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Using Delaware Corporate Bylaws and Charters to Set the Rules for Shareholder Litigation

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Recent court decisions, including the Delaware Supreme Court's opinion earlier this month in *ATP Tour, Inc. v. Deutscher Tennis Bund*, have focused new attention on the use of **corporate bylaws** and charters to establish the ground rules for **shareholder litigation** involving the corporation's internal affairs. In *ATP Tour*, the Delaware Supreme Court held that Delaware law does not prohibit a non-stock corporation from enacting a **fee-shifting bylaw** that makes an unsuccessful plaintiff liable for the defendant's attorneys' fees and costs in cases brought by a member against the corporation or another member, or by the corporation against a member. While the decision specifically concerned a non-stock corporation, there is nothing in the court's reasoning per se that would bar its application to a stock corporation as well. Last summer the Delaware Court of Chancery also upheld forum selection bylaws adopted by FedEx and Chevron that required suits relating to those companies' internal affairs to be brought in Delaware, their state of incorporation.

In light of these decisions, boards of public companies whose charters empower their boards to do so, and their counsel, may want to consider amending their bylaws to adopt such provisions. Such provisions may also be of interest for private companies, especially those that are contemplating an IPO or otherwise expanding their stock ownership, or or have an expansive ownership already. These companies may also wish to consider inserting such provisions directly in their charters or adopting shareholder-approved bylaws containing such provisions.

But boards should proceed with caution, as such provisions are not uncontroversial. Most significantly, the *ATP Tour* decision has already spawned a proposal to amend the Delaware General Corporation Law to prohibit Delaware stock corporations from adopting fee-shifting bylaws similar to the non-stock corporation bylaw at issue in *ATP Tour*. And regardless of whether fee-shifting provisions can be legally adopted and utilized, boards considering them will want to think carefully about the anticipated reactions of institutional shareholders and shareholder representative organizations, which tend to view forum selection provisions with skepticism and will likely regard fee-shifting provisions similarly.

In *ATP Tour*, the Delaware Supreme Court was responding to certified questions from the U.S. District Court for the District of Delaware arising from litigation in which the German Tennis Federation and the Qatar Tennis Federation accused ATP Tour and its officers and directors of antitrust violations and breaches of fiduciary duty. After the plaintiffs lost at trial, the defendants

sought to recover their fees and costs from them, invoking ATP Tour's fee-shifting bylaw.

In holding that ATP Tour's fee-shifting bylaw was facially valid, the Delaware Supreme Court made the following points:

- While Delaware follows the "American Rule," under which parties to litigation generally must pay their own attorneys' fees and costs, neither the Delaware General Corporation Law, nor any other Delaware statute, nor any principle of common law prohibits directors from enacting fee-shifting bylaws. It is settled that contracting parties may agree to modify the American Rule, and corporate bylaws are contracts among a corporation's shareholders.
- The court cautioned that a facially valid bylaw may not be enforced if it was adopted inequitably or used for an inequitable purpose. But the court also observed that an intent to deter litigation is not necessarily an improper purpose that would render the bylaw unenforceable. Fee-shifting provisions by their nature tend to deter litigation, yet they are not per se invalid.
- The court held that a fee-shifting bylaw is enforceable even against a member who joins the corporation before its adoption, where the corporation's certificate of incorporation gives directors the power to adopt bylaws.

The *ATP Tour* decision follows in the footsteps of another decision issued last summer by then-serving Chancellor Leo Strine of the Delaware Court of Chancery, now Chief Justice of the Delaware Supreme Court. In *Boilermakers Local 154 Retirement Fund v. Chevron Corp*., 73 A.3d 934 (Del. Ch. 2013), Chancellor Strine upheld forum selection bylaws adopted by the boards of Chevron and FedEx that required suits relating to those companies' internal affairs to be brought in Delaware, their state of incorporation. The FedEx bylaw designated the Delaware Court of Chancery as the exclusive forum for: derivative suits brought on behalf of the corporation; actions alleging breaches of fiduciary duty by the corporation's directors, officers, employees, or shareholders; actions asserting claims under the Delaware General Corporation Law; and actions asserting claims governed by the internal affairs doctrine. The Chevron bylaw was similar but permitted such suits to be brought in any state or federal court in Delaware with jurisdiction over the parties.

The Court of Chancery held that these forum selection bylaws were statutorily valid because they regulated permissible subject matters under the Delaware statute governing corporate bylaws, 8 Del. C. § 109. The court also held that the bylaws were contractually valid because, even though they were not adopted by the shareholders, the shareholders were on notice that the boards had the power to adopt bylaws unilaterally without shareholder consent. The court noted that shareholders retained the power to amend or repeal the bylaws or to elect new directors, and that courts would not enforce the bylaws if they were used unreasonably and unjustly.

Other recent court decisions indicate that corporate bylaws may also be used to require arbitration of shareholder claims involving a corporation's internal affairs, as law professor Ann Lipton has noted. In a decision issued in March 2014, for example, a federal district court in Massachusetts denied the plaintiffs' motion to invalidate a REIT bylaw that required shareholders to arbitrate claims against the trust or its officers or employees. The court upheld the bylaw both on the merits and on res judicata grounds, following an earlier Maryland court decision addressing the same issue. *See Delaware County Employees' Ret. Fund v. Portnoy*, No. 13-10405-DJC, 2014 U.S. Dist. LEXIS 40107 (D. Mass. Mar. 26, 2014).

Will other states take a similar approach and enforce corporate bylaws (whether adopted by local or foreign corporations) that impose limitations on shareholder litigation? It's difficult to predict, of

course, but there are numerous decisions in other jurisdictions enforcing fee-shifting bylaws governing other types of groups, such as condominium associations, as a matter of contract. Furthermore, some jurisdictions already have statutes that allow defendants to recover their fees and costs from unsuccessful shareholder plaintiffs in derivative litigation. For example, Section 7.46 of the Model Business Corporation Act, which has been adopted in various forms by many states, authorizes a court to award fees and costs to a defendant in a derivative suit if the suit was brought without reasonable cause or for an improper purpose. But jurisdictions that tend to follow Delaware law on corporate matters may also be influenced by the proposed Delaware legislation to prohibit fee-shifting bylaws, if it is adopted.

But even where bylaws regulating shareholder litigation have been validly adopted, there may be situations where courts refuse to enforce them. Opinions in Delaware cases involving the invocation of advance-notice bylaws, for example, indicate that boards may have a duty to waive them if shareholder voting rights would otherwise be impaired. *See, e.g., Icahn Partners LP v. Amylin Pharms., Inc.*, C.A. No. 7404-VCN, 2012 Del. Ch. LEXIS 85, 2012 WL 1526814 (Del. Ch. April 20, 2012); *Hubbard v. Hollywood Park Realty Enterprises, Inc.,* No. 11779, 1991 Del. Ch. LEXIS 9 (Del. Ch. Jan. 14, 1991).

Corporate charter and bylaw provisions offer potentially useful tools to control the burdens of shareholder litigation and to deter frivolous lawsuits. But whether these provisions are appropriate for a particular company, and whether they are enforceable, will necessarily depend upon the company's circumstances, the governing state law, and the context in which the provisions are adopted and enforced.

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