifting bylaws, while not necessarily discouraging meritorious suits, would be likely to make shareholders much less willing to rush the net with frivolous suits if they know that a blistering forehand down the line in the form of a big fee award against them may be coming if they lose.

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[16] *Id*. at 940.

[17] *See* D.G.C.L. § 109.

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