The Advocate
FOR INSTITUTIONAL INVESTORS

Shareholders Face a New Barrier to Litigation

Adoption of Fee-Shifting Bylaws is Corporations' Latest Effort to Undermine Shareholder Rights

By Edward Timlin and Adam Hollander

Under the "American Rule," each party pays its own attorneys' fees — win or lose — which opens the courthouse to litigants without the resources to match deep-pocketed corporate defendants. The American Rule is now in grave danger.

The adoption of fee-shifting bylaws has recently become a divisive (and threatening) issue within the corporate governance community. In its May 8, 2014 ruling in *ATP Tour v. Deutscher Tennis Bund*, the Delaware Supreme Court upheld a fee-shifting bylaw requiring unsuccessful plaintiffs to bear the fees, costs, and expenses of intra-corporate litigation. Since then, at least 24 public companies have adopted fee-shifting bylaws. Because *ATP* could significantly limit shareholder litigation involving Delaware corporations, the Delaware Corporation Law Council almost immediately initiated an effort to ban such bylaws through an amendment to Delaware's General Corporation Law. Unfortunately, the vote on the proposed amendment has been tabled until next year, after intense pressure from corporate lobbyists. The SEC is now being urged by corporate governance experts to take action to ensure the continued existence of private enforcement actions. In the meantime, as discussed below, until the law is changed, Delaware corporations are free to change their bylaws, and shareholders will pay the price.

The Delaware Supreme Court's Decision in *ATP*

A fundamental premise of litigation in the United States is that each party is responsible for its own attorneys' fees — win or lose. This is such a foundational tenet of American litigation that it is universally referred to as the "American Rule." The alternative structure, referred to as "loser pays" or the "English Rule," provides that the losing party is responsible for the winner's fees. A hallmark of the American Rule is that it opens the courthouse to litigants who do not have the budget to match deep-pocketed corporate defendants — even small shareholders can sue

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large corporations without the risk of crippling financial liability. The American Rule is now in grave danger following *ATP*.

In *ATP*, the Delaware Supreme Court held that fee-shifting provisions in a corporation's bylaws "can be valid and enforceable under Delaware law." As a result, the boards of directors of Delaware corporations may now unilaterally adopt bylaws that make the company an exception to the American Rule. This means that any shareholder who sues a company with a fee-shifting bylaw and loses will bear the company's legal costs and fees. Under the very aggressive bylaw upheld in *ATP*, a plaintiff may be liable for the company's legal bills even if: (i) the plaintiff was partially or *even mostly successful* in its litigation; (ii) the corporation adopted the bylaw unilaterally, without even putting it to a shareholder vote; (iii) the bylaw was adopted specifically to deter litigation; and (iv) the plaintiff was a shareholder before the fee-shifting bylaw was adopted. Although *ATP* concerned a private, non-stock company, *ATP's* reasoning applies equally to shareholder litigation against publicly traded companies incorporated in Delaware.

Within weeks of *ATP*, several public companies enacted fee-shifting bylaws in an effort to quash shareholder litigation, including Alibaba Group, The LGL Group, Inc., Echo Therapeutics, Inc., Townsquare Media, LLC, and Hemispherx Biopharma. Other concerns include whether courts outside of Delaware will permit fee-shifting bylaws, and whether state legislatures will enact laws imposing fee-shifting regimes. In fact, the Oklahoma legislature has already passed a law mandating fee-shifting for *all* shareholder derivative litigation. Unless *ATP* is limited or reversed, boards of directors can unilaterally threaten massively punitive fee shifting against any shareholder who dares to pursue litigation, no matter how meritorious.

ATP is a Serious Threat to Legitimate Investor Litigation

The justification for fee-shifting bylaws of the type approved by *ATP* is that they supposedly deter "frivolous" lawsuits. But the adoption of fee-shifting bylaws creates risks that far outweigh any perceived deterrence benefit. The Delaware Supreme Court's decision in *ATP* poses a substantial threat to investors for at least three reasons.

First, widespread adoption of fee-shifting bylaws would make judicial relief for board and management misconduct impracticable for all but the very largest investors. *ATP* upheld such an aggressive form of fee-shifting that "shareholders pay" is a more accurate description than "loser pays." The *ATP* bylaw imposes personal liability — for defendants' entire legal bill — on any investor who does not achieve "substantially all" of the relief sought in its litigation. In other words, even if the plaintiff is right about the alleged misconduct, prevails on some or even many of its claims, and obtains much of the relief initially sought, the plaintiff still faces the risk of millions of dollars of personal liability if even one claim or allegation is unsuccessful. Investors already face an uphill litigation battle when squaring off against well-heeled corporate defendants and their expensive Wall Street law firms. Investors may be reluctant to bear the risk of

litigation against corporations with fee-shifting bylaws that are incentivized to run up substantial legal bills to increase investors' potential exposure.

Second, contrary to assertions by the corporate defense bar, there is no "epidemic" of "frivolous" shareholder litigation. Defendants seem particularly concerned about litigation challenging merger and acquisition transactions. However, such cases frequently result in meaningful financial recovery to investors and substantial corporate governance enhancements. In just the past few years, we have seen M&A litigation improve the way Wall Street vets conflicts of interest, curtail previously widespread use of debt provisions as a tool to entrench directors and protect them from proxy contests, and deter controlling shareholders from insisting on "side payments" that amount to little more than theft from public investors. Moreover, successful cases warn the directors and officers of other companies that they must adequately protect their public investors in future deals, creating a better corporate governance culture. Imposing defense costs on shareholders threatens to preclude meritorious M&A litigation.

Third, *ATP* may implicate legitimate shareholder claims beyond the context of M&A transactions. The scope of the bylaw provision and the decision in *ATP* applies to all shareholder lawsuits, including claims under the federal securities laws and proxy fight litigation, and seriously threatens the viability of these claims. *ATP*-type bylaws would have disincentivized shareholders from bringing many of the watershed cases compensating shareholders for corporate malfeasance in connection with the mortgage-backed securities meltdown of the late 2000s, pervasive stock-option backdating in the early 2000s, and the implosions of companies such as Enron, WorldCom, and Tyco. These important cases might not have been brought, and the corporate misconduct might not have ever been remedied, if shareholders had not braved the litigation. Those same shareholders might have reached a different conclusion about filing suit if they could have ended up on the hook for the defendants' legal bills.

Government Intervention May be Needed to Protect Investors from Fee-Shifting Bylaws

It initially appeared that the risks posed by *ATP* would be swiftly mitigated. Just two weeks after the decision, the Delaware Corporation Law Council drafted an amendment to the Delaware General Corporation Law that would prohibit fee-shifting bylaws for stock corporations (limiting *ATP* to non-stock Delaware corporations). Although the Delaware legislature was scheduled to vote on the proposed amendment on

Application of* ATP *may make judicial relief for board and management misconduct impracticable for all but the very largest investors.* ATP *upheld an extremely aggressive form of "loser pays" that imposes personal liability for defendants' entire legal bill on any plaintiff who does not achieve "substantially all" of the relief sought in its litigation.

Companies incorporated outside of Delaware may adopt similar bylaws, creating a "race to the bottom" whereby corporations flock to states that endorse fee-shifting bylaws. Given the sweeping potential implications of ATP and its chilling effects on shareholder litigation across the United States, the SEC may well intervene.

June 10, 2014, the US Chamber of Commerce's intense lobbying efforts succeeded in removing the vote from the calendar. Because the legislative session has since closed and the next session does not begin until January 13, 2015, no legislative change will occur in Delaware this year.

But even if Delaware does act to restrain fee-shifting bylaws, the issue would still not disappear. Delaware courts and/or legislature might only partially limit the use of such bylaws. In addition, companies incorporated outside of Delaware may adopt similar bylaws, creating a "race to the bottom" whereby corporations flock to any states that endorse fee-shifting bylaws. Given the sweeping potential implications of *ATP* and its chilling effects on shareholder litigation across the United States, the SEC may well intervene.

On October 9, 2014, the SEC's Investor Advisory Committee held a hearing on the issue of fee-shifting bylaws. At the hearing, legal experts like Columbia Law School Professor John C. Coffee, Jr. urged the Commission to take action "or concede the decline of private enforcement." During his testimony, Professor Coffee outlined three avenues the SEC could pursue. First, the SEC could assert that automatic fee shifting violates the federal securities laws, unless it is predicated on violation of Rule 11 of the Federal Rules of Civil Procedure (implicating wrongdoing by the plaintiff). Second, the SEC could require issuers to state in registration statements that the SEC believes that the federal securities laws are inconsistent with fee-shifting bylaws, which would at least embarrass issuers and alert courts to the SEC's views without submitting an *amicus curiae* brief. Third, the SEC could assert its position as a third party to lawsuits where it deems fee-shifting inappropriate.

As Professor Coffee explained at the SEC hearing:

> *The impact of fee-shifting bylaws could be decisive. The defendant's expenses in a securities class action can easily exceed $10 million, and this amount would bankrupt many smaller plaintiff's law firms.... Even if a bold plaintiff's law firm did sue, it would likely have to agree to indemnify the class representative from fee-shifting, and some class representatives might decline the position, fearing that the plaintiff's firm could not fully protect them. As the case proceeded, the defendant's expenses will progressively mount, increasing the potential penalty. This will predictably force cheaper settlements, thereby injuring the class. If fee-shifting bylaws are upheld, defendant issuers should logically regard them as a riskless move that has little downside.... As a result, such bylaws, if upheld, will predictably become widely prevalent.*

Unfortunately, however, while the SEC's aid could be valuable, particularly with respect to federal securities or antitrust claims, it would be an incomplete fix at best. It is unlikely that the SEC would (or could) prohibit fee-shifting with respect to state law claims like breaches of fiduciary duty.

Shareholders are already being harmed by the chilling effect of fee-shifting bylaws endorsed by the Delaware Supreme

Court in *ATP*. Although the number of companies adopting such a bylaw is still relatively small, the trend is quickly accelerating. Unless *ATP* is limited or reversed, boards of directors can unilaterally threaten punitive fee shifting against any shareholder who dares to pursue even highly meritorious litigation.

Stopping the expansion of *ATP* fee-shifting bylaws is sound policy. The expansion of *ATP*, if permitted, will cause long-lasting damage to our economy, and the hard-earned retirement funds of millions of individuals, by effectively preventing meritorious shareholder litigation that exposes corporate wrongdoing.◆

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