

Delaware Chancery Court Strikes Down Fee-Shifting Bylaw

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In [*Solak v. Sarowitz*](#), the Delaware Court of Chancery held that a corporate bylaw ran afoul of 8 Del. C. Section 109(b), as recently amended, where it purported to shift attorney fees and expenses to an unsuccessful stockholder that filed an internal corporate claim outside of the state of Delaware.

Two recent amendments to the Delaware General Corporate Law (DGCL) were at issue in the case. The first was the addition of Section 115, which expressly authorized Delaware corporations to adopt bylaws requiring internal corporate claims to be filed exclusively in the state of Delaware. The second was the amendment of Section 109, which, in the wake of the Delaware Supreme Court's decision in *ATP Tour v. Deutscher Tennis Bund*, 91 A.3d 554 (Del. 2014), precluded Delaware stock corporations from issuing bylaws imposing liability on shareholders for the corporation's or other parties' attorney fees and expenses in connection with internal corporate claims.

Shortly after these amendments were codified, the board of Paylocity Holding Corp. adopted new bylaws that: required all internal corporate claims to be filed in the state of Delaware (the forum selection bylaw); and purported to shift fees and costs to unsuccessful shareholders that filed internal corporate claims outside the state of Delaware without the company's permission (the fee-shifting bylaw). As the *Solak* court recognized, to trigger the fee-shifting bylaw, a shareholder must first violate the forum selection bylaw.

Following the adoption of the bylaws, a Paylocity shareholder brought suit, seeking, among other things, a declaration that the fee-shifting bylaw violated Section 109(b) and was thus invalid. The company responded in two primary ways. First, the company argued that the suit was unripe because there was no action pending in another jurisdiction that could trigger the fee-shifting bylaw, nor did the plaintiff plead any intention to file such a suit. The company next argued that, in any event, the fee-shifting bylaw was permitted by law.

With respect to Paylocity's ripeness defense, although Paylocity correctly asserted that no suit was pending (or threatened by the plaintiff in the complaint), the court determined that the dispute was ripe for decision. The court explained that it was highly unlikely that a rational shareholder would ever file an internal claim outside of Delaware due to the risk of personal liability triggered by the fee-shifting bylaw. Thus, according to the court, "to decline to review the fee-shifting bylaw ... would mean, as a practical matter, that its validity under the DGCL would never be subject to judicial review." Moreover, the court noted that hearing the case now would help clear up any uncertainty and inform other corporations and investors as to the permissibility of fee-shifting bylaws following the recent DGCL amendments.

As to the merits of the fee-shifting bylaw, the defendants advanced three arguments in their defense—all of which were rejected by the court. First, defendants argued that the amendment to Section 109(b) should be read in tandem with Section 115, as those provisions were simultaneously adopted. Thus, according to defendants, Section 109(b) should not be read to preclude fee-shifting for internal corporate claims filed outside of Delaware where the company had first enacted a bylaw requiring internal corporate claims to be filed in Delaware. The court rejected this argument, however, holding that nothing in the text of either provision reflected any intent by the legislature for them to be read in concert. Additionally, Section 109(b) did not distinguish between internal corporate claims filed inside or outside of Delaware.

The court next rejected defendants' argument that Section 109(b) did not displace the common law, which generally permitted fee-shifting. In doing so, the court, citing *A.W. Financial Services v. Empire Resources*, 981 A.2d 1114 (Del. 2009), noted that the common law could be repealed by implication where "there is fair repugnance between the common law and a statute, and both cannot be carried into effect." To the extent the *ATP* decision, which prompted the amendment to Section 109(b), could have been read to approve the use of fee-shifting bylaws for stock corporations as they related to internal corporate claims, the legislature expressly removed such a possibility in its recent amendment of that statute.

Finally, the court rejected defendants' argument that the fee-shifting bylaw was valid because it contained a savings clause, making it enforceable only to the "fullest extent permitted by law." The problem, in the court's view, was that there was no part of the fee-shifting bylaw that was permitted by law. Thus, after the invalid portions of the fee-shifting bylaw were removed, there was nothing left to save.

While the court held that the fee-shifting bylaw violated Section 109(b), the court dismissed a similar challenge based on Section 102(b)(6), which generally prevents a corporation from imposing personal liability on shareholders for corporate debts except as specifically set forth in the certificate of incorporation. The plaintiffs argued that the fee-shifting bylaw violated Section 102(b)(6) because, if upheld, shareholders could be forced to reimburse the company for its attorneys' fees and expenses even though there was no provision authorizing the shifting of corporate debts to shareholders in Paylocity's certificate of incorporation.

In dismissing plaintiffs' claim, the court held that plaintiffs failed to meet their heavy burden of establishing that Section 102(b)(6) renders the fee-shifting bylaw "invalid under any circumstances." While it is possible that the fees and expenses set forth in the fee-shifting bylaw constitute "debts," as that term is used in Section 102(b)(6), the court noted that plaintiffs failed to provide authority supporting that position. The court also stated that it was possible that by filing an action outside of Delaware in contravention of the forum selection bylaw, the exception to Section 102(b)(6) may apply, which permits corporations to look to shareholders for corporate debts caused by the shareholders' own acts. Finally, the court noted that dismissal of the Section 102(b)(6) claim was warranted in light of the fact that the court already found that the complaint stated a claim under Section 109(b), and as such, there was no practical need for further relief.

The court similarly dismissed plaintiffs' claim for breach of fiduciary duty against Paylocity's directors, in which the plaintiffs alleged that the Paylocity board may have acted in bad faith by approving the fee-shifting bylaw and by failing to properly disclose it to the shareholders. In doing so, the court observed that Paylocity's certificate of incorporation contained a Section 102(b)(7) provision exculpating its directors from breaches of the duty of care, and the plaintiffs pleaded no facts from which one could reasonably infer that the Paylocity board acted in bad faith or otherwise knew they were violating the law.

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