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Staying in the Delaware Corporate Governance Lane:
Fee Shifting Bylaws and a Legislative Reaffirmation of the Rules of the Road

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On May 12, 2015, the Delaware State Senate passed Senate Bill No. 75.² The bill, if it becomes law, would amend Section 102 of the Delaware General Corporation Law (DGCL) to prohibit the certificate of incorporation from containing “any provision that would impose liability on a stockholder for the attorneys’ fees or expenses of the corporation or any other party in connection with an internal corporate claim. . . ”³ Similar language would apply to bylaws adopted under Section 109(b) of the DGCL.⁴

The legislation bars fee shifting provisions in the context of “internal corporate claims.” These include derivative and other claims “(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.”⁵ The language, therefore, applies to challenges premised on a breach of a board’s fiduciary obligations and claims arising under Title 8 of the Delaware Code, a title that includes the DGCL.

The ban does not, however, explicitly extend to other types of actions. Claims brought under the federal securities laws, although often brought by shareholders (or former shareholders), can⁶ but may not always⁷ be predicated upon a breach of duty by officers and

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⁵ Senate Bill No. 75.
⁶ As the Supreme Court has noted, “[s]ilence, absent a duty to disclose, is not misleading under Rule 10b-5.” Basic v. Levinson, 485 US 224, 239 n. 17 (1988). As a result, actions under the securities fraud provisions are often predicated upon a breach of a duty.
⁷ Actions alleging false disclosure under the antifraud provisions of the securities laws are often brought against the corporation. See Matrixx Initiatives v. Siracusano, 131 S.Ct. 1309 (2011). Nonetheless, such

directors. At least one commentator has raised the possibility that this “oversight” may have been deliberate.8

There is, however, a more likely explanation. The authority granted to corporations in Sections 102 and 109 of the DGCL was not intended to, and does not reach beyond, “internal corporate claims.”9 Extending the ban on fee shifting provisions to other types of actions is, therefore, unnecessary.

This interpretation is apparent from language in the two sections prohibiting bylaws and certificate provisions that are contrary to, or inconsistent with, “the law”10 and from the consequences that would arise from a different reading of the DGCL.11

First, to the extent allowing bylaws and certificate provisions that restrict federal causes of action, issues of preemption and enforceability would arise.12 Courts generally do not apply state imposed restrictions in claims arising from federally created rights.13 Thus, in actions seeking enforcement of the securities laws, courts have refused to apply state law claims also typically involve allegations against individuals, particularly officers and directors. See id. at 1313 (“Respondents, plaintiffs in a securities fraud class action, allege that petitioners, Matrixx Initiatives, Inc., and three of its executives . . . failed to disclose reports of a possible link between its leading product, a cold remedy, and loss of smell, rendering statements made by Matrixx misleading.”). The ban on fee shifting bylaws may well apply in these types of actions.

8 See John C. Coffee, Delaware Throws a Curveball, The CLS Blue Sky Blog (Mar. 16, 2015), http://clsbluesky.law.columbia.edu/2015/03/16/delaware-throws-a-curveball (“Before we assume that the narrow phrasing of Sections 102 and 109 was an oversight by the Corporation Law Council, we need to consider the alternative possibility: namely, that they deliberately wrote it narrowly. Why? This is speculative and may sound cynical, but the Corporation Law Council may have wanted to cover only traditional ‘Delaware-style’ litigation”).

9 As the courts in Delaware have recognized, actions under the antifraud provisions of the federal securities laws are very different from internal corporate claims. See In re Activision Blizzard, Inc. Stockholder Litigation, C.A. No. 8885-VCL (Del. Ch. May 20, 2015) (“A Rule 10b-5 claim under the federal securities laws is a personal claim akin to a tort claim for fraud. The right to bring a Rule 10b-5 claim is not a property right associated with shares, nor can it be invoked by those who simply hold shares of stock.”). Whether Sections 102 and 109 were intended to permit provisions that restricted shareholder access to the courts is another question beyond the scope of this piece. 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.”).

10 Section 109(b) allows bylaws that are not “inconsistent with the law.” tit. 8 § 109(b). Section 102(b) allows provisions in the certificate that are “not contrary to the laws of this State.” Tit. 8 §102(b).


12 See Coffee, supra note 8 (discussing the possibility of preemption).

13 See CILP Associates LP v. PriceWaterhouse Cooper, LLP, 735 F.3d 114, 122 (2nd Cir. 2013) (“Whether a party has standing to assert claims under Section 10(b) is a question of federal law.”).
provisions that limit standing to record, rather than beneficial, owners\textsuperscript{14} and state law requirements mandating the posting of security.\textsuperscript{15}

Second, allowing bylaws and certificate provisions that went beyond “internal corporate claims” would have the potential to interfere with other causes of action authorized under Delaware law. The Delaware Blue Sky statute, for example, provides a private right of action for defrauded shareholders and other investors.\textsuperscript{16} To the extent not deemed an “internal corporate claim,” these claims would be discouraged or even eliminated through the implementation of fee shifting bylaws, effectively upending a carefully crafted statutory framework put in place by the Delaware legislature.\textsuperscript{17}

Third, such an interpretation could cause conflict with the laws of other states.\textsuperscript{18} In affirming the authority to adopt Blue Sky Statutes, the US Supreme Court recognized the right to regulate securities transactions “within the state.”\textsuperscript{19} To the extent that fee shifting bylaws remained applicable to these actions, Delaware corporations would be able to throw up roadblocks to fraud claims brought by shareholders in other states.\textsuperscript{20}

\textsuperscript{14} See Drachman v. Harvey, 453 F.2d 722, 727 (2d Cir. 1971) (“Federal law must be consulted to decide whether there is standing to sue under the Exchange Act, and that federal law confers standing upon beneficial shareholders”).

\textsuperscript{15} See Fielding v. Allen, 181 F.2d 163, 168 (2d Cir.), cert denied, 340 US 817 (1950) (“we think that the right of a stockholder to sue on his corporation’s federal cause of action is itself federal in nature and therefore not subject to special requirements for cognate actions under state law”).

\textsuperscript{16} See Del. Code Ann. tit. 6, §73-605(a).

\textsuperscript{17} With respect to internal corporate claims, the impact of fee shifting bylaws has been described as eliminating shareholder rights. See Q&A Accompanying Draft Legislation Banning Fee Shifting Bylaws, Prepared by the Corporation Law Council, Delaware State Bar Association, 2015, available at http://www.law.du.edu/documents/corporate-governance/legislation/delaware-stat-revisions/Council-Second-Proposal-FAQs-3-6-15.pdf (“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.”). The provision would presumably have the same effect on other causes of actions that are regularly dismissed.

\textsuperscript{18} Claims under state Blue Sky statutes do not implicate the internal affairs of a corporation. Friese v. Superior Court of San Diego, 134 Cal.App.4th 693, 710 (Cal. Ct. App. 2006) (finding that securities regulation in California “is not subject to the internal affairs doctrine”).

\textsuperscript{19} Hall v. Geiger-Jones Co., 242 US 539, 557 (1917) (“The provisions of the law, it will be observed, apply to dispositions of securities within the state, and while information of those issued in other states and foreign countries is required to be filed . . . , they are only affected by the requirement of a license of one who deals in them within the state.”) (emphasis in original). See also Edgar v. MITE Corp., 457 US 624, 641 (1982) (noting that Blue Sky statutes do not violate commerce clause because they “only regulate[ ] transactions occurring within the regulating States.”).

\textsuperscript{20} Indeed, the Delaware Supreme Court has made it clear that state securities regulation is entirely distinct from a corporation’s internal affairs. See Singer v. The Magnavox Co., 380 A.2d 969, 981 (Del. 1977) (“we do not read the [Blue Sky Law] as an attempt to introduce Delaware commercial law into the internal affairs of corporations merely because they are chartered here.”). See also Blinder, Robinson & Co., Inc. v. Brutton, 1988 WL 32375, at 4 n 3 (Del. Ch. March 31, 1988) (noting that Singer “stands for the proposition that
As a matter of legislative intent, therefore, it is not reasonable to assume that the Delaware legislature intended Sections 102 and 109 to be used to upend private rights of action under other titles of the Delaware Code, to raise issues of enforceability and preemption under the federal securities laws, or to interfere with the laws in other states. Moreover, an alternative interpretation would be inconsistent with the traditional approach taken by Delaware in the governance process. The State is protective of its preeminent role in determining a corporation’s internal affairs\(^{21}\) and has opposed encroachment by other regulators.\(^{22}\) At the same time, courts have specifically rejected invitations to extend Delaware corporate law into areas already under the control of other regulators.\(^{23}\) Bylaws and certificate provisions that interfere with causes of action in other states or at the federal level do exactly that.

The limitation on the reach of Sections 102 and 109 to “internal corporate claims” ensures that these conflicts will not occur and that the interpretation of bylaws and certificates adopted by Delaware corporations will remain within the purview of that State. The language in Senate Bill 75 is consistent with this approach. Given the existing limitations in the scope of the DGCL, broader language is unnecessary. Adoption of the Bill, as currently drafted, will, therefore, effectively reaffirm existing limits on bylaws and certificates and will ensure that Delaware remains firmly within its own corporate governance lane.

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\(^{22}\) See Letter from James L. Holzman, Chair, Council of the Corporation Law Section, Delaware Bar Association, to Ms. Elizabeth M. Murphy, SEC, July 24, 2009 (commenting on proposed SEC rule; “We do so in this instance because we believe that the Access Proposal significantly implicates what the Commission properly notes is ‘the traditional role of the states in regulating corporate governance.’”), available at [http://www.sec.gov/comments/s7-10-09/s71009-65.pdf](http://www.sec.gov/comments/s7-10-09/s71009-65.pdf)

\(^{23}\) See *Arnold v. Society for Savings Bancorp, Inc.*, 678 A.2d 533, 539 (Del. 1996) (“We see no legitimate basis to create a new cause of action which would replicate, by state decisional law, the provisions of section 14 of the 1934 Act.”). *See also Malone v. Brincat, 722 A.2d 5, 13 (Del. 1998) (declining to adopt a cause of action based upon “fraud on the market” in “deference to the panoply of federal protections that are available to investors in connection with the purchase or sale of securities of Delaware corporations”).*