Decision Allows Fee-Shifting Provisions in Bylaws, and a Win for Sotheby's, Loeb

Not so fast: Delaware legislation that would have nullified court's decision is postponed.

By Francis G.X. Pileggi and Kevin F. Brady

The Delaware Supreme Court recently issued a decision that has triggered great interest among directors and officers, for two reasons: first, it discusses a significant change in the scope of what is permissible in a corporation's bylaws, and second, it demonstrates how quickly the Delaware legal community can act to keep its corporate statutes in line with new developments in the law.

In *ATP Tour, Inc. v. Deutscher Tennis Bund*, the court determined that, as a general principle, it is permissible for corporate bylaws to include a provision that makes the losing party responsible for any legal fees incurred in connection with a lawsuit filed by a stockholder against a company.

The case involved a Delaware non-stock membership corporation governed by a board that had the authority to unilaterally amend its bylaws. Because the analysis of the Supreme Court interpreted provisions of the Delaware General Corporation Law (DGCL) that apply equally to stock and non-stock corporations, the conclusion in this decision can be fairly read to apply to stock corporations as well.

An important qualification is that such a bylaw adopted by the board will only be facially valid if it was not adopted or used for an inequitable purpose. This is consistent with the bedrock equitable principle of Delaware corporation law, which provides that "inequitable action does not become permissible simply because it is legally possible."

The court cited previous Delaware decisions that invalidated bylaws adopted for the purpose of perpetuating board members in office or obstructing efforts by dissident stockholders in the exercise of their rights to undertake a proxy contest against management.

By comparison, the court in a separate, prior case upheld a restrictive bylaw that was adopted by a majority stockholder in order to limit the anti-takeover maneuvering of the board after the majority stockholder had gained control of the corporation. The bylaws upheld in that case increased the board quorum requirement and mandated that all board actions be unanimous. Also, the court reasoned in that case that the bylaw amendments were a permissible effort on behalf of the stockholder to avoid its disenfranchisement. Thus, the circumstances surrounding the adoption of a bylaw are relevant to its enforceability.

Subject to those limitations, the court ruled that a bylaw that shifted fees even where "no relief at all against the corporation" was obtained could also be valid. The court explained that fee-shifting provisions by their nature deter litigation, and therefore, the adoption of such a bylaw with the intent to deter litigation is not *per se* invalid.

Legislation Quickly Proposed

The opportunity to adopt such bylaws, however, was thought to be in danger of being curtailed.

Within the same month of the *ATP Tour* decision by the Delaware Supreme Court upholding fee-shifting bylaws, the Corporation Law Section of the Delaware State Bar Association (which each year updates the state's corporate statute) proposed a new Section 331 to the DGCL that would prohibit the adoption of fee-shifting bylaws, and would preclude virtually all charter or bylaw provisions that

would purport to impose monetary liabilities on stockholders. The net effect would have been to nullify the court's decision as it pertains to stock corporations. (The proposed Section 331 would exclude nonstock corporations from its application.)

This proposed addition to the DGCL addresses the concern that fee-shifting bylaws would reduce the ability of stockholders to bring even meritorious claims, which would eviscerate the important protection that recourse to the courts provides to stockholders of both public and private corporations. Although some may consider such bylaws a cure to what they view as the bane of excessive stockholder litigation, the Council of the Delaware Corporation Law Section (which consists of a cross-section of Delaware attorneys who represent corporations and stockholders) is concerned that if such a bylaw provision were permitted by the DGCL, it would have an adverse impact on capital formation, in addition to chilling the ability of stockholders to police the obligations of directors and officers through the mechanism of access to the courts.

The state legislature decided to postpone consideration of this proposal until next year. One concern of the Council was that it would not be in the interest of Delaware corporation law to impose on shareholders liabilities that exceeded the cost of their investment.

Costly Decisions

In a recent decision, the Delaware Chancery Court rejected the request by activist investor Daniel S. Loeb of Third Point LLC to overturn Sotheby's corporate defense mechanism, a so-called two-tiered poison pill. Loeb claimed in the case filed in March against the 270-year-old auction house that the so-called poison pill was hampering Third Point's efforts to seek three seats on Sotheby's board. Loeb also claimed that the poison pill adopted by the company was unfair because it discriminated only against activist investors like him.

In its ruling, the court called Loeb's assessment inaccurate and rejected the activist investor's appeal to force the company to retract its shareholder rights plan, writing that the adoption of the poison pill was rational because Sotheby's management rightfully feared a hostile takeover attempt. The court wrote that the defense mechanism "does not contain any features that would outright force a stockholder to vote in favor of the board or allow the board to induce votes in its favor through more subtle means."

> The decision in *Sotheby's* gives directors the power ...to rebuff the advances of an unwanted suitor.

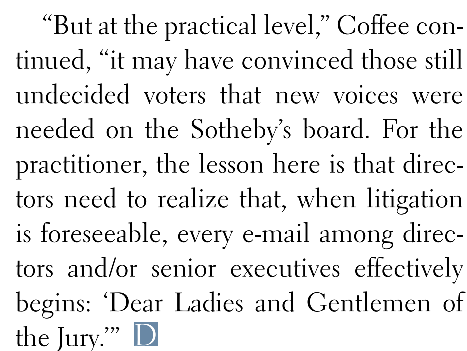
In a settlement, Sotheby's agreed to give Loeb most of what he sought, expanding its board to include Loeb and two other board candidates he had proposed—but not allowing him to gain control. Third Point agreed to end its proxy battle and to cap its ownership of Sotheby's at 15 percent.

Boards will have to think twice before spending time and money to adopt and defend an anti-activist poison pill. This decision, however, gives directors the power, in the right circumstances, to rebuff the advances of an unwanted suitor when the company is not for sale and the board does not believe that the activist's bid is in the long-term best interests of the company.

Writing on the Columbia Law School blog, John C. Coffee Jr., who served as an expert witness for Sotheby's (and so admitted the potential for some bias in his analysis), nonetheless spelled out four lessons as a result of the court's decision. It was Coffee's second lesson that caught our attention: "Winning the war in the courtroom, does not win the war on the proxy battlefield. In fact, the reverse may be true."

Coffee, the Adolf A. Berle Professor of Law at Columbia and director of its Center on Corporate Governance, wrote: "Sotheby's pill was upheld, but so what? Sotheby's still had to sue for peace and accept all three insurgent directors. ... Also, Third Point's counsel made great use in court of e-mails showing some Sotheby's directors [shared] Third Point's doubts about internal governance and compensation levels at Sotheby's. Legally, this evidence probably demonstrated the independence of the Sotheby's directors and illustrated a robust and candid internal debate.

"But at the practical level," Coffee continued, "it may have convinced those still undecided voters that new voices were needed on the Sotheby's board. For the practitioner, the lesson here is that directors need to realize that, when litigation is foreseeable, every e-mail among directors and/or senior executives effectively begins: 'Dear Ladies and Gentlemen of the Jury.'"



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