New Corporate Bylaws Allow Directors to Write the Rules for Stockholder Litigation

By Lee Rudy*

Spurred by the Delaware Supreme Court's *ATP* decision,[1] dozens of corporate boards have passed so-called "fee-shifting" bylaws. The U.S. Chamber of Commerce has described these bylaws as simply dissuading "pirate investors" who bring "abusive shareholder lawsuit[s] and lose in court."[2] The truth is that these bylaws are so broadly drafted that they make it economically irrational for even the most sophisticated investors to bring highly meritorious litigation.[3] Moreover, as drafted, these bylaws even threaten crippling financial penalties against stockholders even when they "win."[4]

ATP, the Association of Tennis Professionals, is a non-stock corporation whose members consist of tennis players and tournament operators, each with representatives on the board, and all of whom depend on the ATP for their livelihood.[5] ATP adopted a "fee-shifting" bylaw, which requires a non-prevailing party to reimburse the prevailing party for its legal fees if the party "does not obtain a judgment on the merits that substantially achieves, in substance and amount, the full remedy sought."[6] The Delaware Supreme Court upheld ATP's bylaw as "facially valid" in a widely publicized decision.[7]

Although ATP is a non-stock corporation, the *ATP* decision is now being touted by public corporations when they adopt new bylaws setting rules for how and where they can be sued. The clear purpose of these new bylaws is to seek to insulate directors and officers from the legal scrutiny imposed by stockholder actions.

Corporations are opportunistically taking advantage of these bylaws by adopting them just after disclosure of negative events that would likely spawn stockholder litigation. For example, Lannett Company, Inc. adopted its bylaw one day after disclosing receipt of a subpoena from the Connecticut Attorney General related to a price-fixing investigation.[8]

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[1] *ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554 (Del. 2014).

[2] Lisa A. Rickard, *Delaware Flirts with Encouraging Shareholder Lawsuits*, WALL ST. J. (Nov. 15, 2014, 5:48 PM), http://www.wsj.com/articles/lisa-rickard-delaware-flirts-with-encouraging-shareholder-lawsuits-1416005328. Ms. Rickard is Executive Vice President of the U.S. Chamber of Commerce. *Id.*

[3] Claudia H. Allen, *Fee-Shifting Bylaws: Where Are We Now?*, BLOOMBERG BNA (Feb. 2, 2015), http://www.bna.com/feeshifting-bylaws-n17179922685/.

[4] *Id*.

[5] *Delaware Law Updates*, POTTER ANDERSON 1 (May 8, 2014), http://www.potteranderson.com/pp/experience-478.pdf.

[6] *ATP*, 91 A.3d at 556.

[7] *Id*. at 557.

[8] Nan Aron & Hank Kim, *Delaware Seeks to Restore Balance Between Corporations and Shareholders,* HUFFINGTON POST (May 5, 2015, 10:40 AM), http://www.huffingtonpost.com/nan-aron/delaware-seeks-to-restore_b_7213428.html.

Hemispherx Biopharma, Inc.'s bylaw was adopted in the middle of ongoing stockholder litigation, with company counsel explicitly trumpeting the company's adoption of the bylaw as a "sword" to pressure plaintiffs to drop their lawsuit.[9] American Spectrum Realty, Inc. adopted its bylaw amidst allegations that its CEO engaged in self-dealing and fraud.[10]

The new bylaws being adopted are also not limited to fee shifting. Hemispherx included a "surety" bylaw allowing the company to require stockholders to post a bond for the company's litigation expenses while the litigation proceeded.[11] A number of companies have passed bylaws decreeing that only stockholders owning or controlling more than 3% of the company's stock are allowed to sue.[12] More and more aggressive provisions are likely to be included in these anti-litigation bylaws, especially since many of the bylaws have "severability" provisions, which state that even if one provision is struck down, the remaining terms still survive.[13]

Fee-shifting bylaws not only dissuade stockholders from filing weak lawsuits but also make virtually all claims economically irrational to pursue. Hypothetically, imagine that a stockholder who owns a substantial 1% of a company's stock wishes to pursue a meritorious $100 million claim against the company. Assume the stockholder brings the suit and wins: she receives 1% of the recovered fund ($1 million), while the rest of the fund is distributed to absent class members. But if she loses, she is liable for 100% of the defendants' fees, which in *ATP*, for example, were ***$17 million.***[14] Of course, the stockholder must also factor in the inherent uncertainty of litigation and must be willing to make the daunting decision to file a case before having any access to discovery.

Then, assuming the stockholder is still willing to file her case and risk paying millions in fees if she loses, she will then face enormous pressure to settle the case quickly, since defendants' fees generally climb exponentially the closer a case gets to trial. These new bylaws, therefore, will not only dissuade economically rational stockholders from ever bringing litigation, but will also force cheaper settlements in the cases that actually get brought, regardless of their merit. Thus, even some well-known corporate law firms concede that fee-shifting bylaws will likely deter meritorious cases as well.[15]

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[9] *Id.*

[10] *Firms Continue to Adopt Fee-Shifting Bylaws Despite Pending Legal Challenges*, CII GOVERNANCE ALERT (Council of Institutional Investors), Dec. 4, 2014, at 2, *available at* http://www.cii.org/files/publications/CII%20Governance%20Alert_12_04_14.pdf.

[11] Motion to Invalidate Retroactive Fee-Shifting and Surety Bylaw or, in the Alternative Dismiss and Withdraw Counsel, Kastis v. Hemispherx Biopharma, Inc., No. 8657-CB (Del. Ch. July 21, 2014), *available at* http://www.delawarelitigation.com/files/2014/09/2104SEPTBLOG-U01137891.pdf.

[12] *See, e.g.*, Alison Frankel, *The Latest in Restrictive Corporate Bylaws: Small Shareholders Can't Sue*, REUTERS (Nov. 13, 2014) (citing Imperial Holdings, Inc. as an example of a company that has enacted a bylaw permitting investors to sue only if "they deliver to the company written consents from the owners of at least [three] percent of the outstanding shares").

[13] Allen, *supra* note 3.

[14] Mark Lebovitch & Jeroen van Kwawegen, *Of Babies and Bathwater: Deterring Frivolous Stockholder Suits Without Closing the Courthouse Doors to Legitimate Claims*, REUTERS BLOG 11 (Mar. 6, 2015), http://blogs.reuters.com/alison-frankel/files/2015/03/babiesandbathwater.pdf.

[15] Peter Allan Atkins et al., *Fee-Shifting Bylaws: The Delaware Supreme Court Decision in ATP Tour, Its Aftermath and the Potential Delaware Legislative Response The Decision*, SKADDEN (May 22, 2014), https://www.skadden.com/insights/fee-

Proponents of these new bylaws typically describe them as "loser pays" bylaws. This is false for two reasons: first, when the company or its directors lose, they do not pay. Second, as drafted, these bylaws shift fees to stockholders even when they "win."

Corporate directors do not pay when they lose because the plaintiffs' attorneys' fees are virtually always deducted before a common fund is distributed to the class. Directors are also indemnified by their companies and are protected by D&O (Director and Officer) insurance. Consequently, while a stockholder knows that she faces a crippling economic penalty if she loses her lawsuit, corporate directors might rightfully believe that they have little to fear economically if they lose at trial.

Proponents of these new fee-shifting bylaws often obscure the fact that stockholders would owe fees even if they "win." These bylaws generally state that the stockholder is liable for fees unless he or she "substantially achieves, in substance and amount, the full remedy sought." A plain reading of this language would mean that a stockholder who seeks $100 million at trial but recovers ("only") $40 million would not have "substantially achieve[d] … the full remedy sought" and would therefore be liable for the defendants' fees.

In *Southern Peru*,[16] for example, described as one of the largest trial victories ever for stockholders, stockholders sought nearly $2 billion in damages from the company's majority stockholder and independent directors. After expensive discovery, the independent directors were dismissed at summary judgment. At trial, plaintiff recovered ("only") $1.3 billion before interest.[17] Under most of these fee-shifting bylaws, plaintiff's counsel in *Southern Peru* would have owed defendants millions of dollars in fees despite winning one of the largest judgments in corporate law history.

By allowing corporate directors to use bylaws to change the rules governing stockholder suits, the Delaware courts have given one party to corporate litigation the power to create its own tactical advantages over the other party. Courts, not directors, should be making and enforcing the rules for stockholder litigation.

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shifting-bylaws-delaware-supreme-court-decision-atp-tour ("[T]here is the risk that adoption of fee-shifting bylaws could significantly deter, or eliminate, even meritorious claims.").

[16] *In re S. Peru Copper Corp. S'holder Deriv. Litig.*, 52 A.3d 761 (Del. Ch. 2011), *aff'd*, 51 A.2d 1213 (Del. 2012). The author served as co-lead counsel in the *Southern Peru* litigation.

[17] Steven Davidoff Solomon, *Grupo México Is Hit with $1.26 Billion Judgment*, N.Y. TIMES (Oct. 17, 2011, 3:52 PM), http://dealbook.nytimes.com/2011/10/17/grupo-mexico-hit-with-1-26-billion-judgment-over-deal/?_r=0.