

EXPLANATION OF COUNCIL LEGISLATIVE PROPOSAL

The proposed legislation arises from the Delaware Supreme Court's May 8, 2014 decision in *ATP Tour Inc. v. Deutscher Tennis Bund, et al.*, 91 A.3d 554 (Del. 2014) ("*ATP*"). This memo describes the *ATP* decision, the opportunity that some perceive that it presents, some concerns the decision raises, and the proposed legislation's efforts to establish balanced corporate policy in light of these issues.

The ATP Decision

ATP is a Delaware nonstock membership corporation that operates the professional men's tennis tour internationally. German and Qatari ATP members brought suit in federal court. Their primary allegation was that decisions by ATP's board to downgrade and change the timing of certain tournaments violated federal antitrust laws. The plaintiffs, who had individually "agreed to be bound by ATP's Bylaws, as amended from time to time" when they became members of ATP, were not successful. ATP had a bylaw that provided in essence that if any member brought a lawsuit that did not substantially achieve "the full remedy sought," then the plaintiffs would be obligated to reimburse ATP for attorneys' fees and expenses incurred in the lawsuit. Based on that bylaw, ATP asked the federal court to order the plaintiffs to reimburse its attorneys' fees. The federal court asked the Delaware Supreme Court to answer four legal questions relevant to the decision on the fee application. In response, the Delaware Supreme Court opined that fee shifting bylaws are permissible under Delaware law, but their enforcement is subject to equitable review. The Supreme Court based its opinion on statutory interpretation, not an endorsement of fee shifting as a matter of corporate law policy.

Although there had been concern about the volume of stockholder litigation involving public companies, corporate practitioners and commentators had not proposed fee shifting bylaws or charter provisions as a remedy. In fact, in 1999, when a stockholder proposal sought a vote to adopt a fee-shifting bylaw in a publicly traded corporation, a leading law firm opined to the SEC that such a bylaw would contravene applicable law

and policy.¹ Almost immediately after *ATP*, however, it was widely suggested that stock corporations (rather than a nonstock corporation as involved in *ATP*) consider adopting such provisions. For example, in a letter to the General Assembly, the Chamber of Commerce identified fee-shifting provisions as a “new tool” that *ATP* provided for public companies.

The Benefit Some Commentators Perceive In Fee-Shifting Provisions For Public Companies

Under Delaware law, directors manage the business and affairs of the corporation, subject to the constraints of statutory law and fiduciary duty. Stockholders’ rights are limited but include the right to bring suit individually, as a group (a class action), or on behalf of the corporation (known as a derivative action), if directors are not honoring their legal or fiduciary obligations. Even though corporate managers seldom, if ever, believe that their conduct warrants legal action, class and derivative actions are widely recognized as important protections for stockholders, and critical to reducing investment risk and the cost of capital. See, e.g., *Agostino v. Hicks*, 845 A.2d 1110, 1116, (Del. Ch. 2004) (enforcement of fiduciary duties is important because “directors and officers of a corporation may not hold themselves accountable to the corporation for their own wrongdoing.”).

¹3Com Corp. No-Action Letter, 1999 SEC No-Act. LEXIS 595. The provision would have “require[d] any stockholder wishing to bring an action against 3Com or any 3Com officer to enter into an agreement reasonably satisfactory to 3Com providing that the losing party in the action pay the prevailing party’s attorneys’ fees and expenses incurred in the action.” Asserting that this provision “violates general principles of contract law” and “violates public policy,” counsel for the corporation argued:

Bylaws are fundamentally different from an agreement negotiated among contracting parties in that a majority of a company’s stockholders can amend the Bylaws without the consent of the other “contracting parties” to the Bylaws. It is true that this kind of arrangement could be (and frequently is) negotiated by the parties to a contractual arrangement (as is generally the case, for instance, in a registration rights agreement), but only with the initial consent of all parties involved. This initial consent is seldom truly obtained in the Bylaw context, since Bylaws, while binding upon a company and all its stockholders, are not usually negotiated and formally approved by all parties involved. Instead, a stockholder is deemed to be a party to the “contract” merely by virtue of ownership of shares in the company, without the opportunity to negotiate any of the Bylaws’ provisions. As a practical matter, all but the most sophisticated stockholders “signing” the Bylaw “contract” by buying 3Com stock will be unaware of the provision establishing the ability to amend the Bylaws without each stockholder’s consent. This important difference suggests that, notwithstanding some courts’ view of the ability of parties to a negotiated contract to enter into a fee-shifting arrangement in the securities litigation context, the absence of adequate notice and a requirement of individual consent should preclude enforceability of the arrangement where, as here, the “contract” involved is a company’s Bylaws.

Some officers and directors and their advocates assert, on the other hand, that stockholder litigation causes corporations expense without producing commensurate benefits. They have therefore welcomed the “new tool” *ATP* allegedly provides, because, as that opinion recognized, “fee-shifting provisions by their nature deter litigation.” Thus, those who believe that stockholder litigation is excessive and undesirable perceive *ATP*-type provisions in corporate charters and bylaws as a means to constrain or eliminate it. Since June, 2014, approximately 39 corporations, of which 30 are Delaware entities, have adopted bylaw or charter provisions that purport to shift counsel fees to less than fully successful stockholder litigants, and related provisions that purport to affect how stockholder claims are litigated.²

Fee-Shifting Provisions Will Make Stockholder Litigation, Even if Meritorious, Untenable.

Most litigation testing the propriety of conduct under either the DGCL or the common law of fiduciary duty is initiated by stockholders. The Council believes that absent legislation, many Delaware corporations will eventually adopt *ATP*-type provisions. The Council is not alone in this view: Professor John C. Coffee, Jr., who has often criticized stockholder litigation, has warned that the trend toward adopting fee-shifting provisions “is accelerating, and it resembles the first trickle of water through a leak in a dam. Soon the dam breaks, and a cascade descends upon those below. . . . This could quickly become part of the standard IPO game plan.” Harvey Pitt, a former chairman of the Securities and Exchange Commission, has said that fee shifting provisions could become the “corporate equivalent of the California Gold Rush. . . .”³

If such adoption became widespread, the effects on stockholder litigation would be severe. Every lawsuit is a risk; no one can confidently

² Allen, Claudia H., “Fee-Shifting Bylaws: Where Are We Now?,” Bloomberg Corporate Law & Accountability Report (January 16, 2015)..

³ Pitt, Harvey L., “Reducing Litigation Perils Fairly”, Bank and Corporate Governance Law Reporter 30, (January, 2015) [hereinafter, “Pitt”].

predict the outcome at the start. Moreover, virtually no lawsuits of any type substantially achieve in substance and amount the full remedy sought as the *ATP* bylaw contemplates. If fee shifting on such a broad basis is possible, even successful litigations could result in plaintiffs having to reimburse opponents' attorneys' fees. Because the consequences of any corporate decision affect investors only commensurately with the scope of their investments, few stockholders will rationally be able to accept the risk of exposure to millions of dollars in attorneys' fees to attempt to rectify a perceived corporate wrong, no matter how egregious.

Nor is it clear that this is a problem that can be solved through the courts. The *in terrorem* effect of fee shifting bylaws is self-enforcing: to even challenge the bylaw itself, a stockholder must risk paying uncapped legal fees of the corporation. In fact, at least one stockholder plaintiff has sought to dismiss its claim in the wake of a corporation's adoption of a fee-shifting bylaw.

The Problems That Open-Ended Use Of Fee-Shifting Provisions Would Create

1. Fee-shifting provisions will curtail the development of the common law of corporations

Delaware corporation law is built on two pillars: the Delaware General Corporation Law ("DGCL"), and the law of fiduciary duty. Statutory law provides a broadly enabling structure in which corporations can operate, but it cannot foresee every issue that may arise in the ongoing operation of the thousands of corporations that are a wealth-creating engine of the American economy. It has been the genius of the Delaware corporate legal structure that the law of fiduciary duty, administered on a case-by-case basis by the Delaware Court of Chancery and the Delaware Supreme Court, has over time filled in the legal gaps inevitably arising between the DGCL and the activities of the many corporations that have made Delaware their legal home.

Fiduciary duty law arises from the basic proposition that investors place their trust and confidence in the officers and directors who manage the

corporation. Corporate managers are not guarantors of business success, but must fulfill two basic responsibilities: a duty of care, that is to be adequately informed about business decisions they must make, and to act thoughtfully and deliberately; and the duty of loyalty, which the Supreme Court more than 75 years ago expressed with the following words: “Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. . . . The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.” *Guth v. Loft Inc.*, 5 A.2d 503, 510 (Del. 1939).

For more than a century, the primary contributor to Delaware’s national and international leadership in corporate law has been the Delaware courts’ thoughtful and nuanced application of these basic fiduciary principles to the ever-evolving business landscape. What Delaware has achieved is the most developed body of case law of fiduciary duty, to which courts in Delaware and many other states look for guidance to resolve business disputes.

Gap filling through judicial decisions is critical to corporate law. The DGCL does not even contemplate many tools that have become commonly used, such as poison pills, advance notice bylaws, or fiduciary outs in merger agreements. Yet each of these tools, and many other features of modern corporate life, is regulated by common law developed through stockholder litigation. While we do not all agree with the outcome of each case, few would argue that any negative consequences of the constraints imposed by this body of law outweigh the benefits to corporations and their stockholders. Indeed, we would argue that the careful balance that underlies this body of law is what has maintained Delaware as the preeminent choice for incorporation through financial crises, the takeover era of the 1980s and various movements towards federal incorporation.

2. The absence of stockholder litigation would eliminate the only extant regulation of substantive corporate law

In the United States, no government body regulates the relationship between stockholders and management. The federal government regulates disclosure and trading in securities, but not the relationship between directors and stockholders. Nor do the administrative branches of state governments generally regulate this relationship. Although this relationship involves trillions of dollars, disputes regarding it are essentially governed solely by the courts. While managements and boards generally act consistently with their statutory and fiduciary obligations, this is not always the case, and currently, the only method for policing perceived misconduct is stockholder litigation.

Without stockholder-initiated litigation, there would be essentially no effective enforcement mechanism for statutory or fiduciary obligations. As one leading corporate attorney recently noted: “fiduciary attacks on announced deals are now the primary vehicle through which the Court [of Chancery] develops the rules that govern director conduct and that provide transaction planners (and plaintiffs’ lawyers) the basis to plan (or attack) the next deal.”⁴ Permitting fee shifting as a limitation on stockholder litigation would be functionally equivalent to permitting corporate charter or bylaw provisions limiting or eliminating fiduciary duties of officers and directors. If investors were to perceive over time that statutory rights and fiduciary obligation had become hollow concepts, investors’ confidence could diminish, and capital formation could be adversely affected

Eventually, other regulators would likely feel compelled to step in. The federal government might perceive a need to occupy the field of corporate law in order to maintain this critical aspect of the national and world economy. Alternatively, states’ attorney generals might look for opportunities to fill the vacuum.

⁴ William Savitt, *The Genius of the Modern Chancery System*, 2012 COLUM. BUS. L. REV. 570, 571 (hereinafter “Savitt”).

The Problem Of Constraining Unproductive Stockholder Litigation

Advocates of *ATP*-type provisions argue that some, much, or most (depending on their perspective) of stockholder litigation lacks merit⁵ and does not produce sufficient benefit to warrant its costs. Opponents of stockholder litigation have noted the expense resulting from a practice that has increased in recent years of a number of stockholders bringing essentially the same type of case contemporaneously in two or more jurisdictions (the problem of multi-forum litigation). The question these concerns pose is how best to address them.

The fact that stockholder litigation can be detrimental as well as beneficial should not result in virtually precluding it, as fee-shifting provisions would. To use a well-worn metaphor, that would be throwing the baby out with the bath water. Less drastic means should be used to channel stockholder litigation constructively towards meritorious claims.

Legislation is a relatively blunt tool and not sufficiently flexible to permit case-by-case adjustments to differing situations. DGCL provisions are fixed until at least the next General Assembly session, and amending statutory provisions is not always simple. In its deliberations this summer and fall, the Council wrestled with many attempts to formulate language that would focus fee shifting only on cases of limited merit and have appropriate procedural protections for adoption (e.g., such that a majority stockholder could not insulate self-dealing by imposing an onerous fee shifting provision on minority stockholders). We ultimately concluded that these drafting efforts could not achieve the twin goals of permitting meritorious claims to proceed while constraining meritless actions.

Delaware courts, with their case-by-case, sophisticated approach to adjudication, are far better equipped to balance those goals, and they already have sufficient tools to address and deter litigation of limited merit. These tools include:

⁵ As Mr. Pitt has noted: “[T]here is a problem in attempting to discern which lawsuits are frivolous and which are not. Frivolousness, like beauty, is in the eye of the beholder. And, some cases said to be frivolous upon their institution turn out to be well-founded, while others, thought to be well-taken, turn out to be frivolous.” Pitt, p. 31.

1. Motions to dismiss, which enable the court to terminate litigation at the outset, before expensive discovery proceedings, where the complaint lacks merit on its face.

2. Rule 11, which permits a court to impose on a litigant and/or its counsel the litigation costs, including attorneys' fees, opponents incur when the litigant has brought claims without adequate investigation or legal analysis.

3. Judicially developed doctrines of fee shifting where the court finds that a litigant has conducted itself either before or during litigation in deliberate disregard of the legitimate interests of others.

4. Determining whether or not the plaintiff is an appropriate representative of other stockholders, which is often critical in litigation brought as class or derivative actions; courts can evaluate any number of factors to determine whether the litigant and its counsel are appropriately advancing the interests of the corporation and/or other stockholders in pursuing the litigation.

5. Disapproving settlements of class or derivative actions, including where the case lacked merit from the outset, or imposing limitations on settlement terms.

6. Determining whether and how much stockholder plaintiffs' attorneys will be paid; courts can limit or refuse compensation to counsel for stockholders for cases lacking merit.

Advocates for fee-shifting provisions in stock corporations argue that the resolution of any problems that fee shifting provisions create should be left to the courts. Ironically, that expressed confidence in the ability of courts to sort out permissible fee-shifting provisions from impermissible ones should also produce confidence that the courts can adequately address litigation abuse. However, charter and bylaw provisions that essentially eliminate litigation cannot be reconciled with the view that courts can and should be trusted to address real problems effectively when and if they arise on a case by case basis.

Delaware courts have already addressed the problem of multi-forum litigation, by validating bylaws that require stockholders of Delaware corporations to bring cases in Delaware courts. *Boilermakers Local 154 Retirement Fund v. Chevron Corporation*, 73 A.2d 934 (Del. Ch. 2013).⁶ The proposed legislation would give statutory force to the *Boilermakers* decision. Ultimately the significance of a venue provision like this in corporate charters and bylaws rests on the respect other courts will give it; statutory endorsement is intended to give other state and federal courts additional reason to honor such exclusive venue provisions.⁷ The Council believes that if a Delaware corporation wants to specify a venue for intracorporate actions, the choice of Delaware incorporation and resulting implicit choice of Delaware corporation law should result in a preference for Delaware courts to resolve disputes. To the extent the prevalence of multi-forum litigation has made Delaware courts reluctant to police stockholder litigation, this proposal's enhanced means to end the multi-forum litigation problem should increase judicial confidence to use the tools available to supervise stockholder litigation more effectively.

Finally, the proposed legislation does not deprive corporations of the ability to adopt other provisions that address unproductive stockholder litigation by means other than fee-shifting. The DGCL is broadly enabling and gives wide authority to boards – and stockholders – to adopt binding bylaws and charter provisions. *ATP* and the recent case law addressing forum selection have respected the broadly enabling nature of the DGCL and suggest that some litigation-regulating provisions may be facially valid. Of course, such provisions may not be enforceable if inequitable, as the Supreme Court noted in *ATP*, stating that “[b]ylaws that may otherwise be facially valid will not be enforced if adopted or used for an inequitable

⁶ There is evidence that the increasing use of exclusive forum provisions has already reduced the severity of the problem of multi-forum shareholder litigation. Olga Koumrian, Cornerstone Research, Shareholder Litigation Involving Acquisitions of Public Companies, Review of 2014 M&A Litigation (2015), at 3, available at <https://www.cornerstone.com/GetAttachment/897c61ef-bfde-46e6-a2b8-5f94906c6ee2/Shareholder-Litigation-Involving-Acquisitions-2014-Review.pdf>.

⁷ The proposed legislation would not address the validity of a bylaw specifying a non-Delaware venue, which the Court of Chancery found facially valid in *City of Providence v. First Citizens BancShares, Inc.*, 2014 WL 4409816 (Del. Ch. Sept. 8, 2014); the legislation would insist, however, that no such provision could preclude bringing intracorporate claims in Delaware courts as a venue. Notably, corporations will remain free not to have a venue provision at all.

purpose.” *Id.* Significantly, such enforceability can be tested in litigation because plaintiffs will be able to challenge such provisions without being subject to the risks inherent in fee-shifting.

A Note About Self Interest and Flexibility

We have considered criticism advanced last spring that this legislation is not motivated by policy concerns but is rather a protectionist act intended to enrich the members of the Council and their firms by invalidating measures that would significantly diminish litigation in Delaware. That criticism, of course, does not address the substance or merits of the issues; it is simply an assertion that whatever the Council does or does not recommend in relation to stockholder litigation is inherently tainted. In any event, we reject that criticism.

Those who have advanced that criticism have argued, and probably will argue, that other states may take steps to accommodate fee-shifting charter and bylaw provisions, and that businesses will therefore choose to incorporate in those other states, rather than in Delaware. That is indeed a risk, but recognizing that risk refutes the very criticism that the Council is acting out of self-interest.

Those who argue that the legislation is protectionist will also note that the DGCL is often praised for its flexibility, and that the inflexibility of the proposed legislation is counter to that tradition. This argument fails to recognize that while the DGCL and fiduciary law do provide remarkable flexibility, they also contain certain “bottom line” provisions that cannot be changed, such as information rights and the fiduciary duty of loyalty. No one seriously argues that the statute should be so flexible as to allow these to be eliminated. Yet fee-shifting is a backdoor method of doing exactly that.

There is also nothing unusual about tailoring the DGCL in light of market developments. Our courts must, as they did in *ATP*, respect the broadly enabling nature of the DGCL. Where, as here, the market begins to use the DGCL’s breadth in new ways, it is the General Assembly, not the courts, that should evaluate whether, on public policy grounds, the statute’s authorizing breadth should be narrowed. As to the subject of fee shifting

provisions in the context of stock corporations, particularly public ones, the Council believes that such tailoring is appropriate and consistent with tradition.

Critics of the legislation will also argue that the market can address these concerns—that is, that stockholders in the public markets currently exercise great power. They have been able to require companies to declassify their boards and take down other barriers to takeovers, for example. The extent to which adoption of fee-shifting provisions may prove to be tenable for large public companies is subject to debate, but there will be little constraint on adoption by many companies without significant market capitalization or with controlling stockholders, and fee shifting provisions will likely become common in the IPO market. Again, if the market really were a sufficient constraint, then that would be the case for all stockholder rights, including rights involving directors’ fiduciary duty of loyalty and information rights.

The Council believes that the long-term interests of the State and its corporate citizens are best served by a flexible structure with a few basic unalterable rights. Almost seventy years ago, a noted corporate law professor criticized Delaware as leading a “race to the bottom” in competition among states for corporate charters. Whatever merit that criticism had at the time, it can no longer be fairly asserted, and we should not reinvigorate it. As litigators and transactional counselors steeped in decades of practice of Delaware corporate law, the members of the Council endorse the position the General Assembly unanimously expressed last June: that we “strongly support a level playing field that provides the ability for stockholders and investors to seek relief on its merits in the Courts of this State and believe that a proliferation of broad fee-shifting bylaws for stock corporations will upset the careful balance that the State has strived to maintain between the interests of directors, officers, and controlling stockholders, and the interests of other stockholders.” We believe that increasing the use of exclusive forum provisions in certificates of incorporation and bylaws will enhance the ability of the Delaware courts to police stockholder litigation. We believe that if the view becomes widely held that the Delaware courts are incapable of exercising that policing

function appropriately – a result that we doubt will occur – those concerns should be addressed first to the courts, and only thereafter should legislation be considered to deal with the issue (just as we are concurrently addressing aspects of the appraisal litigation process).

We also believe that the market may continue to experiment with litigation-regulating bylaws that do not have the *in terrorem* effect of fee-shifting provisions, and that the courts will be able to develop an equitable jurisprudence that fairly regulates such provisions.

By proposing legislation that would limit *ATP* to its facts, the Council is seeking to preserve the tradition and status quo that preceded *ATP*, in which the courts, and not charter and bylaw provisions, control stockholder litigation and the allocation of litigation costs among the parties. That tradition has served the goals of wealth creation quite well over the years:

It is no exaggeration to say that the Court of Chancery is an invisible presence in every boardroom where a public company deal is being considered, silently promoting compliance with its refined standards of fiduciary conduct. This constitutes a remarkable regulatory achievement. It should be recognized and protected by confiding to Chancery the prerogative to manage the docket and ultimately the destiny of Delaware-law fiduciary duty litigation.⁸

In the view of the Council, there is no crisis, in litigation or elsewhere, which warrants upsetting tradition by intruding on the Court of Chancery’s “prerogative to manage the docket and ultimately the destiny of Delaware-law fiduciary duty litigation,” and ultimately encouraging other regulators to step in. We have steadfastly declined to permit the fiduciary duties of corporate directors to be limited or eliminated by charter or bylaw provision, and we believe that permitting fee-shifting provisions would give corporations the authority to achieve essentially the same result.

⁸ Savitt, at 601.