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Shifting the Focus: Let the Courts Decide

Theodore N. Mirvis & William Savitt

Wachtell, Lipton, Rosen & Katz

The frenzy over fee-shifting bylaws and charter provisions is no surprise. Anything that addresses the economics of the game so directly is cause for either alarm or implementation, depending on the side of the caption. And in a world where intracorporate litigation is ubiquitous, and very profitable even though far more derivative and class suits lose than win, no change in substantive law would have quite the bite. In our view, however, the calls to resolve the fee-shifting debate by legislative fiat are misguided. The Delaware courts should be allowed to do what only they can: address the propriety of fee-shifting provisions carefully, contextually, and incrementally.

It is somewhat surprising that the Delaware Supreme Court's decision in *ATP* v. *Deutshcer Tennis Bund* spawned the present kerfuffle. The case, decided on May 8, 2014, involved a non-stock non-public membership organization of professional men's tennis tournaments. Two of the member tournaments objected to being downgraded and so sued. They lost. The corporation sought to recover the expenses of defense under a bylaw that called for fee-shifting if one of the members brought suit and did not substantially prevail. The logic of the bylaw was pure: if a club member chose to go to court and lost, why should the other members be made to pay for the defense?

Enforcing the bylaw, the Supreme Court's opinion emphasized that it had before it a non-stock corporation. It made the point three times in just its opening paragraph. To be sure, the Court was called upon to address the broad language of DGCL § 109 (requiring that bylaws "relat[e] to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers or powers of its stockholders, directors, officers or employees"), and that statutory language is applicable to public company bylaws as well. Some on the defense side of the bar saw the decision as a welcome mat for public corporation fee-shifting, some

going so far as to issue client alerts urging corporations to consider implementing such bylaws. By ignoring the non-stock character of the corporate defendant and the peculiarities of the facts before the Court, this reaction went out on a limb that the Court's opinion did not appear support.

Then the empire struck back. And fast. By the end of May 2014, the Delaware Corporate Council came up with a proposed bill to present to the Delaware legislature seeking to overrule *ATP* on the ground that the decision violated the most elemental of all corporate law principles—the principle of limited liability. The proposed statute expressly forbade any charter or bylaw of a stock corporation from "impos[ing] monetary liability, or responsibility for any debts of the corporation, on any stockholder of the corporation." The proponents of the legislation argued that the Delaware Supreme Court in *ATP* had suggested that a corporation could "expose stockholders to a wide variety of liabilities, including substantially greater liability than the cost of their investments." Perhaps revealing a broader agenda, the proponents warned menacingly that *ATP*'s "extension of the contract theory of corporate constitutional documents" could have "unforeseen consequences on capital formation." Yet, pulling a punch, the proponents simultaneously acknowledged that the Court's decision "made clear that enforcing such a bylaw would require equitable scrutiny, leaving a significant question as to the viability of such provisions if widely adopted."

Both the speed and the theory of that proposal was odd. It is an important part of the Delaware genius and DNA that resort to legislation is a sparingly used tool. It is reserved, typically, for relatively non-controversial fine tuning of the purposefully flexible and enabling corporation statute under which room for private ordering is a significant value. Even during the height of the takeover period, Delaware acted cautiously and eventually enacted legislation that left most of the heavy lifting to private ordering and judicial review. Likewise the legislative fix to the *Van Gorkom* decision (authorizing exculpation charter provisions) took some time even though the D&O insurance crisis triggered by the decision created by that decision was far more acute than the (phantom?) threat of *ATP*.

Pressing the legislative panic button should, at the least, be preceded by robust debate and sober recognition that legislative medicine may be more harmful than the illness, and much more difficult to undo. Turning over corporate law issues to a political process is risky business. Politics and corporate law don't always mix well. For some, Dodd-Frank might be exhibit A for the point. For others, the PSLRA.

Speed and process aside, those on the stockholder rights team who would rush to seek solution in the legislature might recall that nearly forty state legislatures have seen fit to pass constituent statutes permitting directors to base decisions on concerns other than, and in

some instances inimical to, stockholder value. These legislatures understand that the privilege of limited liability is bestowed by the state not only for one interest group—stockholders—but for the common good. And they also understand that the high-sounding rhetoric of stockholder rights and synergies and efficient use of assets masks an unattractive economic and political objective, not so easily squared with that common good: the loss of jobs.

Beyond that, the proposed legislation's premise of preserving limited liability is forced and unpersuasive. Fee-shifting bylaws may be many things but they do not impinge on that principle. What they do is disable one stockholder who has caused the corporation to incur costs from imposing those costs on all the other stockholders. It was rather ironic for proponents of stockholder-centric corporate governance to disenfranchise even their fellow stockholders from deciding to adopt any form of fee-shifting on the perplexing theory that fee-shifting violates stockholder immunity. Perhaps that theory was necessary as an excuse to prevent any private ordering, or to overcome the natural Delaware prejudice against the idea that in no circumstances can directors (or stockholders) do something not forbidden on its face by the corporate law.

Moreover, the push for that legislation was seen in many quarters as a thinly veiled attack on the "contract theory" of bylaws and charters, and hence an effort to limit the rights of Delaware directors and stockholders to corporate self-governance. And the effort to start down the road of one-size-fits-all was properly challenged by some as antithetical to a central premise of the Delaware long game: that Delaware with its enabling statute and special judiciary is able to address legitimate concerns in a contextual fact-specific way without resort to mandatory rules of prohibition or affirmation.

In all events, the proposed legislation died a sudden death. By the second week of June, action on the bill was postponed. The episode had the unfortunate consequence of nourishing press reports of corporate lawyers and plaintiffs' lawyer uniting to protect the "franchise" of unimpeded stockholder litigation in the Delaware courts. The Delaware legislature ultimately sent the matter back to the Delaware bar with a request that it examine not only fee-shifting but more generally the use of charter or bylaw provisions to affect "the conduct and the forum for litigation."

As part of the fallout, the usual governista suspects have put forward all manner of proposed legislative fixes. Proposals have been advanced to limit fee-shifting to post-IPO stockholder-approved provisions or to cut off the fee-shift at the motion to dismiss stage (with survival of the motion eliminating the risk). The mix-and-match possibilities are endless. No fee-shifting if a plaintiffs folds early (demonstrating restraint). No fee-shifting if a plaintiffs persists through discovery (demonstrating diligence). No fee-shifting if a plaintiff

agrees to mediation (demonstrating realism). No fee-shifting for low fees (demonstrating parsimony). No fee-shifting on the Sabbath (demonstrating piety)?

The SEC has even been blamed. The Alibaba IPO, the largest in years (albeit under Cayman law, not Delaware), came with an embedded fee-shifter in the corporate charter with no mention in the registration statement, and yet the SEC did nothing. Professor Coffee deemed this miss "equivalent to the Las Vegas bookies missing that one side in the Super Bowl had invoked a rule under which no penalties could be called against it." The Professor's conclusion: "The SEC's continuing passivity adds to the growing sense that it is not the agency it once was." (Presumably the Professor thinks that is a bad thing.) The Professor's solution: the SEC should announce that it will challenge "onerous fee-shifting provisions" as s step that will "chill interstate charter competition (and might even be welcomed in Delaware)." Indeed.

Big Money has weighed in. CII and a range of institutional investors have urged that Delaware adopt legislation to overturn or narrow *ATP* across the board, albeit without specifics. Warming up, the CII letter made the point that since 2011, 18 of 20 corporations in which management has proposed exclusive forum bylaws have seen stockholder approval, with the prospect being that fee-shifting will diminish the role of the Delaware judiciary. (No faith in the same judiciary to address the fee-shifting issue was visible.) Overheating, the institutional investor letter stated that not only Delaware's continued preeminence is at stake but also "the very underpinning of our publicly traded financial markets."

In our view, legislation is a bad idea whatever one thinks of the merits or demerits of any kind of fee-shifting. In addition to the concerns rehearsed above, legislation is a blunt instrument. It cannot distinguish good from bad or good from worse. There are doubtless untold, unknown variations on the fee-shifting theme. Left to develop over time, we think it certain that some species of fee-shifting will prove optimizing and be sustained and other species will prove welfare-destroying and be stricken. The only practical way to continue the tradition of private ordering, and incremental and contextual decision-making, is to trust the Delaware courts to do what they have always done: to distinguish the reasonable from the unreasonable, the legitimate from the illegitimate. This is the genius of the common law, and quite especially the genius of the Delaware courts.

There are certainly forms of fee-shifting that should not be worrisome and cannot fairly be though to threaten the republic. Now that the validity of exclusive forum bylaws has been established, there is no legitimate reason that the cost of having a suit brought in derogation of such a bylaw should be borne by all the stockholders. A fee-shifting bylaw might provide that the unsuccessful plaintiff be reimbursed if the stockholders voted to do so at the next

annual meeting. Perhaps fee-shifting could be in order when a would-be derivative plaintiff meritlessly alleges demand futility without even seeking recourse to books-and-records. No doubt other plainly abusive litigation can be and will be identified with sufficient precision to provide fair warning to would-be plaintiffs and their counsel and fair protection to stockholder from the needless cost of needless litigation.

There can be no doubt that the Delaware courts will be able to draft appropriate tools by which to measure fee-shifting bylaws and separate the good, the bad and the ugly. Doubtless the courts will give great weight to the potential input of any form of fee-shifting on stockholder access to the courts. *ATP* itself—as the proponents of the ill-fated initial legislative gambit recognized—full well recognized that equitable scrutiny is inherently a part of the analysis. Equitable scrutiny fits the task at hand in a way that legislative fiat cannot.

Nor do we perceive much force in the argument that no plaintiff lawyer could even bring suit to challenge a fee-shifting bylaw, lest the cost of defeat include the corporation's cost of defense (as if that were immutably a violation of the laws of physics). The courts can be trusted to prevent that Catch-22. Or a fee-shifting bylaw can provide that it does not apply to a suit challenging its efficacy (provided, of course, the suit is in the Delaware courts, and one test case is enough). Similarly, there is no real reason to fear provisions that fee shift unless the plaintiff is "substantially" successful; the courts certainly can prevent inequitable fee-shifting where the stockholder-plaintiff achieved a real result even if not everything prayed for.

In the final analysis, the poets seems to have it about right:

> *"You can't always get what you want*
>
> *But if you try sometime you just might find*
>
> *You get what you need."*

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