Fee-Shifting FAQs

Q. ***Who was responsible for drafting this legislation?***

A. The bill was drafted by the Corporation Law Council (the "Council"), which is a committee of the Delaware State Bar Association (the "DSBA"). The Council drafts recommendations for amendments to the Delaware General Corporation Law (the "DGCL") every year. The group includes 22 lawyers with significant representation from law firms that regularly represent corporations and their directors and officers in transactions and litigation, as well as lawyers who generally represent investor plaintiffs.

Q. ***Does that small group act alone?***

A. Any legislation the Council drafts must be approved by the DSBA Corporation Law Section, which consists of almost 500 Delaware attorneys, and must then be approved by the Executive Committee of the DSBA. In addition, the head of the Division of Corporations participates in Council deliberations as a non-voting member, so that there is administration input on legislation the Council drafts.

Q. ***Does this process result in legislation that causes the DGCL to favor the members of the Council and their clients?***

A. Although clients may make their views known to members of the Council, there is a strong tradition of "leaving clients at the door" when the Council deliberates. Furthermore, Council members understand that in order to preserve Delaware's status as the leading jurisdiction for incorporation, the DGCL must be balanced. Legislation that overly favors management would lead stockholders to abandon Delaware, whereas legislation that creates too much risk for managers would cause these decision-makers to favor other jurisdictions. The DGCL has successfully maintained this balance over the years, and Delaware has retained its edge, including through the pitched takeover battles of the 1980's, the corporate scandals of the early 2000s and the financial crisis of 2008. Unlike groups from outside Delaware that represent solely investors or solely management, the members of the Council have a specific interest in maintaining Delaware as a balanced jurisdiction and thus as the preeminent location for incorporation. As a result, the General Assembly has a unique reason to have confidence in the judgment of the members of the Council, and the DSBA.

Q. ***But isn't the legislation particularly favorable to the plaintiff's bar; wasn't it really drafted by them to preserve their ability to bring lawsuits?***

A. No. The legislation specifically endorses Delaware forum selection provisions, which will further support decisions by courts in other states to respect provisions selecting Delaware as the sole jurisdiction for stockholder litigation. This is the very remedy that corporations have been seeking for some time to curb abusive legislation. In fact, Council members who regularly represent directors and management actively participated in drafting the final bill.

Q. ***What prompted this legislation?***

A. On May 8th of last year, the Delaware Supreme Court decided the ATP case, which permitted a membership corporation to enforce a "fee-shifting" bylaw. The bylaw provided that any member who brought a lawsuit against the corporation or its members or directors would be liable to pay those defendants' legal fees if the member was not fully successful in the lawsuit. Because the DGCL does not have separate provisions for stock and member corporations, some corporate practitioners saw the case as an opportunity to press for fee shifting provisions for profit stock corporations, including publicly traded corporations.

Q. ***What happened after the case was decided?***

A. A number of national law firms quickly put out memos to their corporate clients, alerting them to the decision and suggesting that they consider whether to adopt fee-shifting provisions. Since the case was decided, over 30 public corporations have adopted fee shifting provisions, and six corporations have gone public with such provisions.

Q. ***Is this any different from the legislation that the DSBA proposed in June?***

A. Yes, although it still prohibits fee shifting provisions, it does so in a more targeted fashion. More importantly, the new proposal adds a legislative endorsement of Delaware forum selection clauses, which are another type of provision intended to curb certain abusive litigation practices. Although these provisions have been endorsed in Delaware and some other state courts, the legislation should further ensure their enforceability.

Q. ***What's wrong with letting the market decide whether these provisions should be adopted? Isn't the DGCL supposed to provide flexibility?***

A. Although the DGCL provides great flexibility, corporate law does have certain bottom line provisions that cannot be altered, including common law concepts of fiduciary duty: directors of all corporations owe stockholders fiduciary duties of care and loyalty. In addition, there are certain statutory rights that cannot be altered, such as the right to obtain information from the corporation. This legislation is in keeping with the natural course of the development of our law. Because the statute is broadly enabling, new uses are proposed that may be deemed at odds with the overall structure of our law. The courts must be disciplined to give the DGCL the broadly enabling effect its terms have, and depend on the General Assembly to address uses of the statute that might be deemed problematic as a policy matter. In this case, the Council believes that fee shifting provisions are problematic for stock corporations, but not member corporations, and recommends tailoring the DGCL accordingly.

Q. ***But fee-shifting provisions do not alter these rights, do they?***

A. The purpose and effect of these provisions is to significantly, if not completely, deter the enforcement of stockholder protections. Stockholder suits are generally brought by one or more stockholders on behalf of, or to benefit, many stockholders. Very few, if any, stockholders will be willing to risk individually paying the corporation's legal fees on

behalf of other stockholders. Accordingly, fee-shifting effectively eliminates stockholder rights, because stockholder litigation is the only method of enforcing them. This would be a radical change in the corporate landscape.

Q. ***But if those provisions are so troubling, aren't the courts likely to strike them down?***

A. Not necessarily: the courts are bound to interpret and apply the DGCL as enacted by the General Assembly. The DGCL is broadly enabling, and courts can't pick and choose which charter and bylaw provisions are valid just based on a policy preference. However, even if it were possible that the court would invalidate such provisions, no stockholder could afford the risk of bringing a claim to challenge them because of the risk of losing that challenge and being required to pay the uncapped legal fees of the corporation.

Q. But if this is what corporate managements really want, will other states adopt provisions permitting fee-shifting, and will corporations migrate to such jurisdictions?

A. That is a risk that the Council considered when drafting the proposed legislation. However, the Council firmly believes that the best way to maintain Delaware as the preeminent for a corporation is to maintain a balanced statute.

Q. Are there specific risks to failing to adopt the proposed legislation, so as to permit fee-shifting to go forward?

A. Yes. In the United States, stockholder litigation regulates stockholders and managers. There is no federal or state regulator that enforces the rights of stockholders: they are enforced almost entirely through the mechanism of stockholder lawsuits. A jurisprudence has developed in Delaware over the last hundred years, which has been very successful in regulating this critical relationship. If the ability of stockholders to bring lawsuits were seriously curtailed by fee-shifting provisions, a regulator is quite likely to fill the void--perhaps the federal government. In the long term, this would likely be a much more costly (and less effective) method of overseeing this relationship than the current lawsuit-based system.

Q. Is there anything that can be done to address abusive stockholder litigation?

A. Yes. The Delaware courts have already taken a strong step in this direction by validating "forum selection" provisions as consistent with the broadly enabling structure of the DGCL. These provisions require that lawsuits by stockholders be brought in a single jurisdiction. Such a provision enables courts to more effectively address abusive litigation because plaintiffs cannot "shop" for favorable forums. The Delaware courts have also addressed abusive litigation in the last several years by, among other things, closely reviewing (and in some cases rejecting) certain settlement proposals, and by dismissing some cases at an early stage. The Council believes that the courts have sufficient tools to address this problem.

Q. Does the proposed legislation take any steps to address abusive stockholder litigation?

A. Yes. The proposed legislation will statutorily validate forum selection provisions, in order to ensure that courts outside of Delaware continue to respect provisions requiring that stockholder litigation be brought in Delaware. This provision will give Delaware courts a strong hand in addressing litigation that the courts determine to be abusive, while ensuring that Delaware courts are always available to Delaware corporations and their stockholders. However, the legislation does not permit charter or bylaw provisions that preclude stockholders from bringing their claims in Delaware courts. In other words, the legislation would prohibit provisions that selected another state as the exclusive forum.

Q. Does that change current law?

A. Consistent with the prior discussion, the proposal does limit the broadly enabling nature of the DGCL as to forum selection provisions. Specifically, a recent Chancery Court decision enforced a provision selecting North Carolina courts as the sole forum for a Delaware corporation. The Council believes that stockholders of Delaware corporations should not be denied access to the protection of the Delaware courts. Thus, the broadly enabling nature of the DGCL would be trimmed back to address this issue. In particular, the Council believes that the value of Delaware as a favored jurisdiction of incorporation is dependent on a consistent development of a balance of corporate law, and that the Delaware courts are best situated to continue to oversee that development.

Q. Does legislation include any other provisions to limit stockholder litigation?

A. Yes. The Council is proposing legislation that will address concerns that the "appraisal" statute (which provides stockholders with certain rights following corporate mergers) is being abused. First, the legislation eliminates "nuisance" appraisal suits for stock exchange-traded companies, by requiring such suits involve claims for at least $1M or one percent of the outstanding shares. Second, the legislation provides a method by which a corporation can stop appraisal claims from accruing interest, which has been a significant concern. These appraisal measures, together with the forum selection provisions, should provide significant relief to corporations that believe that they are being victimized by abusive litigation tactics.

Q. Are those tools sufficient to contain problematic litigation?

A. If not, the recent decisions upholding forum selection and fee-shifting provisions suggest that corporations may adopt additional provisions that regulate abusive litigation tactics. Unlike fee-shifting provisions, stockholders could challenge such provisions without risking significant liability, so that a jurisprudence permitting reasonable litigation regulating bylaws may develop.