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PERSPECTIVES

DELAWARE CORPORATIONS TURN TO BYLAWS, AGAIN, TO DISCOURAGE LAWSUITS

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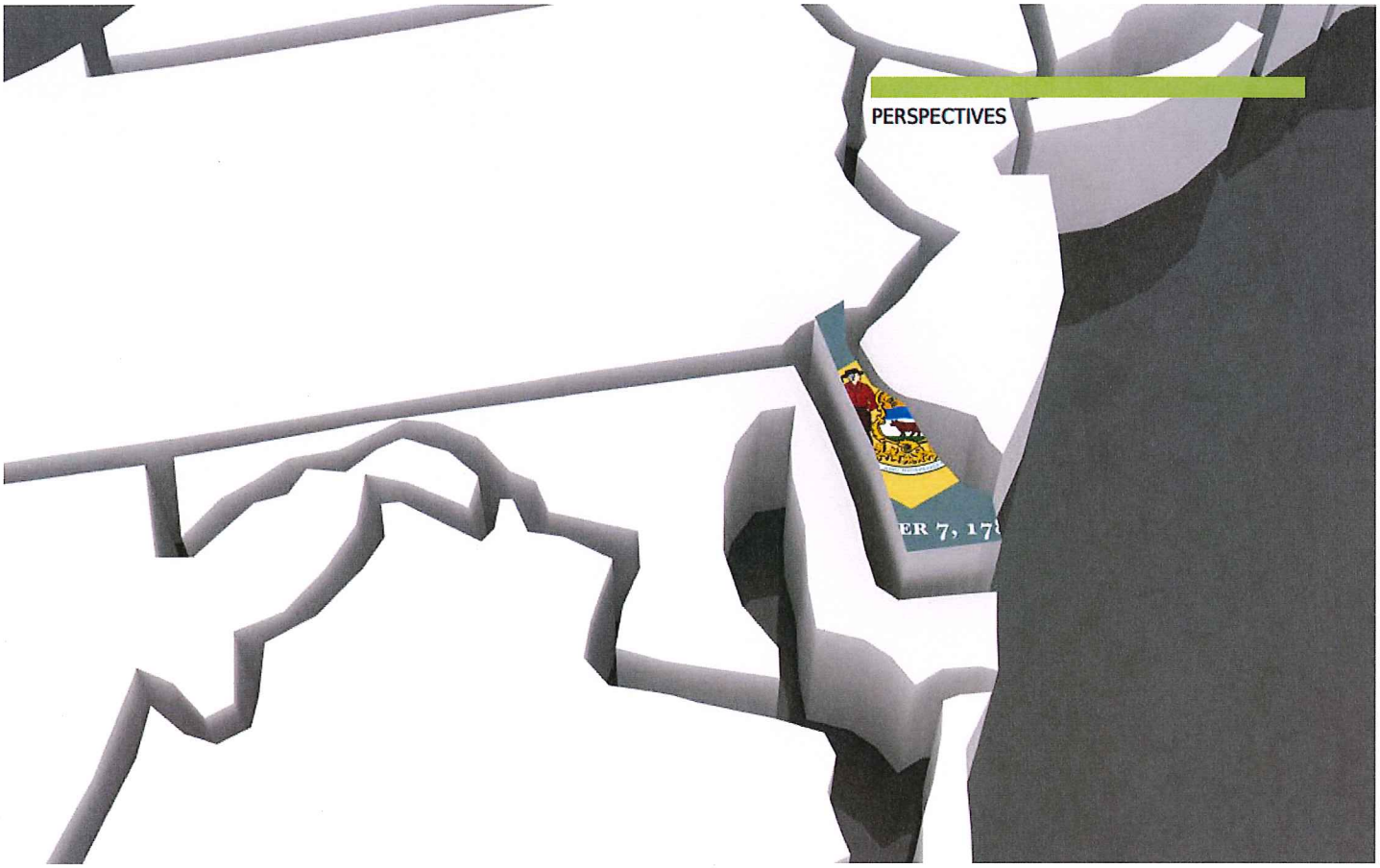
In Delaware, where half the country's publicly traded companies are chartered, corporate boards are unilaterally amending their bylaws in an attempt to discourage lawsuits accusing them of breaching their fiduciary duty. Though some courts have sanctioned the latest changes, investors' rights advocates say they could discourage meritorious litigation and make corporations less answerable to shareholders.

Two types of provisions are at issue. 'Exclusive forum' provisions seek to restrict certain litigation to courts in Delaware. 'Fee shifting' or 'loser pays' provisions require shareholders who bring such suits and fail to prove their claims to pay legal fees for defendants – a major departure from US rules, where each party typically shoulders its own court costs.

While Delaware courts have upheld both types of provisions, exclusive forum bylaws are far more widespread. At least 450 Delaware companies now have exclusive forum clauses in place, according to a search of SEC filings. Only a handful of corporations have adopted loser pays provisions, at least for now.

This is not the first time companies have looked to bylaws or charters to address what they view as a plague of frivolous lawsuits. In recent years, some companies have instituted bylaw provisions requiring binding arbitration for legal disputes, effectively denying shareholders their day in court. Those efforts inspired near-universal condemnation



by institutional investors, lawmakers and proxy advisory services.

Loser pays and exclusive forum provisions both deal with so-called 'intra-corporate litigation', which includes mergers and acquisition lawsuits and derivative actions – lawsuits brought by shareholders on behalf of the corporation that accuse officers and directors of failing to act in the company's best interests.

It should be no surprise that exclusive forum provisions are more popular than fee-shifting bylaws. The Delaware Court of Chancery blessed their validity more than a year ago in *Boilermakers Local 154 Ret. Fund v. Chevron Corp*. and, since then, courts in at least four other states have agreed to respect the enforceability of Delaware's decision.

And while it is true that investor advocates, such as the Council of Institutional Investors (CII), and some proxy advisory services, such as Glass Lewis, have opposed them, proposals to adopt exclusive forum provisions largely have been ratified by shareholders and have inspired scant repercussions. Corporate lawyers who feared investor backlash and initially urged their clients to 'wait and see' have apparently seen enough. According to a 4 June article by lawyers at Jones Day, 150 companies have adopted exclusive forum provisions since *Boilermakers*, making them 'mainstream'.

In contrast, the Delaware Supreme Court's ruling on litigation fee shifting, *ATP Tour, Inc. v. Deutscher Tennis Bund*, is more recent and arguably narrower.

The case arose from a US federal lawsuit brought by the German Tennis Federation, an ATP Tour member, after the ATP Tour downgraded a tournament in Hamburg operated by the German entity. After the German federation lost, the ATP Tour moved to recover its fees. The district court said such fee-shifting agreements were preempted by federal antitrust laws. The ATP Tour appealed and the federal appeals court asked the Delaware Supreme Court to clarify four questions of law, including whether such bylaw arrangements are allowed under state law.

In a unanimous 8 May opinion, the Delaware Supreme Court affirmed, as a matter of law, a non-stock corporation's right to include in its bylaws of a provision shifting the costs of intra-corporate litigation to plaintiffs whose claims are not substantially upheld. That such a bylaw is "facially valid" does not mean it is necessarily enforceable, the court said. "Bylaws that may otherwise be facially valid will not be enforced if adopted or used for an inequitable purpose," Justice Carolyn Burger wrote on behalf of the full, five-judge tribunal.

Perhaps more importantly, unlike *Boilermakers*, the *ATP Tour* decision prompted an immediate and forceful backlash.

Legislation to limit loser-pays bylaws to non-stock corporations – quickly introduced in the Delaware state senate and almost as quickly tabled for study – drew support not only from traditional investor advocates, but also from some large publicly traded companies and corporate law firms.

> **"While the battle over exclusive forum provisions appears lost, for now, the fight to stop companies from expanding loser-pays bylaws beyond non-stock corporations goes on."**

The CII, whose corporate, union and public pension plan members manage more than $3bn in assets, supported the Delaware bill as "necessary and appropriate to preempt the potential adoption" of fee-shifting provisions in bylaws. "In our view, and the view of many other corporate governance experts, the proliferation of 'fee-shifting bylaws' that could result from the *ATP Tour* decision would reduce, rather than protect and enhance,

a corporation's accountability to shareowners," General Counsel Jeff Mahoney wrote to Sen. Bryan Townsend, the bill's sponsor.

But even some traditional backers of measures designed to discourage litigation questioned the need for such a sledgehammer approach as loser-pays bylaws. In a memorandum on the *ATP Tour* decision and its consequences, defence firm Skadden Arps cited "the risk that adoption of fee-shifting bylaws could significantly deter, or eliminate, even meritorious claims". *Forbes* magazine, hardly an advocate of fettering business, asked if opponents of the bill like the US Chamber of Commerce were "pushing too far" for a cure that might be "worse than the disease".

In the end, the US Chamber and its allies succeeded in convincing legislators to withdraw the bill on 18 June. In its place, Delaware's legislators and governor adopted a joint resolution on 30 June recognising the need to balance the interests of all stakeholders and asking the Delaware State Bar Association to report on the issue in time for legislators to revisit it during their next session, in early 2015.

According to Joint Resolution 12, "the Governor and the Delaware General Assembly 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".

While the battle over exclusive forum provisions appears lost, for now, the fight to stop companies from expanding loser-pays bylaws beyond non-stock corporations goes on. CD

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