Delaware Throws a Curveball

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Since the Corporation Law Council of the Delaware State Bar Association announced earlier this month that it was recommending statutory amendments to prohibit "loser pays" fee shifting bylaws and charter provisions (and thus overrule the Delaware Supreme Court's 2014 decision in *ATP Tour v. Deutscher Tennis Bund*¹), a predictable reaction has followed. Plaintiff attorneys and most academics applauded the decision, fearing that the alternative would be the death knell of private enforcement. In contrast, conservatives have attacked the proposed legislation, seeing it as the end of Delaware's position as the champion of "enabling" corporate legislation and predicting that Delaware would lose market share to other, more permissive jurisdictions in the market for corporate charters. Although the Corporation Law Council usually dictates corporate law legislation in Delaware, lobbyists are at work on both sides, and the outcome is uncertain.

Yet, even with a battle brewing, no one seems to have read the statute closely. Had these commentators focused on the actual language of the proposed legislation, they would have discovered that the legislation does not quite do what either side in this debate thinks it does. Perhaps it is too late in the day to expect legal academics to actually read legislation before turning to economics or political theory, but this instance is especially symptomatic. Outdated as my "old school" approach may be, I will begin with the proposed statutory language. The Corporation Law Council (a 22 member body) has proposed changes to §§102 and 109 of the Delaware General Corporation Law (DGCL), which provisions regulate the contents of the certificate of incorporation and the bylaws, respectively. The proposed legislation will provide that neither the certificate of incorporation nor the bylaws may contain a provision that "imposes liability on a stockholder for the attorney fees or expenses of the corporation or any other party in connection with an intracorporate claim."² As later stressed, this would represent only a partial repeal of *ATP Tour's* broader acceptance of the theory that the bylaws are a contract that can bind shareholders retroactively, and it still leaves open the ability of board-approved bylaws to impose liability on shareholders in other contexts. But, at first glance, the above language may indeed seem to preclude "loser pays" fee-shifting provisions.
But that first glance is deceiving. Fee-shifting bylaws and charter provisions are only precluded "in connection with an intracorporate claim." What is that? Proposed new §115 of the DGCL would define "intracorporate claim" to mean "claims, including claims in the right of the corporation, (I) that are based upon a violation of a duty by a current or former director or officer or stockholder in such capacity, or (II) as to which this title confers jurisdiction upon the Court of Chancery."\(^3\)

What is wrong with this definition? Like the well-known dog that did not bark in the night, there is something missing here. This underinclusive language clearly covers (1) derivative actions, (2) merger class actions based on Weinberger\(^4\) or similar breach of fiduciary duty claims; and (3) appraisal actions. But it does not cover federal securities class actions, which do not need to allege a "violation of a duty," but rather must allege a material misstatement or omission. Typically, the principal defendant in a securities class action will be the corporation issuer, itself, and officers and directors may not be named. Moreover, because a misrepresentation by a corporate officer may have been intended to benefit the corporate issuer, it did not necessarily violate a duty owed to the entity. Thus, read literally, the new legislation would not preclude a board-adopted bylaw that shifted the corporation's and other defendants' expenses against a plaintiff who lost (or was less than substantially successful) in a federal securities class action (at least so long as the action did not allege a "violation of a duty" by any corporate officer or director).

Was this an unintentional oversight made somehow by skillful lawyers? Possibly, but that 22 member Corporation Law Council is not staffed with dummies. To cover federal securities litigation, that body needed only to add the words ", or a material misstatement or omission by the corporation or any officer or employee thereof at the end of clause (1) of its above-quoted proposed §115. Even if it was an oversight, attentive corporate defense counsel will predictably seize upon the opportunity it provides. For example, they might add a final clause to their already standard bylaw or charter provision (which shifts fees against any plaintiff who is not "substantially successful" (as defined)), and this final clause would say: "provided, however, that this provision shall not apply to attorneys' fees and related expenses relating to actions that are necessarily based on a violation of a duty by a current or former officer, director or stockholder or as to which Sections 102 or 109 of the Delaware General Corporation Law otherwise prohibit the corporation from seeking reimbursement from a plaintiff shareholder." Thus, the bylaw or charter provision would require reimbursement to the corporation of any fees or expenses that are not within the scope of the prohibition in §§102 and 109. Seemingly, corporate counsel have little to lose in drafting such a provision.

Plaintiff's counsel may also change their behavior in light of the proposed statutory language. They may revise their complaints so as to assert a "violation of a duty" by one or more corporate officers or employees, even though this does not legally strengthen their case, in order to attempt to come within the language of §§102 and 109. In response, corporate counsel will need to assert in their bylaw or charter provision that the action must be "necessarily" based on a "violation of a duty" to the corporation in order for reimbursement to be prohibited. Both sides will need to engage and respond to the statutory language that has so far been ignored.
Before we assume that the narrow phrasing of §§102 and 109 was an oversight by the Corporation Law Council, we need to consider the alternative possibility: namely, that they deliberately wrote it narrowly. Why? This is speculative and may sound cynical, but the Corporation Law Council may have wanted to cover only traditional "Delaware-style" litigation (where the interests of the Delaware Bar on both sides were jeopardized if "loser-pays" fee shifting were to reduce the volume of such litigation). In contrast, securities litigation tends not to be brought in Delaware nor to involve Delaware counsel in most cases. If the goal was to protect the local Bar, nothing more needed to be done than to exempt "Delaware-style" litigation from the impact of "loser pays" fee shifting.

Still, it would have been easy to also cover federal securities litigation in §§102 and 109. Is there a reason why Delaware might deliberately not cover securities litigation? Here, one needs to consider Delaware's persistent desire to preserve its market share in the competition for corporate charters. To the extent that Delaware prohibited fee shifting, it exposed itself to competition from other jurisdictions (for example, Nevada and Texas) that might be willing to uphold "loser pays" provisions. After all, these states could point to the Delaware Supreme Court's decision in AT&T v. AT&T as recognizing the legitimacy of fee shifting by bylaw. No local constituency of lawyers was threatened in these other rival jurisdictions where intracorporate litigation is relatively rare. In the future, counsel may advise some prospective IPO firms to incorporate outside of Delaware (at least if federal courts seem likely to permit fees to be shifted to a losing plaintiff in securities litigation). Corporate counsel will know that many IPOs decline in price after the offering but before the statute of limitations expires, and they might rationally seek to preclude securities actions if they can find a jurisdiction that enables them to do so.

Viewed realistically, corporate defense counsel are likely to feel far more threatened by securities class actions than by a traditional "Delaware-style" litigation (which normally settles for non-pecuniary relief and often only for revised disclosures). In this light, the Delaware's Corporation Law Council may have struck a very artful balance. That is, the proposed legislation may protect "Delaware-style" litigation from the threat of fee shifting, but not securities class actions. If corporate counsel can still use bylaws and charter provisions in Delaware to deter securities class actions, they will feel less inclined to move to rival jurisdictions. In short, Delaware may have found a compromise that protects the local Bar without threatening Delaware's competitive position. The premise here is that defense counsel see derivative actions as a nuisance, but securities class actions as a serious threat.

To be sure, it is still too early to know that events will actually play out in this fashion. We first need to assess two issues: (1) Will corporate counsel actually adopt charter and bylaw provisions to discourage securities class actions through fee shifting?; and (2) Will federal courts allow them to do so? The obvious alternative possibility is that federal courts will find the federal securities law to preempt fee shifting based on bylaws or charter provisions authorized by state law.

With respect to the first question, good reasons exist why most public companies will not adopt a one-sided "loser pays" bylaw, even if Delaware allows them to do so. One reason is that any such bylaw will trigger the fervent animosity of the major proxy advisors. Both Institutional Shareholder Services (ISS) and
Glass Lewis have made clear that they will oppose the election of directors who vote for such a bylaw. In an era of heightened hedge fund activism, corporate issuers do not needlessly pick a fight with the major proxy advisors. If so, what firms might still adopt such a bylaw? My prediction is that such a fee-shifting bylaw will still be attractive to companies with controlling shareholders or a powerful control group. These firms do not need to fear ISS. Also, fee-shifting provisions seem more likely to be placed in the charters of issuers planning an IPO than to be adopted by board-approved bylaws. Once such a provision is inserted in a company's certificate prior to the IPO by the promoters and underwriters, shareholders will have bought into a known structure, and the proxy advisors can less easily blame the board or seek to remove them. For the IPO firm, the greater threat is §11 of the Securities Act of 1933, and here the Corporation Law Council's language may give such companies as much protection as any other U.S. jurisdiction.

This brings us to the second question: Will federal courts uphold and enforce charter and bylaw provisions mandating fee shifting? Or will they treat such provisions as preempted by the federal securities laws (or possibly, even more broadly, by Rule 11 of the Federal Rules of Civil Procedure)?

A simple primer on preemption needs to begin with the recognition that there are three categories of preemption: express preemption, field preemption, and implied conflict (or "obstacle") preemption.\(^5\) Express preemption is not applicable here, but the latter two theories may be. "Field preemption" recognizes that there are some contexts where Congress has so dominated the field as to leave little or no room for state action. "Obstacle" preemption instead looks to whether the state rule creates a substantial obstacle that frustrates a Congressional policy. No bright-line division separates these two doctrines, and the "cornerstone" of both doctrines is that the "purpose of Congress is the ultimate touchstone in every preemption case."\(^6\)

Although a good argument can be made for field preemption because the Private Securities Litigation Reform Act (PSLRA) comprehensively prescribes standards for securities class actions, let's consider only the case for "obstacle prevention." Here, the PSLRA expresses at least two important federal policies that are frustrated by a "loser pays" rule.

First, a major goal of the PSLRA was to shift control of the securities class action from nominal "in-house" plaintiffs, who held possibly only 100 shares but who had sued in hundreds of cases, to institutional investors who had a real stake in the action and could monitor class counsel.\(^7\) It did this by creating a presumption that the "lead plaintiff" (its term) would be the person or group with the largest stake in the action.\(^8\) As a direct result, public pension funds are now the most common "lead plaintiffs" in securities class actions (but not in other class action contexts). Now, look what happens under a "loser pays" rule. The public pension fund owes its first duty to its pensioners. It knows that around half of securities class actions are dismissed before trial, and thus it would face liability in at least that percentage of the cases—and maybe more if the "loser pays" provision required (as most do) that the plaintiff be "substantially" or "completely" successful on all its theories to avoid fee shifting. Moreover, there is a substantial asymmetry between the pension fund's likely gains and losses. If there is a settlement, plaintiffs have historically received 1-3 percent of their market losses (in terms of the decline in the stock's market
capitalization. But if the case is lost, the pension fund would alone be liable for the corporate defendant’s expenses, which in a securities class action could easily exceed $10 million (and other defendants will also have claims). Thus, as a fiduciary to its pensioners, the public pension fund would have difficulty accepting a 50 percent chance of such a liability (and an even higher risk under a "substantial" success standard) in return for a 50 percent (or so) chance of recovering 1-3 percent of its market losses in a settlement.

Conceivably, class counsel could agree to indemnify the public pension fund serving as lead plaintiff, but this is uncharted territory and the law firm could become insolvent and thus unable to pay. Insurance may only be available with large co-insurance or deductible provisions. As a result, many pension funds may prove unwilling to accept this risk and will no longer serve as lead plaintiff, thereby frustrating Congress’ original intent in the PSLRA.

Ironically, the one party who could rationally serve as a lead plaintiff under a "loser pays" rule will be the judgment-proof, nominal plaintiff with no assets. A plaintiff’s law firm could arrange to give a few shares to a number of otherwise asset-poor plaintiffs, and they could serve as lead plaintiffs (if no one else was willing). In short, we would have come full circle from an original environment of nominal plaintiffs to one of substantial plaintiffs capable of monitoring counsel and then finally back to the starting point. If this happened, Congress’ intent would again be frustrated.

A second Congressional policy that would be frustrated is that set forth in §21D(c) of the Securities Exchange Act of 1934, which was added by the PSLRA. Captioned “Sanctions for Abusive Litigation,” it specifically addresses the problem of frivolous litigation, but in a different and more balanced fashion. Essentially, it provides that at the conclusion of a securities case, the court must make findings as to whether both sides have complied with Rule 11(b) of the Federal Rules of Civil Procedure. If the court finds a violation by either side, then §21D(c)(2) provides that sanctions in some form are mandatory, and §21D(c)(3) creates a presumption that the appropriate sanction is to shift the opposing side’s “reasonable attorney fees” to the side that violated Rule 11(b). But, §21D(c)(3)(ii) requires that the court first find a “substantial failure” to comply with Rule 11(b) in the case of a claim that the complaint was so deficient as to flunk Rule 11(b)’s standards.

So what are the differences between §21D(c) and a "loser pays" rule? First, the PSLRA provision is two-sided, while "loser pays" provisions are inevitably one-sided, applying only to the plaintiff. Second, while a "loser pays" bylaw is automatic, §21D(c) relies on judicial discretion and interposes the court before any penalty is imposed. Third, §21D(c) requires not simply a technical failure, but a "substantial failure" in the case of a claim that the complaint was frivolous. In sum, Congress in the PSLRA decided to impose sanctions only for culpable behavior (and only for a "substantial failure"), whereas sanctions are automatic under a "loser pays" rule (even when the plaintiff is marginally successful under the popular "substantial success" variation on the "loser pays" formula).

Put differently, Congress opted to use a scalpel (possibly to preserve the viability of meritorious securities class actions), while defendants that adopt "loser pays" provisions are choosing the blunderbuss. Again,
the broader sweep and harsher impact of such "loser pays" provisions arguably frustrates the more moderate balance that Congress intended to strike.

Strong as these arguments may be, relatively few cases have dealt with the federal preemption of state procedural rules. Two such cases merit attention. First, in *Burlington Northern Railroad v. Woods*, the issue was whether a state law requiring an appellant to post an appeal bond applied in federal court. Even though the action had been tried in federal court based on diversity jurisdiction, the U.S. Supreme Court found the state rule on appeal bonds not to apply, finding instead that only federal procedural rules applied under its landmark decision in *Hanna v. Plumer*.

Still, a few decisions have upheld the application of state procedural statues in federal court, some even permitting fee shifting against the losing side in federal court. Here, a second case is particularly relevant. In *Smith v. Psychiatric Solutions*, decided last year by the Eleventh Circuit, a fired employee brought a retaliatory-discharge action in federal court, alleging violations of both the Sarbanes-Oxley Act (SOX) and the Florida Whistle-Blower Act. She lost, and the district court awarded attorney fees to her employer. On appeal, she argued that SOX preempted Florida law and precluded such an award of attorney fees to the defendant. But the Eleventh Circuit found no conflict between SOX and the Florida statute, because SOX said nothing about defendants' attorney fees. Still, before one reads too much into this decision, one must recognize that the Florida statute made fee shifting discretionary with the court (and did not mandate them in the way that a "loser pays" rule does). Also, the PSLRA is distinct from SOX in that it is not silent on fee shifting, but has a very clear position on when fee shifting is appropriate.

Add to all this the fact that proposed §§102 and 109 will not permit fee shifting in Delaware-based litigation, even as they tolerate it in federal court. To many federal courts, this may look as if Delaware is discriminating against federal litigation. That is, it forbids in Delaware what it would authorize in federal litigation. Does Delaware have a right to uniquely burden federal litigation with a fee-shifting rule that does not apply in Delaware? We may soon see.

To be sure, a "loser pays" rule is not mandated by state law, but only permitted by bylaws or charter provisions authorized by Delaware law. Still, this is a distinction without a difference. If a state law-mandated "loser pays" rule would be preempted, then so should a state law-authorized such rule. If the state cannot do something because it conflicts with federal law, it cannot authorize others to do what it cannot do.

One final question about the pending Delaware statute merits attention: Will it apply to bylaws or charter provisions adopted before its passage? Is it retroactive? Delaware counsel have argued that revised §§102 and 109 will apply retroactively under §394 of the DGCL, which deems every provision of the DGCL to be incorporated into the charts of existing compliance.

It remains to be seen whether the Corporation Law Council's proposals will pass. Powerful interest groups are lined up on each side. Still one has to wonder if the lobbyists opposed to these proposals truly realize just how little is at stake. By the same token, *ATP Tour* remains alive under this legislation and may haunt
Delaware jurisprudence for years to come. At some future point, some Delaware corporation will adopt a bylaw or charter provision that will require an unsuccessful proxy contestant to reimburse the corporation for the expenses that the contestant has caused the firm. Then, this same drama over the scope of ATP Tour will play out again, and the issue of federal preemption will again return to stage center.

Endnotes:

1. 91 A.3d 554 (Del. 2014).

2. The italicized language is critical. The above-quoted language would be added by §§2 and 3 of the proposed legislation to both §§102 and 109(b) of the DGCL.

3. Emphasis added. This definition is in §5 of the proposed legislation, which would add a new §115 ("Forum selection provisions") expressly to authorize bylaws making Delaware the exclusive forum for "intracorporate claims." One reason this provision defines "intracorporate claims" narrowly may have been a desire to avoid requiring federal securities claims to be brought only in Delaware federal court—a provision that federal courts would not easily tolerate.


7. An older generation of readers will remember the names Harry Lewis and William Weinberger, who each served as a plaintiff in hundreds of cases (if not more), but only owned trivial amounts of stock in many, many corporations.


10. See §21D(c) of the Securities Exchange Act of 1934.


13. 750 F.3d 1253 (11th Cir. 2013).

14. For example, some federal decisions have found private indemnification agreements to be preempted by the federal securities laws, even though the state legislation only authorized (and did not mandate) the indemnification provision. See Globus v. Law Research Service, 448 F. 2d 1276 (2d Cir. 1969); Heizer v. Ross, 604 F. 2d 330, 334 (7th Cir. 1979).

15. Prof. Lawrence Hamermesh, a leading expert on the Delaware corporate law, has taken this position
in a recent blog post. Section 394 is Delaware's "reserved power," and it seemingly makes corporate legislation retroactive unless otherwise provided.

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