

Company & Commercial - USA

Facial validity of fee-shifting provisions in bylaws of Delaware non-stock corporation

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Introduction

On May 8 2014 the Delaware Supreme Court sitting *en banc* unanimously decided *ATP Tour Inc v Deutscher Tennis Bund*, No 534 (2013). The court held that fee-shifting provisions in the bylaws of a Delaware non-stock corporation were valid on their face and were enforceable against members who joined before their adoption. The court further stated that adopting fee-shifting provisions with an intent to deter litigation would not necessarily render such bylaws unenforceable. The court's conclusion extends logically to Delaware stock corporations, as its analysis draws on case law concerning Delaware stock corporations and the Delaware General Corporation Law and describes bylaws as a contract between a company and its investors (under which the typical rule that each party bear its own attorneys' fees and costs could be modified).

Background

ATP Tour Inc, a Delaware membership corporation, operates a global professional men's tennis tour. ATP's members include tennis players and entities which own and operate tennis tournaments. Two entities, Deutscher Tennis Bund (the German Tennis Federation) and Qatar Tennis Federation, joined ATP in the early 1990s and agreed to be bound by its bylaws, as amended from time to time. In 2006 ATP's board of directors amended ATP's bylaws to add a provision stating that if a current or former member initiates litigation against ATP and "does not obtain a judgment on the merits that substantially achieves, in substance and amount, the full remedy sought", the member initiating litigation will be obliged to reimburse ATP for any fees, costs and expenses incurred by ATP in connection with such litigation.

In 2007 the two tennis federations challenged a decision made by ATP, suing the company and six of its seven directors in the US District Court for the District of Delaware. The plaintiffs lost their claims on the merits and ATP moved to recover its fees, costs and expenses pursuant to the new fee-shifting provision. The district court certified questions concerning the validity and enforceability of fee-shifting bylaws to the Delaware Supreme Court, which found such bylaws to be facially valid.

Shifting litigation costs

Shifting the cost of defending litigation to unsuccessful plaintiffs could reduce the frequency of shareholder litigation against Delaware corporations and mitigate the significant costs, monetary or otherwise, of shareholder litigation. However, such measures may also have the unintended effect of discouraging meritorious litigation.

Potential Delaware legislative response

In response to the court's decision, the Delaware State Bar Association proposed an amendment to the Delaware General Corporation Law that would effectively overrule the Delaware Supreme Court's ruling. The amendment aimed to limit the applicability of the holding to non-stock corporations only and to limit the imposition of monetary liability by Delaware corporations on stockholders through charter or bylaw provisions. As a result of lobbying efforts by several Delaware-headquartered corporations, the Delaware legislature has postponed discussion of the proposed amendment until early 2015.

Amending bylaws

In the interim, boards of directors of both public and private Delaware corporations may seek to

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amend their bylaws to adopt fee-shifting provisions, in either the form permitted by *ATP* or an alternative that seeks to take into account the potential legislative response to the decision. Given existing uncertainty at the legislature, such provisions risk being rendered invalid by future legislative action. Delaware corporations must also consider the possibility that activist stockholders may try to adopt provisions that oppose or restrict any fee-shifting construct. Boards should consider the corporate environment in which such provisions are adopted and how stockholders and proxy advisory firms may react and whether it may be seen as an anti-corporate governance manoeuvre.

Applicability of fee-shifting provisions

Even if fee-shifting bylaws are valid on their face under Delaware law, they may not be viable in every circumstance. Federal law could pre-empt Delaware law with regard to the enforcement of fee-shifting provisions in connection with federal law based claims (eg, in the context of antitrust actions); other states may have different rules regarding fee shifting; and other courts may apply non-Delaware law in interpreting or enforcing a fee-shifting bylaw, leading to unintended results. Finally, the circumstances at the time of adoption of a fee-shifting bylaw may affect its enforceability – for example, if adopted in the face of an active claim the bylaw may be seen as an impermissible attempt at entrenchment.

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