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THE FUTURE DIRECTION OF DELAWARE LAW

(INCLUDING A BRIEF EXEGESIS ON FEE SHIFTING BYLAWS)

J. ROBERT BROWN, JR.[†]

I. INTRODUCTION

The Online Law Review for the University of Denver will, for the third time, publish an entire issue of student papers on a common topic in the area of corporate law and governance. Past issues have involved discussions of the JOBS Act² and proxy plumbing issues.³ The third issue for the first time looks at topics under Delaware law.

Delaware sets the governance standards for most public companies.⁴ This has not always been the case. At the beginning of the 20th Century, other states such as New Jersey competed successfully for charters.⁵ Nonetheless, the title eventually shifted to Delaware, with other states providing no serious competition.⁶

The title brought financial benefits,⁷ something recognized overtly.⁸ As a result, changes to the corporate code reflected the influence of “pro-

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2. *Jobs Act Issue*, DULR ONLINE, (Apr. 27, 2013), <http://www.denverlawreview.org/jobs-act-feature>.

3. *“Proxy Plumbing” Issue*, DULR ONLINE, (Apr. 19, 2014), <http://www.denverlawreview.org/proxy-plumbing>.

4. Other states generally view Delaware law as persuasive. See J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L. REV. 317, 347 (2004) (“Delaware decisions interpreting management’s fiduciary obligations are widely followed by other states.”).

5. See Richard W. Jennings, *The Role of the States in Corporate Regulation and Investor Protection*, 23 LAW & CONTEMP. PROBS. 193, 195 n.9 (1958) (noting that New Jersey adopted the first “liberal” general incorporation statute in 1896).

6. As has long been recognized, “competition” in the area of corporate governance comes not from other states but from the federal government. See Ernest L. Folk, III, *Some Reflections of a Corporation Law Draftsman*, 42 CONN. BAR J. 409, 426 (1968) (stating as a prophecy the “shift to federal law administered through federal tribunals is a long-run secular trend, not likely to be altered”); see also *infra* note 72.

7. For a discussion of the financial benefits to Delaware, see J. Robert Brown, Jr. & Sandeep Gopalan, *Opting Only In: Contractarians, Waiver of Liability Provisions, and the Race to the Bottom*, 42 IND. L. REV. 285, 306 (2009).

8. When the legislature sought to create a committee to consider revisions to the state’s general corporation law in the 1960s, the resolution noted that “the favorable climate which the State of Delaware has traditionally provided for corporations has been a leading source of revenue for the State”. See *An Act Making an Appropriation to the Secretary of State for a Comprehensive Review and Study of the Corporation Laws of the State for the Preparation of a Report Containing Recommended Revisions of Such Laws for submission to the General Assembly*, 122nd General Assembly, Dec. 31, 1963, available at <http://delcode.delaware.gov/sessionlaws/ga122/chp218.shtml>. The

management corporation attorneys.”⁹ Measured by the number of public companies incorporated in the state, the approach proved highly successful. By 1971, more than 200 of the companies in the Fortune 500 were incorporated in the Delaware,¹⁰ a number that had increased to over 300 by 2014.¹¹

The ability to attract corporations could not be explained solely by the existence of a favorable statutory regime. Delaware was not invariably the first or the only state to implement management friendly provisions.¹² Given the interpretive gaps in the statute and the critical importance of the common law in the governance process, courts played an outsized role in setting legal standards.¹³ The management friendly nature of the Delaware courts contributed significantly to the state’s attraction to public corporations.¹⁴

Management friendly decisions generally divided into three categories, those that: (1) maximized board discretion; (2) minimized board liability; and (3) facilitated director retention.¹⁵ A current example of a management friendly trend in the case law had seen the recent decisions setting out the board’s authority to adopt bylaws under Section 109 of the Delaware General Corporation Law (DGCL), particularly those involv-

revisions are discussed in S. Samuel Arshat, *A History of Delaware Corporation Law*, 1 DEL. J. CORP. LAW 1, 14 (1976).

9. Ernest L. Folk, III, *Some Reflections of a Corporation Law Draftsman*, 42 CONN. BAR J. 409, 411 (1968) (noting that the Delaware code adopted in 1967 was drafted by a committee that “consisted chiefly of pro-management corporation attorneys”). This phenomenon is not limited to Delaware. See Elvin R. Latty, *Why Are Business Corporation Laws Largely “Enabling”?*, 50 CORNELL L. REV. 599, 616 (1965) (“But the personnel of the corporation law drafting committees in most states are usually identified psychologically with management.”).

10. See Ernest L. Folk, III, *Some Reflections of a Corporation Law Draftsman*, 42 CONN. BAR J. 409, 412 n.5 (1968) (noting that as of Jan. 1968, 203 of the corporations in the Fortune 500 were incorporated in Delaware).

11. See Christopher Wink, *64% of Fortune 500 firms are Delaware incorporations: here’s why*, TECHNICAL.LY DELAWARE, (Sept. 23, 2014), <http://technical.ly/delaware/2014/09/23/why-delaware-incorporation/>.

12. In the aftermath of the decision in *Van Gorkom*, Delaware authorized corporations to amend their certificate to eliminate liability for breaches of the duty of care. See J. Robert Brown, Jr. & Sandeep Gopalan, *Opting Only In: Contractarians, Waiver of Liability Provisions, and the Race to the Bottom*, 42 IND. L. REV. 285, 306 (2009). (Delaware was actually the second state to legislatively overturn the decision. Moreover, all states eventually followed suit.)

13. The fiduciary duties of directors are determined as a matter of common law. See *CA v. AFSCME Emps. Pension Plan*, 953 A.2d 227, 238 (Del. 2008).

14. William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L. J. 663, 690 (1974) (describing the courts as having a “laissez faire” attitude towards fiduciary duties and management’s responsibilities to shareholders); see also Gideon Mark, *Multijurisdictional M&A Litigation*, 40 J. CORP. L. 291, 320 (Winter 2015) (noting that Delaware is “widely regarded as management-friendly”). For a discussion of the management friendly evolution of corporate law doctrines by the Delaware courts, see J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L. REV. 317, 338-49 (2004).

15. See J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L. REV. 317, 331 (2004).

ing the shifting of fees in litigation against the corporation or its directors.¹⁶

II. FEE SHIFTING BYLAWS

A. *Bylaw Authority and the Board of Directors*

Section 109(a) of the DGCL gives shareholders the power to adopt bylaws.¹⁷ The board of directors may also do so if expressly permitted in the certificate.¹⁸ Delaware corporations universally accede to management the right to adopt bylaws.¹⁹ As a result, both groups can adopt, amend and repeal bylaws.

The DGCL allows bylaws that address “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.”²⁰ The broad parameters are, however, subject to limits. Bylaws cannot be inconsistent with the certificate of incorporation or “the law.”²¹ Law includes the common law.²²

The Delaware courts have used the limitations imposed by “the law” to severely restrict the reach of shareholder inspired bylaws. They have found limitations on this authority in both the DGCL and the common law. Under the DGCL, shareholders cannot adopt bylaws that interfere with the board’s statutory authority to manage the corporation;²³ under the common law, they cannot adopt bylaws that interfere with the

16. DEL. CODE ANN. tit. 8, § 109.

17. § 109(a)

18. *Id.* (“Notwithstanding the foregoing, any corporation may, in its certificate of incorporation, confer the power to adopt, amend or repeal bylaws upon the directors”).

19. *Klaassen v. Allegro Dev. Corp.*, C.A. No. 8626–VCL, 2013 WL 5967028 (Del. Ch. Nov. 7, 2013) (noting that such authority is “customarily given”).

20. *See* DEL. CODE ANN. tit. 8, § 109(b). The formulation is fundamentally different from the language in the Model Business Corporation Act (“MBCA”). The MBCA formulation makes no explicit mention of the rights of shareholders or directors. *See* MODEL BUS. CORP. ACT § 2.06(b) (2006) (“The bylaws of a corporation may contain any provision for managing the business and regulating the affairs of the corporation that is not inconsistent with law or the articles of incorporation.”). States that do mimic Delaware and include language with respect to shareholders and directors do not explicitly allow bylaws that apply to “employees.” *See* N.Y. BUS. CORP. ACT. LAW § 601(b) (2013) (bylaws may regulate the “rights or powers of its shareholders, directors or officers”).

21. DEL. CODE ANN. tit. 8, § 109(b)

22. *See* CA v. AFSCME Emps. Pension Plan, 953 A.2d 227, 238 (Del. 2008). *See also* Franz Mfg. Co. v. EAC Indus., 501 A.2d 401, 407 (Del. 1985) (“A bylaw that is inconsistent with any statute or rule of common law, however, is void”). The limitation is a longstanding one. *See* Klotz v. Pan-American Match Co., 108 N.E. 764, 221 Mass. 38, 43 (Mass. 1915) (“Undoubtedly a corporation may make reasonable regulations as to the time and manner of the inspection of its books by stockholders. But it cannot make a by-law which denies or unreasonably obstructs their common-law right.”)

23. *See* DEL. CODE ANN. tit. 8, § 141.

board's fiduciary obligations.²⁴ These limits cast doubt on bylaws that purport to impose mandatory obligations on the board.²⁵

The courts have not used the same principles to impose similar restraints on bylaws adopted by the board of directors. This can be seen with respect to bylaws that restrict or even eliminate the right of shareholders to bring actions against management and the corporation. Such rights sometimes arise under the DGCL but are also found in the common law.

Shareholders have a common law right to bring derivative actions.²⁶ In *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*,²⁷ the Chancery Court addressed a bylaw that designated Delaware as the "sole and exclusive forum" for such actions.²⁸ Because Section 109(b) authorized bylaws that governed the "rights" of shareholders, the court found the issue to be a matter of "easy linguistics" and upheld the provision. As for the unusual nature of a bylaw restricting access to judicial process, the opinion merely observed that "the Supreme Court [had] long ago rejected the position that board action should be invalidated or enjoined simply because it involves a novel use of statutory authority".²⁹

The analysis ignored any number of potential limitations on board authority with respect to forum selection bylaws. At a minimum, the limitation was inserted into the wrong document. Forum selection bylaws "limited" the rights of shareholders.³⁰ Under the DGCL, bylaws could address the "rights" of shareholders; limitations were to be included in the certificate.³¹ Moreover, the distinction had a compelling logic; limitations could only be imposed if first approved by shareholders.³²

24. See *AFSCME Emps.*, 953 A.2d at 239-40.

25. See Ben Walther, *Bylaw Governance*, 20 *FORDHAM J. CORP. & FIN. L.* 399, 432 (2015) (noting that the case "serves to invalidate any bylaws that are-- whatever their purpose--functionally controlling the board").

26. Derivative suits arose under principles of equity. See *Taormina v. Taormina Corp.*, 32 Del.Ch. 18, 78 A.2d 473, 475 (1951) ("[E]quity will permit a stockholder to sue in his own name for the benefit of the corporation solely for the purpose of preventing injustice when it is apparent that the corporation's rights would not be protected otherwise."). The legislature has adopted provisions that regulate derivative suits. See DEL. CODE ANN. tit. 8 § 327. Nonetheless, the courts have continued to treat these actions as a matter of common law. See *Schoon v. Smith*, 953 A.2d 196, 204 (Del. 2008) ("The equitable standing of a stockholder to bring a derivative action was judicially created but later restricted by a statutory requirement that a stockholder plaintiff must either have been a stockholder at the time of the transaction of which she complains or her stock must have devolved upon her thereafter by operation of law.").

27. 73 A.3d 934, 942 (Del. Ch. 2013).

28. In addition to derivative actions, the bylaw applied to claims for breach of fiduciary duty against "any director, officer or other employee", actions arising under the DGCL, and any claim "governed by the internal affairs doctrine." *Id.*

29. *Id.* at 953.

30. A limitation connotes a "restriction." BLACK'S LAW DICTIONARY 1012 (9th ed. 2009). Forcing shareholders to litigate in a specified forum falls within this definition.

31. DEL. CODE ANN. tit. 8, § 102(b)(1) (certificate of incorporation could include "[a]ny provision . . . limiting . . . the powers . . . of the stockholders").

32. See DEL. CODE ANN. tit. 8, § 242 (requiring stockholder approval of amendments to the certificate).

Chevron, however, eliminated the safeguard and allowed management to unilaterally adopt bylaws that restricted the ability of shareholders to select the relevant forum.

The bylaw also went beyond the language of Section 109(b). The provision applied to the rights of “shareholders.” Forum selection bylaws, however, controlled the choice of forum not only in derivative actions but also in class actions alleging breach of fiduciary duty.³³ Although at one time owning shares, plaintiffs in class actions no longer needed to retain their status as such.³⁴ Nonetheless, the bylaw at issue in *Chevron* facially applied to these former shareholders.

Most importantly, however, the court opened the door to the use of bylaws to regulate judicial process. The court in *CA* justified the position by treating the subject matter as an “internal affair” of the corporation,³⁵ a traditional limit on bylaws.³⁶ Inconsistent with the historical role of bylaws, the approach confused the substance of a claim with the process used to maintain an action.³⁷ The internal affairs doctrine was designed to protect directors and shareholders from conflicting duties and “competing demands.”³⁸ The doctrine avoided the result by providing a single source of

33. To bring a derivative action, plaintiffs must be shareholders at the time of the alleged wrong. See DEL. CODE ANN. tit. 8, § 327 (imposing contemporaneous ownership requirement on shareholder bringing derivative action). In addition, plaintiff must hold the shares through the date of final disposition. See *Ark. Teacher Ret. Sys. v. Countrywide Fin. Corp.*, 375 A.3d 888, 897 (Del. 2013) (noting that continuous ownership requirement “is settled Delaware law and has been consistently followed since 1984.”); *Ala. By-Products Corp. v. Cede & Co.*, 657 A.2d 254, 264 (Del. 1995) (“a plaintiff must also maintain his shareholder status throughout the derivative litigation.”).

34. See *Temple v. Combined Props. Corp.*, 410 A.2d 1375, 1376 (Del. Ch. 1979) (class action brought by “former stockholder”).

35. The opinion uses the phrase “internal affairs” thirty-three times.

36. See Samuel Willison, *History of the Law of Business Corporations before 1800*, 2 HARV. L. REV. 105, 122–23 (1888) (“But by the change in the conception of a corporation from an institution for special government to a simple instrumentality for carrying on a large business, the right to pass by-laws was restricted to regulations for the management of the corporate business.”); Judd F. Sneirson, *Green is Good: Sustainability, Profitability, and a New Paradigm for Corporate Governance*, 94 IOWA L. REV. 987, 996–97 (Mar. 2009) (“Bylaws govern a corporation’s internal affairs.”); JAMES D. COX & THOMAS LEE HAZEN, *TREATISE ON THE LAW OF CORPORATIONS*, 3d Ed. 2010 (“The bylaws establish rules for the internal governance of the corporation. Bylaws deal with such matters as how the corporation’s internal affairs are to be conducted by its officers, directors, and stockholders.”); see also Henry DuPont Ridgely, *Essay: The Emerging Role of Bylaws in Corporate Governance*, SMU CORPORATE COUNSEL SYMPOSIUM 4 (2015), http://www.delawarelitigation.com/files/2014/11/The_Emerging_Role_of_Bylaws_in_Corporate_Governance-copy.pdf (“As this early corporate history demonstrates, bylaws have long been needed to govern the manner in which an organization operates.”).

37. See *Corporations – Stockholders: Powers of Majority – Expulsion of Competing Shareholders By Amending By-Laws*, 33 HARV. L. REV. 979 (May 1920) (noting that “restrictions on the right of members to sue the corporation” have “uniformly been held invalid.”).

38. See *Edgar v. MITE Corp.*, 457 U.S. 624, 645 (1982) (“The internal affairs doctrine is a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation’s internal affairs—matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders—because otherwise a corporation could be faced with conflicting demands.”).

substantive law. Because other forums were required to apply the law of the state of incorporation, little risk existed of inconsistent substantive standards.³⁹ Forum selection bylaws were not, therefore, about ensuring legal uniformity but mandating a specific set of decision makers.

Chevron, therefore, dramatically increased the scope of bylaws adopted by the board of directors. Given the preponderance of businesses incorporated in Delaware and the management friendly nature of the courts, the rational also had the effect of validating bylaws that would ensure a greater role for Delaware in corporate litigation.⁴⁰ Nonetheless, the decision purported to limit the reach of bylaws to those governing a corporation's internal affairs. Moreover, the consequences of the bylaws were reduced by the role of foreign courts in their enforcement.⁴¹

B. ATP and Fee Shifting Bylaws

The restrictions on board adopted bylaws preserved in *Chevron* disappeared in *ATP Tour, Inc. v. Deutscher Tennis Bund*.⁴² In that case, the court addressed a certified question asking about the validity of fee shifting bylaws in the context of a non-stock company. The bylaw had little relationship to the internal affairs of the corporation. It applied not only to actions by owners but also to "prior" owners and third parties providing "substantial assistance" to, or having a financial interest in, a claim. The bylaw was not limited to derivative and other similar actions but extended to "any" claim. Indeed, the certified question came from a federal district court seeking to determine the applicability of the bylaw in the context of an antitrust claim. Finally, only the claiming party and

39. *Vantagepoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108, 1115 (Del. 2005) ("Applying Delaware's well-established choice-of-law rule—the internal affairs doctrine—the Court of Chancery recognized that Delaware courts must apply the law of the state of incorporation to issues involving corporate internal affairs, and that disputes concerning a shareholder's right to vote fall squarely within the purview of the internal affairs doctrine.").

40. See Anne M. Tucker, *The Short Road Home: Boilermakers Local 154 Retirement Fund v. Chevron*, 7 J. BUS. ENTREP. & L. 467, 483-84 (Spring 2014) ("The end result of *Chevron* and its supporting cases will be to concentrate corporate litigation in Delaware, which is not an unintended consequence."). The bylaws have apparently had this effect. See *Shareholder Litigation Involving Acquisitions of Public Companies: Review of 2014 M&A Litigation*, CORNERSTONE RESEARCH 3 (2014), available at <https://www.cornerstone.com/GetAttachment/897c61ef-bfde-46e6-a2b8-5f94906c6ee2/Shareholder-Litigation-Involving-Acquisitions-2014-Review.pdf> ("For acquisitions of Delaware-incorporated companies, the Delaware Court of Chancery gained ground as a filing destination, likely reflecting the choice of this court as the exclusive litigation forum.").

41. The enforcement of these bylaws has been mixed. The decisions in this area are discussed in one of the articles in this issue. See Patrick J. Rohl, *The Reassertion of the Primacy of Delaware and Forum Selection Bylaws*, 92 DENV. U. L. REV. ONLINE 143 (2015).

42. 91 A.3d 554 (Del. 2014).

not the company was at risk for fee shifting and could be liable in some cases even if successful on the merits.⁴³

In a brief and shockingly cursory discussion,⁴⁴ the decision upheld the bylaw as facially valid.⁴⁵ The court noted the absence of any explicit limitation on fee shifting bylaws in the DGCL⁴⁶ and concluded that the allocation of “risk among parties in intra-corporate litigation would . . . appear to satisfy” Section 109.⁴⁷ Moreover, characterizing bylaws as contractual, the court determined that fee shifting bylaws were affirmatively permitted.⁴⁸

The decision ignored a number of obvious legal infirmities. First, unlike *Chevron*, the bylaw at issue was not limited to matters affecting the entity’s internal affairs. The bylaw on its face extended to any claim, something that could include not only those under the antitrust laws but also the federal securities laws.⁴⁹ Likewise, the obligation in the DGCL to include “limits” on shareholder rights in the certificate was all but ignored.⁵⁰ The bylaw also extended to persons who never owned shares.⁵¹ The interpretation, therefore, completely unmoored bylaws from the language of the DGCL.

The decision also did not take into account the one-sided nature of the bylaw. The provision shifted fees where owners failed to substantial-

43. The bylaw shifted fees unless the claiming party “substantially achieve[d]” the “full remedy sought.” *Id.* at 559–60.

44. The opinion consisted of a meager 2835 words. Compare that with the more recent decision in *C&J Energy*, a case in which the court dedicated 13,706 words to an analysis of a board’s “*Revlon* duties.” *C&J Energy Servs. Inc., v. City of Miami Gen. Emps.*, 107 A.3d 1049 (Del. 2014).

45. The operative analysis consisted of four sentences and two footnotes. The court cited no cases, treatises, or other authority in the one paragraph discussion.

46. See *ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554, 558 (Del. 2014) (“Neither the DGCL nor any other Delaware statute forbids the enactment of fee-shifting bylaws.”).

47. See DEL. CODE ANN. tit. 8, § 109(b) (“The bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating 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.”).

48. See *ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554, 558 (Del. 2014) (“But it is settled that contracting parties may agree to modify the American Rule and obligate the losing party to pay the prevailing party’s fees. Because corporate bylaws are ‘contracts among a corporation’s shareholders,’ a fee-shifting provision contained in a nonstock corporation’s validly-enacted bylaw would fall within the contractual exception to the American Rule.”).

49. To the extent applicable to claims under the federal securities laws, the provision had the capacity to treat differently different classes of plaintiffs injured by the same fraud. The bylaw presumably shifted fees where actions were brought by shareholders. Fraud actions under the securities laws are not, however, limited to classes of shareholders. See James J. Park, *Bondholders and Securities Class Actions*, 99 MINN. L. REV. 585 (Dec. 2014).

50. Limits in turn were required to be in the charter. See DEL. CODE ANN. tit. 8, § 102(b)(1). The court was aware of the legislative mandate but chose to disregard it. See *ATP Tour*, 91 A.3d at 558 (“The corporate charter could permit fee-shifting provisions, either explicitly or implicitly by silence.”).

51. See DEL. CODE ANN. tit. 8, § 109(b) (allowing bylaws that governed the “rights” of shareholders). See also *Vantagepoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108, 1113 (Del. 2005) (“The internal affairs doctrine applies to those matters that pertain to the relationships among or between the corporation and its officers, directors, and shareholders.”),

ly achieve the requested remedy but did not impose similar obligations on the company.⁵² The unequal application arguably rendered the bylaw inequitable on its face.⁵³

Finally, the court did adequately address the requirement in Section 109(b) that bylaws be consistent with “the law.” The decision obliquely acknowledged that the provisions would “by their nature, deter litigation” but otherwise made no effort to assess the impact of this deterrence on shareholders causes of action.⁵⁴ Indeed, the court affirmatively minimized the concern, emphasizing that the “intent to deter litigation . . . [was] not invariably an improper purpose.”⁵⁵

The provision in fact had the practical effect of restricting, if not eliminating, litigation rights granted by the DGCL and the common law. To the extent applicable to the exercise of inspection rights, fee shifting bylaws had the capacity to prevent shareholders from obtaining access to corporate books and records,⁵⁶ a basis for invalidating bylaws in other circumstances.⁵⁷ Likewise, to the extent applicable to suits seeking a judicial determination of fair value, fee shifting bylaws had the ability to deny shareholders their statutory right to appraisal.⁵⁸ Likewise, the bylaws threatened to curtail direct claims involving common law duties.⁵⁹

Perhaps most significantly, however, the bylaws significantly limited common law rights of shareholders to bring actions against the corporation and the board.⁶⁰ Given the high dismissal rates for these ac-

52. See John C. Coffee, Jr., *Fee-Shifting and the SEC: Does It Still Believe in Private Enforcement?*, Columbia Blue Sky Reporter (Oct. 14, 2014), <http://clsbluesky.law.columbia.edu/2014/10/14/fee-shifting-and-the-sec-does-it-still-believe-in-private-enforcement/> (noting that fee shifting bylaws were “one-sided; that is, a defendant who loses does not pay the successful plaintiff’s fees and expenses.”).

53. *ATP* acknowledged that a facially valid bylaw could be facially invalidated as inequitable. See *ATP*, 91 A.3d at 558 (“Whether the specific ATP fee-shifting bylaw is enforceable, however, depends on the manner in which it was adopted and the circumstances under which it was invoked. Bylaws that may otherwise be facially valid will not be enforced if adopted or used for an inequitable purpose.”).

54. *Id.* at 560.

55. *Id.*

56. See DEL. CODE ANN. tit. 8, § 220. The provision allows shareholders denied a right to inspect to bring an action in the Chancery Court “for an order to compel such inspection.” *Id.* Actions to appraise the value of shares are “in the nature of the class action.” *Ala. By-Products Corp. v. Cede & Co.*, 657 A.2d 254, 260 (Del. 1995).

57. See *Loew’s Theatres, Inc. v. Commercial Credit Co.*, 243 A.2d 78, 81 (Del. Ch. 1968) (“Section 220 gives ‘any’ stockholder a ‘right’ to inspect a list of stockholders. It follows that Commercial Credit’s certificate of incorporation limiting inspection to a person or persons holding 25% of the outstanding stock is void.”).

58. See DEL. CODE ANN. tit. 8, § 262. Appraisal right actions are discussed in this issue. See Jennifer McLellan, *An Appraisal of Appraisal Rights in Delaware*, 92 DENV. U. L. REV. ONLINE 109 (2015).

59. See *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1033 (Del.2004) (setting out standards for differentiating direct and derivative claims).

60. Courts have created a number of actions under the common law. In addition to derivative actions, they include quasi appraisal action. See *Berger v. Pubco Corp.*, 976 A.2d 132, 134 (Del. 2009).

tions,⁶¹ fee shifting bylaws imposed a meaningful risk of liability on plaintiffs.⁶² Moreover, because judgments in derivative suits were paid to the corporation, shareholders serving as plaintiffs confronted the risk of liability without any offsetting direct benefit. By preventing suits in this area, the bylaw effectively insulated the behavior of boards from legal challenge.

This effect was not lost on the Corporation Law Council, a committee of the Delaware State Bar Association, when drafting legislation designed to address fee shifting provisions. As the accompanying commentary noted:

The purpose and effect of these provisions is to significantly, if not completely, deter the enforcement of stockholder protections. Stockholder suits are generally brought by one or more stockholders on behalf of, or to benefit, many stockholders. Very few, if any, stockholders will be willing to risk individually paying the corporation's legal fees on behalf of other stockholders. Accordingly, fee-shifting effectively eliminates stockholder rights, because stockholder litigation is the only method of enforcing them. This would be a radical change in the corporate landscape.⁶³

The view was also supported by the actual behavior of counsel in litigation implicating fee shifting bylaws.⁶⁴ Moreover, the risk was exacerbated

61. Comprehensive data in this area is not easy to find. Nonetheless, dismissals in derivative suits are common. See Jessica Erickson, *Corporate Governance in the Courtroom: An Empirical Analysis*, 51 WM. & MARY L. REV. 1749, 1789 (2010) ("An additional 43 percent of the resolved suits (73 out of 170) in my study were involuntarily dismissed by the court. These involuntary dismissals almost always turned on procedural grounds, rather than the merits of the derivative plaintiff's claims."). The same is true with respect to actions brought under the federal securities laws. See Dr. Renzo Comolli & Svetlana Starykh, *Recent Trends in Securities Class Action Litigation: 2013 Full-Year Review*, NERA, January 21, 2014, available at http://www.nera.com/content/dam/nera/publications/archive2/PUB_2013_Year_End_Trends_1.2014.pdf ("Out of the motions to dismiss for which a court decision was reached, the following three outcomes account for the vast majority of the decisions: granted (48%), 10 granted in part and denied in part (25%), and denied (21%)."). These statistics understate the risks. Under the typical fee shifting bylaw, shareholders are required to pay fees where they do not "substantially achieve" the remedy sought. Even if the case is not dismissed, therefore, they may be required to pay the fees of the defendants.

62. Derivative actions are a matter of common law. See *supra* note 27. So are actions under the federal securities laws. See A.C. Pritchard, *Justice Lewis F. Powell, Jr., and the Counterrevolution in the Federal Securities Laws*, 52 DUKE L.J. 841, 865 (2003) (Justice Powell describing law under Rule 10b-5 as "a species of federal common law").

63. Fee-Shifting FAQs 2, <http://www.law.du.edu/documents/corporate-governance/legislation/delaware-stat-revisions/Council-Second-Proposal-FAQs-3-6-15.pdf>.

64. *Strougo v. Hollander*, C.A. No. 9770-CB, 2015 WL 1189610, at *4 n.19 (Del. Ch. Mar. 16, 2015) ("Tellingly, in the only other case in this Court of which I am aware in which a non-reciprocal fee-shifting bylaw has been the subject of litigation, the stockholder plaintiff moved to invalidate the fee-shifting bylaw or, alternatively, to dismiss the action and to permit plaintiff's counsel to withdraw."); see also Transcript, *Kastis v. Carter*, No. 8657, Del. Ch., Aug. 22, 2014, at 17 ("if a bylaw may apply to these plaintiffs, they cannot -- and virtually no stockholder can [maintain an action], particularly in a derivative case. You have no direct interest in any recovery and your indirect interest is going to be minimal."). The transcript is available here: <http://www.law.du.edu/documents/corporate-governance/governance-cases/kastis/Transcript-Discussing-Amendment-to-Bylaw-Kastis-v-Carter-Case-No-8657-CB-Aug-15-2014.pdf>

ed by the substantial fees charged by counsel in defending these actions.⁶⁵

C. Consequences

The *ATP* decision was poorly reasoned and overstepped acceptable boundaries. The management friendly decision threatened the preeminent role of Delaware in the development of corporate law. The decision raised the specter of federal intervention and the potential for meaningful competition from the states.

By allowing bylaws unmoored from a corporation's internal affairs, the *ATP* court effectively invited other states to adopt alternative, even conflicting, approaches. They could implement provisions that invalidated the bylaws by extending to the courts the exclusive authority to award fees,⁶⁶ an approach taken in Section 11(e) of the Securities Act of 1933.⁶⁷ Such an approach would provide shareholders with an incentive to bring actions in these jurisdictions, diminishing the role of the Delaware courts.

An indication of the questionable reasoning could be seen from the negative response to the *ATP* decision. Almost immediately, lower courts began to restrict its reach. In *Strougo v. Hollander*, the court considered a fee shifting bylaw adopted after the plaintiffs ceased to be shareholders.⁶⁸ The decision expressed concern with fee shifting bylaws, noting that they raised "serious policy questions" as to whether "it would be statutorily permissible and/or equitable to adopt bylaws that functionally deprive stockholders of an important right: the right to sue to vindicate their interests as stockholders."⁶⁹ In the end, however, the court invalidated the bylaw on narrow grounds, concluding that, under Section 109, the board lacked the authority to bind persons who had ceased to be

65. For a discussion of "skyrocketing" defense costs in securities class action law suits, see Douglas W. Greene, *The Root Cause of Skyrocketing Securities Class Action Defense Costs*, LANE POWELL, <http://www.dandodiscourse.com/2014/09/09/the-root-cause-of-skyrocketing-securities-class-action-defense-costs/>

66. Oklahoma put in place a statutory provision that required fee shifting for both domestic and foreign companies in certain circumstances. See OKLA. STAT. tit. 18, § 1126(C). For a discussion of the provision, see J. Robert Brown, Jr., *Fee Shifting in Derivative Suits and the Oklahoma Legislature*, THE RACE TO THE BOTTOM BLOG (Sept. 24, 2014), <http://www.theracetothetbottom.org/home/fee-shifting-in-derivative-suits-and-the-oklahoma-legislatur.html>

67. 15 U.S.C § 77k(e) (2012) (authorizing the court to "require an undertaking for the payment" of costs "including reasonable attorney's fees" where "the court believes the suit or the defense to have been without merit"). The provision was designed to deter "frivolous" litigation, a very different standard from the one appearing in the typical fee shifting bylaws. See Friedman v. Ganassi, 853 F.2d 207, 211 (3rd Cir. 1988).

68. *Strougo*, 2015 WL 1189610, at *1.

69. *Id.* at *4.

shareholders at the time of bylaw's adoption,⁷⁰ an analysis with potentially broad implications.⁷¹

The possibility of federal intervention also became more concrete.⁷² The Securities and Exchange Commission (SEC) expressed concerns over the impact of the bylaws on securities actions. Hearings on the matter were held before the Investor Advisory Committee at the SEC.⁷³ Likewise, the Chair of the agency gave a speech indicating that the staff was keeping a "close-eye" on the bylaws.⁷⁴ Some in Congress pushed the Commission to act on these provisions.⁷⁵

Perhaps most noticeably, legislation was drafted to prohibit fee shifting provisions by for-profit companies.⁷⁶ The Corporation Law

70. *Id.* (finding that section 109(b) did "not authorize the adoption of bylaws to regulate the rights or powers of former stockholders whose interests in the corporation already have been eliminated."). The court also relied on contract principles. *Id.* ("I conclude based on principles of contract law that the Bylaw does not apply to this case because it was adopted after the plaintiff was cashed out of the Company by operation of the Reverse Stock Split. More specifically, I hold that changes made to the Company's bylaws after the plaintiff was cashed out are not binding on him for the same reason that a non-party to a contract is not bound by the terms of that contract."); *see also* Cobb v. Ironwood Country Club, C.A. No.G050446, 2015 WL 358794, at *6 (Cal. App. 4th. Jan. 28, 2015) (bylaw not applicable to *former* members).

71. The reasoning could also apply to any other party who never attained the status of shareholder, including beneficial owners. Although beneficial owners have some statutory rights in Delaware, the courts do not recognize them as shareholders. *See* Licht v. Storage Tech. Corp., CA No. 524-N, 2015 WL 1252355, at *5 n.29 (Del. Ch. May 6, 2005) ("The brokers hold legal title, as the owners of record, and, as far as the corporation is concerned as a matter of Delaware law . . . they have the legal authority to vote the shares in person or by proxy. The stock exchanges, however, have rules that govern the relationship, for these purposes, between the brokers, as record owners, and their customers (the shareholders), as **beneficial owners.**").

72. *See* Explanation of Council Legislative Proposal, *available at* <http://www.law.du.edu/index.php/corporate-governance/legislation/delaware-statutory-revisions-legislative-history> ("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.").

73. *See* Agenda: October 9, 2014, Meeting of the Securities and Exchange Commission Investor Advisory Committee, U.S. SEC. & EXCHANGE COMMISSION, <https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac100914-agenda.htm> The IAC was authorized in Dodd-Frank. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 911, *available at* <http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf>.

74. *See* Chair Mary Jo White, *A Few Observations on Shareholders in 2015*, Tulane University Law School 27th Annual Corporate Law Institute (Mar. 19, 2015) ("Our staff is thus keeping a very close eye on the evolving developments [on fee shifting bylaws], and I am too."), *available at* <http://www.sec.gov/news/speech/observations-on-shareholders-2015.html>.

75. *See* Letter from Senator Blumenthal to Chair White, Secs. & Exch. Comm'n (Oct. 30, 2014), *available at* <http://www.blumenthal.senate.gov/newsroom/press/release/blumenthal-calls-on-sec-to-protect-critical-check-on-corporate-malfeasance>.

76. Efforts were made to amend the Delaware law in the immediate aftermath of the ATP decision. The efforts, however, were unsuccessful when opponents to the changes sought delay. *See Delaware Legislature Delays Anti-Fee-Shifting Legislation*, U.S. CHAMBER INSTITUTE FOR LEGAL REFORM (June 20, 2014), <http://www.instituteforlegalreform.com/resource/delaware-legislature-delays-anti-fee-shifting-legislation/>; *see also* S. Res. 12, 147th Sess. (Del. 2014) (resolution calling for "continued examination" of fee shifting bylaws), *available at* <http://legis.delaware.gov/LIS/lis147.nsf/vwlegislation/29B3C3E91094EE3B85257CFB005ADE25>. The resolution is available at [http://legis.delaware.gov/LIS/lis147.nsf/vwLegislation/SJR+12/\\$file/legis.html?open](http://legis.delaware.gov/LIS/lis147.nsf/vwLegislation/SJR+12/$file/legis.html?open)

Council developed proposed amendments to the DGCL that, by the spring of 2014, had been approved by the state's bar association and was expected to be introduced in the legislature. The draft legislation provided that neither the certificate nor the bylaws could include provisions that imposed "liability on a stockholder for the attorneys' fees or expenses of the corporation or any other party in connection with an intracorporate claim".⁷⁷ Intracorporate disputes included any claims, including claims in the right of the corporation, (i) that are based upon a violation of a duty by a current or former director or officer or stockholder in such capacity, or (ii) as to which this title confers jurisdiction upon the Court of Chancery."⁷⁸

Applying only to "intracorporate" disputes, the proposed legislation did not, on its face, preclude fee shifting provisions in the context of actions brought under the federal securities laws. At least one commentator has asserted that the oversight may have been deliberate.⁷⁹ A more likely explanation, however, is that Section 109 does not apply to "external" actions, including those brought under the federal securities laws. As a result, any explicit language addressing actions under the securities laws would be superfluous. Moreover, affirmative language would suggest that, in fact, Delaware had jurisdiction over federal causes of action, a dubious proposition.

D. Observations

The ATP Court confronted a bylaw that effectively restricted if not eliminated owner instigated litigation against the corporation. The poverty of the analysis reflects a misreading of the relevant provisions under Delaware law. Because the opinion examined the bylaw in the context of non-stock companies, the reasoning may remain applicable only to those entities and never make the leap to for-profit stock corporations.⁸⁰

77. For a draft of the proposed legislation, go here: <http://www.law.du.edu/index.php/corporate-governance/legislation/delaware-statutory-revisions-legislative-history>. See also Fee-Shifting FAQs, *supra* note 62, at 3 ("If the ability of stockholders to bring lawsuits were seriously curtailed by fee-shifting provisions, a regulator is quite likely to fill the void--perhaps the federal government. In the long term, this would likely be a much more costly (and less effective) method of overseeing this relationship than the current lawsuit-based system.").

78. The proposed legislation was not, however, intended "to prevent the application of such provisions pursuant to a stockholders agreement or other writing signed by the stockholder against whom the provision is to be enforced." *Id.*

79. See John C. Coffee, Jr., *Delaware Throws a Curveball*, THE CLS BLUE SKY BLOG (Mar. 16, 2015), <http://clsbluesky.law.columbia.edu/2015/03/16/delaware-throws-a-curveball/> ("Was this an unintentional oversight made somehow by skillful lawyers? Possibly, but that 22 member Corporation Law Council is not staffed with dummies . . . we need to consider the alternative possibility: namely that they deliberately wrote it narrowly.").

80. Indeed, a majority of the Justices on the court at the time of the decision indicated either that the rational might not apply to public companies or, at least, that the issue was an open one. See *Ridgely*, *supra* note 36, at 19 ("Since the court's decision in ATP Tour, a number of commentators have assumed that it applies equally to for-profit, stock corporations. The Delaware Supreme Court did not say that in ATP Tour, so this remains an open question."); Cindy Posner, *A little inside scoop in the ATP fee-shifting bylaws case*, PUBCO@COOLEY (Nov. 7, 2014),

Nonetheless, the analysis reflects a management friendly approach that does not adequately take into account the impact of the provision on the rights of shareholders.

IV. STUDENT PAPERS

In this issue, students have explored in pithy but thorough papers assorted issues under Delaware law. The papers address a myriad of subjects, not all of which can be fairly characterized as management friendly. In this issue:

Robin Alexander has written an article on director independence, particularly the cases that address the impact of business and personal relationships. *See* [Director Independence and the Impact of Business and Personal Relationships](#).

Riley J. Combelic has written an article that focuses on the obligations of the board of directors in connection with the selection and oversight of financial advisors. *See* [Rural Metro Corp and Ensuring Fairness in a Fairness Opinion](#).

Charles Gass has looked at the development of the doctrine of waste, the safety value that allows actions even for board decisions that fall within the business judgment rule. *See* [Outer Limits: Fiduciary Duties and the Doctrine of Waste](#).

Jennifer McLellan has written an article on appraisal rights and the multiple tests used by the courts in assessing share valuation. *See* [An Appraisal of Appraisal Rights in Delaware](#).

Gabrielle Palmer has examined the right of shareholders to inspect corporate records in the context of socially responsible activity. *See* [Stockholder Inspection Rights and an “Incredible” Basis: Seeking Disclosure Related to Corporate Social Responsibility](#).

Patrick J. Rohl has tackled the development of forum selection bylaws. *See* [The Reassertion of the Primacy of Delaware and Forum Selection Bylaws](#).

<http://cooleypubco.com/2014/11/07/a-little-inside-scoop-in-the-atp-fee-shifting-bylaws-case/> (“The former Justice [Jacobs] indicated (and please recognize that below is just a summary paraphrase of some of his comments as I heard them) that he was surprised that many counsel assumed that the holding in the case would be applied in the larger public company context. The court, he said, had viewed ATP (a non-stock entity) to be similar to a private club or closely held corporation; the types of bylaw arrangements that may be upheld as valid in that context might not necessarily be viewed as valid and appropriate for large public companies.”); Michael Greene, *Delaware Supreme Court’s Chief Justice Voices Support for Fee-Shifting Limitation*, BLOOMBERGBNA (Apr. 3, 2015), <http://www.bna.com/delaware-supreme-courts-n17179924991/> (“I [Chief Justice Strine] never contemplated fee-shifting in a public company context. It is something that never really occurred to me,” he said. While Strine said that in the context of member corporations a fee-shifting provision could make a lot of sense, such provisions do not make sense for public companies to adopt.”).