Delaware court upholds draconian loser-pays provision

Unilateral changes to corporate by-laws that undermine shareholder rights can't be justified by contract law

By Paul Bland

The world of corporate governance and securities law is in an uproar. On May 8, 2014, the Delaware Supreme Court issued a decision in *ATP Tour, Inc. v. Deutscher Tennis Bund* ("the *ATP Decision*")[1] that upheld the facial validity, in at least some circumstances, of a draconian loser pays provision. Under the provision, if a member of a non-stock corporation brings a civil action against the officers and directors of a corporation (and/or the corporation itself), and fails to obtain, in substance and amount, "the full remedy sought," the stockholder is liable for the defendants' attorneys' fees. There are many ways (a number of which will be discussed below) that the scope and impact of the *ATP Decision* might be limited. But if the corporate defense bar succeeds in pushing for a broad interpretation and if most Delaware corporations adopt such provisions, the impact on securities law could be catastrophic.

The prospect that a plaintiff in a non-frivolous securities, breach of fiduciary duty or antitrust case could be liable for enormous attorneys' fees (in the *ATP Decision*, the defendants were seeking just under $18 million as of last May) could certainly have a chilling effect on such litigation, and the chill will only grow colder if the logic of the *ATP Decision* is extended from non-stock corporations like ATP to cover claims brought by investors in publicly traded corporations. If the *ATP Decision* leads to the widespread use and acceptance of loser pays rules, it becomes very hard to see how some future plaintiff would be willing to take the risk to obtain any remedy for even the kinds of egregious fraud that we saw in the infamous Enron or Worldcom cases, for example.

How can this worst-case scenario be prevented? The answer in states other than Delaware may be found in fundamental contract law principles.

By-laws are a contract, shareholders have agreed to its provisions

The Delaware Supreme Court based its acceptance of ATP's loser pays term on principles of contract law. The corporation's by-laws are a contract, the Court reasoned, so the stockholders have agreed to all the provisions of the by-laws. And even though the loser pays provision at issue was adopted long after the plaintiffs had become members of the corporation, the *ATP Decision* held that they were bound by contract principles because they had "agreed" to be subject to changes in the by-laws. The law in Delaware may be established that by-laws (and changing by-laws) are contracts, according to the *ATP Decision*, but the principal question for this article is whether other state high courts are likely to agree with the conclusion that unilateral amendments to by-laws can be given effect under normal rules of contract law? This article will argue that for most states, a wealth of well-developed contract law (the major points of which were not even considered by the Delaware Supreme Court in the *ATP Decision*) dictates that the answer is "no."

Contractual agreements involve *binding* promises between two parties, and can't be rewritten after-the-fact by one side. If one party claims the power to unilaterally amend a contract to add new terms or amend a contract in any way, without providing the other party with clear notice and an opportunity to reject the proposed amendments, most courts would rule such an arrangement does not constitute a contract. The reason is that the arrangement is illusory – there is no binding promise. If an arrangement amounts to "I will do A, and you will do B, but I could change my mind on my own about A, B, or any other terms I might add, and you agree in advance that I can rewrite the contract entirely as I wish without your further consent or involvement," that is not a contract pretty much anywhere (with the apparent bizarre exception of Delaware).

Moreover, core rules of contract law provide that material terms may not be added to an agreement by one party, without the agreement of the other party. A contract constitutes a binding agreement that contains a collection of rights and responsibilities by each party. The law is well established throughout the U.S. (at least, it is outside of Delaware) that if one party to a contract declares that it also wants the deal to include a material new term, the new term does not become part of the contract unless there is a new document. The Delaware Supreme Court's invocations of the concept of contract in the *ATP Decision* were sloppy at best, and counter to core principles of established contract law in a great many other states.

ATP's By-law

The "American Rule" provides that parties to civil litigation are normally

liable only for their own attorneys' fees, with certain exceptions. Perhaps the most prominent exception is that there are a number of statutes aimed at protecting individuals from corporate misconduct – the securities laws, the antitrust laws, the civil rights laws, etc. – that provide that prevailing plaintiffs may recover their reasonable attorneys' fees. But the general rule is that these fee shifting statutes do not apply to prevailing defendants (with very few exceptions) unless the plaintiff brought a case in bad faith, or a case so lacking in merit as to be frivolous.

ATP, a corporation that operates international men's tennis tournaments, adopted a new by-law in 2006 that rejected the American Rule, and replaces it with a very strict loser pays rule for any litigation brought against the league or its members by other members. This by-law provides that if the plaintiff:

> does not obtain a judgment on the merits that substantially achieves, in substance and amount, the full remedy sought then each claiming Party shall be obligated jointly and severally to reimburse the League and any such member or Owners for all fees, costs and expenses of every kind and description (including but not limited to, all reasonable attorneys' fees and other litigation expenses) . . . that the parties may incur in connection with such a Claim.[2]

The language triggering the loser pays provision if the plaintiff does not achieve "in substance and amount, the full remedy sought" is arguably extremely severe. Suppose a plaintiff brings a claim under three theories and prevails on two of them; did the plaintiff achieve "in substance" "the full remedy sought," or would a plaintiff prevailing upon 66 percent of its theories be subject to a large attorneys' fees award? Suppose a plaintiff sues for $10 million and wins "only" $7 million. Did that plaintiff receive "the full remedy sought" in amount, or a lesser figure that will trigger a huge loser pays award? If plaintiffs who win most of their claims can still be hit with multi-million dollar attorneys' fees awards, it will obviously be an enormous deterrent to the filing of cases in the first place.

One other notable fact about ATP's provision is that it was adopted in 2006, but was applied to members who had joined the ATP back in the early 1990s. In other words, the provision was a retroactive loser pays provision, adopted by the board of directors as a protection against the members but without seeking the members' input or consent.

The *ATP Decision*

The tennis federations of two nations (Germany and Qatar), which are members of ATP, sued ATP, alleging a number of illegal actions in connection with certain decisions the ATP had made about how to restructure the tennis tour. The ATP had allegedly downgraded a tournament operated by Germany and Qatar (the Hamburg Tournament) in ways that those two federations found objectionable. In keeping with the old saw about bad facts making bad law, it's frustrating to many plaintiffs' lawyers that whether scam artists like the guys who ran Enron can avoid liability under the securities laws might be determined by a case about where a tennis tournament will be held.

In any case, the plaintiffs asserted both state law and federal antitrust claims against ATP. After a good deal of discovery and substantial motions practice, the case proceeded to a ten-day trial. At the end of the trial, the District Court granted ATP's motion for judgment as a matter of law with respect to the fiduciary duty claims, and the jury ruled for the defendants on the antitrust claims. In short, the plaintiffs did not prevail upon any claim.

ATP then sought to enforce its loser pays by-law, and asked the court to award it nearly $18 million in attorneys' fees. The District Court denied ATP's motion, on the grounds that it would contradict the purposes of the federal antitrust laws for the defendant to be awarded its attorneys' fees in a case that was not frivolous.[3] Put another way, the District Court held that even if one assumed that ATP had a valid claim under Delaware law for its attorneys' fees under its by-law, that any such Delaware law would be preempted by the federal antitrust laws.

The Third Circuit vacated the District Court's decision.[4] The argument that the federal antitrust laws override Delaware state law, which was the basis of the district court's decision, is rooted – like all federal preemption arguments – in the Supremacy Clause of Article III of the U.S. Constitution. But the Third Circuit held that the district court should not have reached the constitutional preemption issue, without first determining if Delaware would allow such a loser pays provision to be promulgated in a by-law.

On remand, the District Court chose not to attempt to resolve in the first instance the myriad questions of Delaware law that had been posed by the Third Circuit. Rather than predict Delaware law as to the validity of a loser pays by-law, the District Court instead certified four questions to the Delaware Supreme Court that it thought would resolve the issue.

The Delaware Supreme Court's opinion responding to the four certified questions in the *ATP Decision* is rather murky, and it has generated substantial debate about its holding and meaning. Two major points stick out, though:

• ATP's loser pays by-law is facially valid under Delaware law, and

• While there is a possibility that the by-law would not be enforceable depending upon certain circumstances not presented to the court in the posture of these certified questions, it was not a problem to apply the by-law against members who joined the corporation before the loser pays rule was enacted.

The Delaware Supreme Court justified the idea that the by-law is enforceable on the grounds that the by-law was a type of contract. The *ATP Decision* states:

> [I]t is settled that contracting parties may agree to modify the American Rule and obligate the losing party to pay the prevailing party's fees. Because corporate by-laws are 'contracts among a corporation's shareholders,' a fee-shifting provision contained in a non-stock corporation's validly enacted by-law would fall within the contractual exception to the American Rule.

How could there be a contractual agreement to the by-law, one might ask, when it was adopted by the corporation a dozen years after the German and Qatar federations had joined the ATP, without their consent? The Court held, in the *ATP Decision*, that when the plaintiff tennis federations had first become members of the corporation, they had agreed to be bound by by-laws that may be adopted and/or amended from time to time by the corporation's board. The idea was that even though the corporation had adopted the loser pays by-law after the federations had become members, they had agreed in advance that the corporation could adopt such a new by-law (or essentially any other by-law the directors might decide to change or add).

Potential limitations on the *ATP Decision*

The full scope of the *ATP Decision* has yet to be fleshed out or made clear. There is an argument, for example, that its holding may not be applicable to shareholder corporations. It is possible that in a case involving a for-profit corporation with generally passive investor shareholders that the Delaware Supreme Court might apply a different rule than it did to the unusual membership corporation involved in the *ATP Decision*. If some future decision were to interpret the *ATP Decision* so narrowly, it would dramatically lessen the significance of the case for enforcement of the securities laws. Some commentators have predicted that the Delaware Supreme Court would not interpret the case as applying to the kinds of shareholder corporations where most "regular investors" put their retirement savings and so forth.

There is certainly a substantial risk that the *ATP Decision* would apply more broadly, however. The opinion's rationale is not obviously cabined to the particular type of corporation involved in the case, and some of the cases cited in the decision for support for various propositions do involve corporations with shareholders. Moreover, it is rather hard to picture the hardy plaintiff who would be willing to bring a test case seeking to narrow the *ATP Decision* to non-stock corporations. The plaintiff tennis federations in the *ATP Decision* are facing the potential of nearly $18 million in liability for the defendants' attorneys' fees. Very few (if any) plaintiffs are likely to risk a similarly ruinous result if they were to lose a challenge aimed at narrowing the precedent set forth in the *ATP Decision*.

Similarly, with respect to cases involving claims under federal statutes (such as the antitrust or securities laws), there is a substantial possibility that Delaware law permitting this by-law is preempted. After all, the Third Circuit did not overturn the District Court's original decision striking the by-law as preempted by the antitrust laws; it merely said that the District Court should not have reached that constitutional issue without first resolving more prosaic issues that might avoid it. There is a very strong argument that the District Court got it right on the merits of its holding about the antitrust laws, however: that imposing loser pays attorneys' fees in a non-frivolous case would strongly deter the enforcement of the federal antitrust laws, undermining their purpose. In the analogous context of employment discrimination, for example, the U.S. Supreme Court has forcefully enunciated the reason that loser pays rules are not included in remedial statutes designed to protect individuals. The Court explained that, if such laws were read to permit prevailing corporate defendants to recover attorneys' fees from individuals, plaintiffs would be discouraged from seeking protection of the law: "[A]ssessing attorney's fees against plaintiffs simply because they do not finally prevail would substantially add to the risks inhering in most litigation and would undercut the efforts of Congress to promote the vigorous enforcement of the provisions of Title VII."[5]

Finally, the Delaware Supreme Court left open the possibility that the loser pays by-law might be unenforceable even in the *ATP Decision* itself, depending upon the full circumstances. The Court noted that even if a by-law is facially valid, it will not be enforced if it was adopted or used for an inequitable purpose.[6] The question then becomes what is an inequitable purpose. The plaintiffs suggested in the *ATP Decision* that it would always be inequitable for a corporation to seek to deter litigation by its members, and the District Court in the case posed that question as the third question certified to the Delaware Supreme Court: "Is such a by-law rendered unenforceable as a matter of law if one or more Board members subjectively intended the adoption of the by-law to deter legal challenges by members to other potential corporation action than under consideration?" While the Delaware Supreme Court reaffirmed the rule that by-laws will not be enforceable where they are inequitable, it did not adopt the broad protective rule suggested by the plaintiffs. It rejected the idea that the by-law was necessarily unenforceable if its purpose was to "deter litigation," because, the Court noted, that is a purpose of all loser pays terms.[7] The Court essentially gave no guidance in the *ATP Decision* itself as to when a by-law might be so inequitable that it could not be enforced. In fairness to the Court, it stated that it did not know enough about the purposes and circumstances animating the adoption of this by-law in this case. After all, the case arrived at the Delaware Supreme Court with a request that the Court decide four specific certified questions, but the Court was not given the chance to decide the entire case based upon a full factual record fleshing out the history of the adoption of the by-law.

It is worth noting that in many other states, a loser pays provision for non-frivolous lawsuits may well be vulnerable as unconscionable under normal provisions of state contract law. In a medical malpractice case, for example, the Utah Supreme Court held that a fee-shifting provision "is not only substantively unconscionable but against public policy."[8] Many other courts have struck loser pays provisions in a wide variety of similar settings.[9]

Reaction to the *ATP Decision*

While the vast majority of corporations have not taken any action yet to adopt similar provisions, "since the [*ATP*] ruling more than two dozen companies have added fee-shifting language to their governing documents."[10] Given the significance of the decision, one might ask why the number of corporations adopting loser pays provisions is not much higher? Part of the answer may lie in the uncertainty and controversy that is widespread in the current climate, and the fierce debate (whose conclusions are not yet clear) that has been stirred up in the legislative, judicial, and public realms. Many corporations may also be holding back, in light of the fierce opposition to loser pays provisions among nearly all large institutional investors.[11]

The *ATP Decision* has triggered an explosion of controversy and fierce debate. On one side, consumer advocates, plaintiffs' attorneys, institutional investors, and many others have vehemently denounced the decision as an enormous threat to the enforcement of the securities laws. One leading consumer advocate wrote, for example, that:

> [F]ee-shifting provisions could effectively bar shareholder securities suits. For example, a company could make a material misstatement or omission its registration statement, or defraud investors into buying its securities, and not face liability. Thus, the presence of a fee-shifting provision could nullify private enforcement of the federal securities laws, weakening investor protections and undermining the integrity of our nation's capital markets.[12]

This author feels that those remarks are exactly on the money. In a similar vein, Professor John Coffey, who is probably the nation's most prominent scholar working on the subject of class actions (and particularly class actions involving securities fraud), has argued that if the Securities and Exchange Commission doesn't take action to prohibit corporations from adopting loser pays provisions in by-laws and in Initial Public Offerings, that it may well risk irrelevance.[13]

On the other hand, some corporate advocates believe that nearly all securities fraud class actions are unjustified, and that it would be good for the country if these cases were largely extinguished. The Executive Director of U.S. Chamber of Commerce's Institute for Legal Reform, which opposes nearly any liability for nearly any corporation under nearly any statute or cause of action (the ILR lobbies and litigates against punitive damages in virtually all circumstances, opposes the use of class actions ins virtually all circumstances, opposes the existence of statutory damages, etc.), took to the pages of the Wall Street Journal to attack the notion that the Delaware legislature might overturn the *ATP Decision*.[14]

Shortly after the Court issued the *ATP* Decision, corrective legislation was introduced in the Delaware state legislature. The legislation quickly proved controversial, and the legislature adjourned for 2014 without having acted upon it. There was a call for further study, however, and during the legislature's recess, the Delaware Corporate Law Section has proposed that no by-law could impose financial liability upon a non-consenting shareholder. To this author, it is rather disturbing (if not surprising) that the Chamber of Commerce has signaled that it will fiercely oppose and lobby against a measure protecting "non-consenting shareholders" from financial liability, but the battle lines will be clearly drawn.

It is always difficult to predict what a legislature will do in the face of a newly emerging controversy, with powerful interests on both sides. Nonetheless, the Delaware legislature has some powerful reasons to take action overturning the *ATP Decision*. Delaware has taken enormous pride in, and benefited a great deal from, the fact that its state courts play an outsized role in corporate governance in the United States. With a large number of large corporations incorporated in Delaware, the state's generally pro-business courts have developed a great deal of sophistication about corporate governance, and it is clear that Delaware courts are interested in maintaining and expanding that role.

The *ATP Decision* threatens the role of Delaware's courts in corporate governance, though. First, if loser pays provisions deter the filing of nearly all securities fraud cases, Delaware's courts – no matter how sophisticated and clever – will have no cases to decide, because cheated shareholders will be sitting at home avoiding ruinous loser pays decisions rather than litigating. Delaware courts can hardly decide the cases that shape our economic policy if no one brings any cases before them. Second, if the *ATP Decision* is interpreted broadly and the Delaware legislature fails to act, it is likely that securities fraud and other corporate governance litigation will all move to other states, and that many other states will refuse to accept or follow Delaware law. In the area of litigation over abusive mandatory arbitration clauses, for example, quite a few courts have found that state laws that would permit arbitration clauses that are essentially exculpatory violate the "public policy" of forum states and have ignored corporation's choice-of-law provisions. If Delaware continues to adhere to an extreme position of embracing loser pays decisions, Delaware's proud courts could find themselves bypassed for most disputes. So even with the Chamber of Commerce opposing any legislation to fix the *ATP Decision*, it's premature to bet against reform.


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Endnotes

1 91 A.3d 554 (Del. 2014) (en banc).
2 *Id.* at 557.
3 *Deutscher Tennis Bund v. ATP Tour, Inc*., No. 07-178, 2009 WL 3367041 (D. Del. Oct. 19, 2009).
4 Deutscher *Tennis Bund v. ATP Tour Inc*., 480 Fed. Appx. 124 (3d Cir. 2012).
5 *Christiansburg Garment Co. v. EEOC*, 434 U.S. 412, 422 (1987).
6 91 A.3d at 558-559.
7 *Id.* at 560.
8 *Sosa v. Paulos*, 924 P.2d 357, 362 (Utah 1996).
9 *See Ragone v. Atl. Video at the Manhattan Ctr.*, 595 F.3d 115, 125-126 (2d Cir. 2010) (enforcement of term awarding fees to prevailing defendant would "significantly diminish a litigant's rights under Title VII"); *In re Checking Account Overdraft Litig.*, MDL No. 2036, 685 F.3d 1269 (11th Cir. 2012) (loser pays provision unconscionable under South Carolina contract law, provision stricken from contract); *Zaborowski v. MHN Gov't Services*, No. C 12-05109, 2013 WL 1363568 (N.D. Cal. April 3, 2013) (arbitration clause substantively unconscionable where it contained a fee-shifting provision where plaintiffs would pay for the defendant's costs if they lost); *Dreher v. Eskco, Inc.*, 2009 WL 2176060 (S.D. Ohio July 21, 2009) (loser-pays provision unenforceable); *Boyd v. Allied Home Mortgage Capital Corp.*, 523 F. Supp. 2d 650, 659 (N.D. Ohio 2007) (refusing to enforce loser-pays clause that would have required plaintiff to pay for defendants' attorney fees in defending arbitration clause); *Wherry v. Award Inc.*, 192 Cal.App.4th 1242 (2011) (loser pays provision in employment contract substantively unconscionable); *Delta Funding Corp. v. Harris*, 912 A.2d 104 (N.J. 2006) (loser-pays provision would impose risk that is unconscionable); *Brown v. MHN Gov't Servs., Inc.*, 2013 WL 4130395 (Wash. Aug. 15, 2013) (clause substantively unconscionable which included a loser pays provision when ordinarily only prevailing employees may recover costs and fees under state wage act); *Gandee v. LDL Freedom Enterprises, Inc*., 293 P.3d 1197 (Wash. 2012) (arbitration clause substantively unconscionable where it contained a loser pays provision).
10 Gretchen Morgenson, *Shareholders, Disarmed by a Delaware Court*, New York Times, October 25, 2014.
11 Michael Green, *ABA Speakers: Fee-Shifting Bylaws, Proxy Access Continue Drawing Attention*, Corporate Counsel Weekly (December 5, 2014) (quoting Patrick McGurn, Executive Director of Institutional Shareholder Services as saying that "institutional investors have a 'virtually universal' and 'absolute visceral reaction' to these types of [loser pays] amendments….")
12 Micah Hauptman, Financial Services Counsel of the Consumer Federation of America, *A Delaware Court Decision Threatens Enforcement of Our Nation's Securities Laws, While the SEC Stands Idly By*, The Huffington Post, November 12, 2014.
13 John C. Coffee Jr., *'Loser Pays': Who Will Be the Biggest Loser?* New York Law Journal, November 20, 2014.
14 Lisa A. Rickard, *Delaware Flirts With Encouraging Shareholder Lawsuits*, Wall Street Journal, November 15, 2014, at A-11.