In Delaware, "loser-pays" decision could have far-ranging consequences

Contract law of many states may be affected, including arbitration provisions

By F. Paul Bland

This is the second of a two-part article. Part 1 can be found in last month's* Plaintiff*, January 2015.

The questions certified to the Delaware Supreme Court in *ATP Tour, Inc. v. Deutscher Tennis Bund* ("the *ATP Decision*")[1] raised the issue of how a bylaw adopted in 2006 could apply to members who joined the corporation in the early 1990s. The answer in the *ATP Decision* was that the members had agreed to abide by a provision allowing the corporation to amend its bylaws down the road in essentially whatever way it chose, and thus, the loser pays provision was enforceable under Delaware's law of contracts. Would this kind of open-ended provision allowing unilateral amendments create binding contractual obligations in other states? The law is fairly clear that most jurisdictions consider such provisions to be illusory and unenforceable.

A number of U.S. Courts of Appeal have embraced and restated the basic rule that "Where a promisor retains an unlimited right to decide later the nature and extent of his performance, the promise is too indefinite for legal enforcement."[2] This principle is also enshrined in the most venerable and established treatise on contract law.[3] The rule has been applied to strike down contract terms by quite a few federal district courts.[4] These principles clearly apply to the rationale of the Delaware Supreme Court in the *ATP Decision*, where members joining the federation supposedly consented in advance to virtually any change to the bylaws that the corporation might seek to make, without notice or opportunity to reject any specific bylaw. As set forth here, the overwhelming weight of authority provides that such provisions are unenforceable as illusory.[5]

It is true that most of the modern case law refusing to enforce open-ended provisions for amendment arise in a different setting, however. Many, though not nearly all of the modern cases addressing this legal doctrine, arise in the context of challenges to pre-dispute binding arbitration clauses. The reason for this is simple: as an enormous number of corporations have adopted mandatory arbitration clauses in consumer and employment settings, in the wake of pro-arbitration decisions from the U.S. Supreme Court, an enormous amount of litigation has sprung up around the enforceability of such clauses. While the Supreme Court's decisions have established that arbitration clauses are generally to be enforced, there are a large number of cases where over-reaching corporations have drafted peculiarly abusive and unfair clauses, and courts have refused to enforce them. Because a great many corporations have adopted sweeping change of terms provisions allowing themselves to rewrite, alter or amend such arbitration provisions, there are dozens of cases striking down such change of terms provisions as illusory in the context of arbitration clauses. Today, the vast majority of corporations have written arbitration clauses that do not include provisions allowing for unilateral amendments, having learned from the great body of case law that such provisions undermine their contracts.

The most common doctrinal basis for courts to refuse to enforce as illusory provisions allowing corporations to unilaterally amend documents is that there is no consideration for any promise. As one court noted, "an illusory promise, 'that is, a promise merely in form, but in actuality not promising anything …cannot serve as consideration.'"[6]

There is also a great deal of authority holding that provisions allowing the stronger party to unilaterally amend documents are unconscionable. Under this doctrine, even if two parties agree to form a contract, it will not be enforceable if it is so unfair that it exceeds the reasonable expectations of the weaker party. The exact formulations of the test and elements of unconscionability doctrine differ a fair bit from one state to another, and there are several types of contract terms that have been held to be unconscionable in several states but that are considered perfectly enforceable in several other states. In any case, quite a few courts have held that terms allowing for unilateral amendments are substantively unconscionable. The Ninth Circuit, for example, has held that a contract term purporting to give a corporation the "unilateral right to modify" an agreement was "precisely the sort of asymmetrical … agreement that is prohibited under California law as unconscionable."[7] A host of other courts have reached the same view.[8]

The upshot is that even though the Delaware Supreme Court did not notice the issue, most other jurisdictions are likely to allow corporations to impose loser-pays provisions upon persons who are already members (or shareholders) of a corporation through a subsequently adopted bylaw, without giving the members (or shareholders) notice of the change and the opportunity to reject it.

"Add-on" provisions to contracts?

The contract law of many states would not permit a party to add a material term after the contract has been formed. Contracts are legally binding agreements between parties under which each party agrees to make certain promises. The entire premise of a contract is undermined if one party can unilaterally add a highly significant term to the agreement after it has been reached. To take an obvious hypothetical, if A promises to sell 100 widgets to B for $10,000, no one would think that contract law permitted B to later say, "I've decided that in addition to $10,000, I also want your car and your house." The simple explanation is that B would be attempting to add a material term after the agreement had been formed, and that no such term becomes part of the contract unless *both* parties agreed to the term. The Delaware Supreme Court inexplicably lost sight of this basic notion of contract law in the *ATP Decision*, where it allowed ATP to add an extremely material term (a term that allowed it to pursue two members for nearly $18 million!) more than a dozen years after the members joined the corporation.

While this rule has common law antecedents that long pre-date the Uniform Commercial Code, some of the most memorable applications of this exceptionally well-established rule come in the business-to-business setting. In particular, most lawyers probably remember from law school hypotheticals about two companies who reach an agreement on all the essential points necessary to form a contract (e.g., the sale of identified goods at a specified time for a specified price), and then one (or sometimes both) companies send over some sort of documentation that not only memorializes the agreement actually reached by the parties, but also attempts to add a bunch of other terms. This is the famous "battle of the forms." For generations, courts have resolved this sort of dispute by holding that no term that would "materially alter the original bargain" will become part of the contract "unless expressly agreed to by the other party."[9] In a landmark case where parties reached an agreement (a contract) over the telephone, and then one merchant sent a "confirmation form" that included a new, material term, the U.S. Court of Appeals for the Fourth Circuit had no difficulty holding that "the additional terms become part of the contract *unless they materially alter it*."[10] These principles are hardly controversial, and have been applied repeatedly by state and federal courts in the context of common law and Uniform Commercial Code cases for decades.[11]

For whatever reason, the Delaware Supreme Court did not even consider the issue of whether ATP's draconian loser pays bylaw was a material term added after the contract had been reached, and if so, what the impact of that fact would be. If the issue is well litigated in a future case in a different jurisdiction, it is unlikely that other state supreme courts will fail to grasp the issue or depart from the normal rule about late-added material terms. And it seems unlikely that many state high courts are going to allow investors to have core rights taken from them through the addition of material terms after the fact.

Conclusion

The scope and import of the *ATP Decision* is impossible to predict at this time. It is possible that the Delaware Supreme Court could rein in its own creation, imposing limits that will greatly reduce the impact of the decision. It is possible that the vast majority of corporations will avoid adopting provisions like ATP's harsh loser pays provision, because they fear the reaction of investors to corporations who essentially strip investors of any remedy if the investors are defrauded. It is possible that the Delaware legislature will step in and take decisive action limiting the decision. It is possible that the Securities and Exchange Commission will decide that part of its mission of protecting investors requires it to take action to prevent corporations from completely immunizing themselves from private enforcement of the securities laws. For these or other reasons, it is distinctly possible that the *ATP Decision* will turn out not to matter a great deal.

On the other hand, it is possible that the U.S. Chamber of Commerce will get its way, as so often happens in America in this era. It is possible that the *ATP Decision* will be read broadly to permit virtually all Delaware corporations to adopt loser-pays provisions, that no federal law will be interposed, that a gigantic number of corporations will adopt such clauses, and that the private enforcement of the securities laws will largely disappear.

But what about corporations that are not incorporated in Delaware? Will courts in other states allow corporations to unilaterally adopt bylaws that strip shareholders of the ability to sue when they are defrauded? The betting here is that for the vast majority of states, the answer is "no." While the Delaware Supreme Court seems to have blinked and simply missed the issue, there is an enormous body of law that provides that parties to contracts may not reserve the right to unilaterally rewrite, alter or amend, or add terms to documents. The vast majority of courts have held that such reservations of power render a document illusory, and prevent the formation of any contract.

Similarly, to the extent that corporations seek to amend their bylaws to include provisions such as a loser pays provision after an investor has purchased a security, the laws of most states would treat such provisions as material terms that are added after the contract was formed, and thus they will be excluded (and not become part

of the contract) unless they are expressly agreed to by the shareholder.

Delaware may have gone off the rails of basic principles of contract law in the *ATP Decision*, but other states are much less likely to completely abandon those principles.


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Endnotes

[1] 91 A.3d 554 (Del. 2014) (en banc).

[2] *Day v. Fortune Hi-Tech Marketing, Inc.*, 536 Fed. Appx. 600 (6th Cir. 2013); *Blair v. Scott Specialty Gases*, 283 F.3d 595, 604 (3d Cir. 2002); *Floss v. Ryan's Family Steak House, Inc.*, 211 F.3d 306 (6th Cir. 2000).

[3] E.g., Samuel Williston Contracts, Section 43, at 140 (3d ed. 1957).

[4] *E.g., Harris v. Blockbuster, Inc.,* 622 F. Supp.2d 396 (N.D. Tex. 2009); *Zamora v. Swift Transp. Corp.*, 547 F. Supp.2d 699, 704 (W.D. Tex. 2008); *Perez v. Hospitality Ventures-Denver LLC*, 245 F. Supp.2d 1172, 1175 (D. Colo. 2003); *Dumais v. Am. Golf Corp.*, 150 F. Supp.2d 1182, 1193-94 (D.N.M. 2001); *Trumbull v. Century Mktg. Corp.*, 12 F. Supp.2d 683, 686 (N.D. Ohio 1998); *Gourley v. Yellow Transp., L.L.C.*, 178 F. Supp.2d 1196 (D. Colo. 2001).

[5] See also *Baker v. Bristol Care, Inc.*, No. SC93451, 2014 WL 4086378 (Mo. Aug. 19, 2014); *Cheek v. United Healthcare of the Mid-Atlantic*, 835 A.2d 656, 662-663 (Md. 2003); *Salazar v. Citadel Communications Corp.*, 90 P.3d 466 (N.M. 2004); *Sears Roebuck & Co. v. Avery*, 593 S.E.2d 424, 432-433 (N.C. Ct. App. 2004).

[6] *Damato v. Time Warner Cable, Inc*., No. 13-CV-994, 2013 WL 3968765, at *5 (E.D.N.Y. July 31, 2013); see *Asmus pac Bell*, 96 Cal. Rptr. 2d 179, 188 (Cal. 2000).

[7] *Net Global Marketing, Inc. v. Dialtone, Inc.*, 217 F. App'x 598, 602 (9th Cir. 2007), citing *Armendariz v. Foundation Health Psychare Sevs., Inc.*, 6 P.3d 669, 694 (Cal. 2000).

[8] See *Raymours Furniture Co., Inc. v. Rossi*, No. 13-4440, 2014 WL 36609 (D.N.J. Jan. 2, 2014); *Merkin v. Vonage America, Inc.*, No. 2:13-cv-08026, 2014 WL 457942 (C.D. Cal. Feb. 3, 2014); *Brennan v. Bally Total Fitness*, 198 F. Supp. 2d 377, 384 (S.D.N.Y. 2002); *Snow v. BE&K Constr. Co.*, 126 F. Supp. 2d 5, 14-15 (D. Me. 2001); *Walker v. Ryan's Family Steak Houses, Inc.*, 289 F. Supp. 2d 916, 934 (M.D. Tenn. 2003); *Sapiro v. Musicians' Union of San Francisco, Local No. 6*, No. C-87-850, 1987 WL 58071 at * 3 (N.D. Cal. Dec. 21, 1987).

[9] *Southeastern Enameling Corp. v. General Bronze Corp.*, 434 F.2d 330, 334 (5th Cir. 1970).

[10] *Supak & Sons Mfg. Co. v. Pervel Indus., Inc.*, 593 F.2d 135, 136 (4th Cir. 1979) (emphasis added, interior quotations and citations omitted).

[11] E.g., *Schnabel v. Trilegiant Corp.*, 697 F.3d 110, 123 (2d Cir. 2012) (material term sent in a "welcome email" after transaction completed did not become part of contract); *McCreary v. Liberty Nat'l Life*, 6 F. Supp.2d 920 (N.D. Miss. 1998) (material term sent to consumer after signing application for life insurance policy did not become part of the contract); *Lima v. Gateway, Inc.*, 886 F. Supp.2d 1170 (C.D. Cal. 2012) (rejecting enforcement of an arbitration clause contained in a user's guide sent to a customer after a sale); *Howard v. Ferrelgas Partners, Ltd. P'ship*, 2013 WL 593638 (D.Kan. Feb. 15, 2013) (consumer not bound by material term sent after the consumers had signed up for services).