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Delaware Supreme Court Holds that Fee-Shifting Bylaws are Presumptively Valid

Boards now await the Delaware legislature's pending vote that may prohibit such provisions

The Delaware Legislature will vote on an amendment to the Delaware General Corporation Law which, if passed, would ban stock corporations from implementing fee-shifting bylaw provisions. The vote is set to take place prior to the conclusion of the current legislative session, which ends on June 30th. The proposed amendment would limit a recent Delaware Supreme Court decision that upheld the validity of a fee-shifting corporate bylaw that was adopted by a non-stock corporation.

On May 8, 2014 the Delaware Supreme Court decided a case involving co-appellees Deutscher Tennis Bund and Qatar Tennis Federation (collectively, the Federations), and appellant ATP Tour, Inc. (ATP).[1] Deciding a question of first impression, the court held as enforceable, a bylaw provision that shifts intra-corporate litigation expenses to the party bringing the claim if it was unable to "obtain a judgment on the merits that substantially achieves" the full remedy sought by that party.[2] Although the court did not rule on the enforceability of the specific fee-shifting provision adopted by ATP, the opinion may serve as a victory for directors looking to discourage frivolous litigation – at least until the outcome of the legislative vote expected later this month. A board pondering the merits of settling potential litigation may very well conclude that mounting a costly defense against a shareholder claim is a viable option if its litigation fees, costs and expenses could be borne by the party who asserted the claim.

FACTUAL BACKGROUND

ATP is a non-stock Delaware membership corporation with the purpose of overseeing and promoting professional men's tennis tournaments. At the trial court level, the dispute stemmed from the ATP board's decision to downgrade the Hamburg tournament (which is owned by the Federations) to the second highest tier of tournaments and reschedule the event from spring to summer. Dismayed by that decision, the Federations sued ATP along with six of its board members; alleging federal anti-trust and Delaware fiduciary duty claims. The Federations did not succeed on any of the aforementioned claims, and pursuant to the fee-shifting provision in its bylaws, ATP sought recovery of its litigation fees, costs and expenses.

The fee-shifting bylaw, adopted by ATP in 2006, provides for a legal expense fee-shifting mechanism allowing the league to recover its litigation fees, costs and expenses if a member files a suit against ATP and fails to obtain a judgment that "substantially achieves" the remedy sought. Following interim decisions regarding questions of federal preemption, the U.S. District Court for the District of Delaware determined that the fee-shifting bylaw's enforceability was a novel question of Delaware law and certified four questions of law to the Delaware Supreme Court for determination.

CONTINUED ON NEXT PAGE

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DELAWARE SUPREME COURT DETERMINES "FEE-SHIFTING" BYLAWS ARE PRESUMPTIVELY ENFORCEABLE:

■ Under Delaware Law, is a fee-shifting bylaw permissible?

The Delaware Supreme Court held that a fee-shifting bylaw is permissible despite Delaware following the American Rule (where each litigating party is responsible for their own attorneys' expenses). The decision cited Delaware precedent which permits contracting parties to alter the American Rule before observing that "corporate bylaws are contracts among a corporation's shareholders."^[3] The court proceeded to determine that fee-shifting bylaws are facially valid exceptions to the American Rule, but tempered that conclusion by emphasizing that enforceability of all bylaws is contingent upon whether the bylaw was enacted for a proper purpose (a fact driven inquiry focusing on "the manner in which [the bylaw] was adopted and the circumstances under which it was invoked"^[4]).

■ If the "substantially achieves" language rendered the ATP bylaw unenforceable, would a more limited version that was only applicable in situations where a plaintiff obtains no relief be enforceable?

The District Court proactively recognized a possible dilemma arising in practice when applying the "substantially achieves" standard, so it framed the

question as "essentially ask[ing] whether a more limited version of the ATP bylaw would be valid"^[5]. The Delaware Supreme Court answered the question in the affirmative, but referenced the first certified question's requirement that bylaws be enacted for a proper purpose.

■ Would the bylaw be enforceable if the Board of Directors adopted it for an improper purpose?

The District Court asked if a bylaw is enforceable as a matter of law "if one or more Board members subjectively intended the adoption of the bylaw to deter legal challenges to other potential corporate action then under consideration."^[6] The Supreme Court held that an otherwise legal bylaw would not be enforceable in equity if that bylaw was adopted for an improper purpose and also noted that the intent to deter litigation, by itself, is not an improper purpose.

■ Can an amendment to a bylaw be enforced against members who join a corporation before the amendment is adopted?

So long as the corporation's certificate of incorporation authorizes the directors to adopt, amend, or repeal the bylaws, the court held that an amendment to the bylaws will be enforceable against all members, regardless of when they joined the corporation.

WHAT'S NEXT?

The Delaware Supreme Court's decision was careful to specify that it made no judgment as to the facts surrounding the ATP bylaw, but only addressed the questions of law certified by the District Court. Thus, pending the outcome of the legislature's vote, Delaware corporate boards have not yet received unequivocal guidance as to the enforceability of a fee-shifting bylaw and should seek counsel prior to considering the adoption of such a provision.

Before considering the adoption of a fee-shifting provision, boards should confirm that the certificate of incorporation permits the directors to amend the bylaws without shareholder approval. Notwithstanding a board's ability to amend the bylaws without shareholder approval, boards should consider the circumstances surrounding the adoption of a fee-shifting bylaw including whether their shareholders might be inclined to try to adopt a further amendment in opposition and whether the board is facing any threatened or pending shareholder derivative suits that could cast a negative light on the board's underlying purpose for the amendment.

[1] *ATP Tour, Inc. v. Deutscher Tennis Bund*. 534. 2013 (Del. May 8, 2014)

[2] *Id.* at 3.

[3] *Id.* at 3.

[4] *Id.*

[5] *Id.* at 4.