

# Client Alert

Shareholder and Securities Litigation Practice Group

March 20, 2015

## Delaware Court Refuses To Enforce Fee-Shifting Bylaw Against Former Shareholder Who Was Cashed Out Before Its Adoption

The validity of corporate bylaws providing for fee-shifting in lawsuits brought by shareholders has become a hot topic in the shareholder litigation landscape. In the wake of the Delaware Supreme Court's 2014 decision in *ATP Tour, Inc. v. Deutscher Tennis Bund*,<sup>1</sup> upholding a fee-shifting bylaw adopted by a non-stock corporation, boards of Delaware stock companies have adopted similar bylaws. The Delaware legislature is presently evaluating legislation addressing fee-shifting bylaws. Earlier this month, the Council of the Corporation Law Section of the Delaware State Bar Association proposed **amendments** to the Delaware General Corporation Law ("DGCL") that would prohibit the inclusion of fee-shifting provisions in stock corporations' bylaws and certificates of incorporation. The proposed amendments would also add provisions confirming that Delaware companies may include in their certificates of incorporation and bylaws provisions specifying that "intracorporate claims" must be brought only in Delaware.

In a decision of first impression issued this week, Chancellor Andre G. Bouchard of the Delaware Court of Chancery dealt a partial setback to the advance of fee-shifting bylaws, holding that a bylaw adopted *after* the completion of a company's 10,000-to-1 reverse stock split will not be applied in a lawsuit brought by a former shareholder who was cashed out in the reverse split prior to the bylaw's adoption.

The case, *Strougo v. Hollander*, challenges the reverse split and the facial validity of the fee-shifting bylaw First Aviation Services, Inc.'s board of directors adopted three days after the reverse split's completion.<sup>2</sup> The challenged bylaw, which defendants contend was modeled on the non-reciprocal fee-shifting bylaw upheld in the *ATP Tour* decision, provides, in pertinent part, that "any current or prior stockholder or anyone [acting] on their behalf" who (i) "initiates or asserts [a] claim or counterclaim . . . or joins, offers substantial assistance to or has a direct financial interest in" a claim or counterclaim against the company or any director, officer, or employee and (ii) "does not obtain a judgment on the merits that substantially achieves, in substance and amount, the full remedy sought, . . . shall be obligated jointly and severally to reimburse" the company and individual defendants for their attorneys' fees and other defense costs.

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The ruling did not address the merits of the plaintiff's challenge to the reverse stock split or the facial validity of the fee-shifting bylaw; instead, the order focused on the narrower question of whether the bylaw could be enforced against a plaintiff whose stock ownership was eliminated prior to its adoption. Drawing on the text of Section 109(b) of the DGCL and principles of Delaware contract law, the Court held that the bylaw could not be applied against the plaintiff. Section 109(b), the Court reasoned, permits the adoption of bylaws "relating to . . . the rights or powers of its stockholders."<sup>3</sup> The Court concluded that one whose stock ownership has been eliminated *prior* to a bylaw's adoption is not a "stockholder" for purposes of Section 109(b); thus, Section 109(b) does not authorize the adoption of a bylaw purporting to regulate the rights of *former* investors who no longer own stock. The Court found further support for its holding in the "fundamental" contract law principle that "only parties to a contract are bound by that contract," observing that "a stockholder whose equity interest is eliminated is equivalent to a non-party to the corporate contract." For these reasons, the Court held that "the bylaws in effect at the time of a cash-out transaction continue to apply to the interests of a cashed-out, former stockholder who challenges the fairness of that transaction. But, in my view, a bylaw amendment that purports to regulate the rights or powers of former stockholders who were no longer stockholders when the bylaw was adopted is beyond the scope of Section 109(b) and, therefore, inconsistent with Delaware law."

While answering that question (for the present at least), Chancellor Bouchard's opinion left unresolved what he described as other "serious policy questions implicated by fee-shifting bylaws in general," including whether such bylaws unduly chill meritorious lawsuits or serve as appropriate safeguards against abusive litigation. The decision also signaled the potential for further challenges to the scope of fee-shifting bylaws, including the degree to which joint and several liability for fees can be shifted to non-stockholders who "assist" in the prosecution of claims or have "financial interest[s]" therein (*i.e.*, plaintiffs' counsel). Corporate boards, litigators, and lawmakers will closely monitor the ever-unfolding debates surrounding such questions as they are hashed out in future battles in the courts and legislatures.

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<sup>1</sup> 91 A.3d 554 (Del. 2014).

<sup>2</sup> C.A. No. 9770-CB, *slip op.*, (Del. Ch. Mar. 16, 2015).

<sup>3</sup> 8 Del. C. § 109(b).