August 11, 2015

Delaware General Corporate Law Amended to Prohibit Fee-Shifting Clauses; Permit Forum Selection Provisions

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

Although the federal government and FINRA have become increasingly active in matters of corporate governance, the states still remain the primary authority and regulator of corporate law. State corporation law is generally based on the Delaware Model Act and offers corporations a degree of flexibility from a menu of reasonable alternatives that can be tailored to companies' business sectors, markets and corporate culture. Moreover, state judiciaries review and rule upon corporate governance matters, considering the facts and circumstances of each case and setting factual precedence based on such individual circumstances.

On June 24, 2015, Delaware amended the Delaware General Corporation Law ("DGCL") to prohibit fee shifting provisions. The DGCL amendments also allow Delaware corporations to adopt exclusive (and non-exclusive) forum selection provisions in their corporate charters. The amendments went into effect August 1, 2015.

Fee Shifting Provisions

As a result of increasing shareholder activism and filed or threatened shareholder lawsuits, corporations have started adding provisions in their corporate charters (articles and/or bylaws) whereby the non-prevailing party in an inter-company lawsuit must pay the prevailing parties' attorneys' fees. Prevailing party attorney's fees provisions are standard in contracts. In adding such provisions to corporate charter documents, a corporation is taking the position that if a person becomes a shareholder of the corporation, they are agreeing to be bound by the terms of the corporate charter documents, much like being bound by a contract, including the prevailing party attorney fee provision.

Absent a contractual (or statutory) prevailing party fee provision, parties to litigation are required to each pay their own attorneys' fees. The prevailing party fee provision acts to shift the fees to the shareholder/plaintiff in the event they are not successful. In addition, the fee-shifting provisions define "successful" in most cases as the substantial achievement, in substance and amount, of the full remedy sought. For example, a plaintiff can ask for $1,000,000, win $750,000 and be a non-prevailing party under a fee-shifting provision. Typically, the fee-shifting provisions extend beyond just the plaintiff to all those with a financial interest in the outcome, or those which assist the plaintiff. With such a broad extension, the plaintiff's attorneys could find themselves also directly responsible for the defendant's attorney's fees in the event the plaintiff is not successful.

Much like an anti-takeover poison pill, these fee-shifting provisions are an anti-shareholder-lawsuit poison pill. Not only do such provisions apply to standard derivative lawsuits for such matters as a corporate breach of fiduciary duty, but they can be broadly applied to inter-company lawsuits, including those involving claims of securities law violations.

The legal basis relied upon by corporations for adding such a provision is that when a shareholder buys stock, they are agreeing to be bound by the corporate charter documents. This theory is not far-fetched and is actually supported by a broad array of legal dicta. For instance, when a shareholder buys stock in a company, they are agreeing to be bound by the voting rights (including number of votes, notice and similar provisions related to shareholder and director meetings), information rights, dividend and participation rights, liquidation rights, and recently choice of law and jurisdiction provisions. It seemed a natural progression to add other standard contractual provisions to such corporate charter documents, but the fee-shifting provisions were instantly met with a great deal of opposition, including by the Delaware legislature.

In May 2014, the fee-shifting provision was challenged and the Delaware Supreme Court upheld the provision as valid, at least in that case. The court did note that the validity of the provision included an analysis of the "circumstances surrounding its adoption and use" and whether it was "adopted or used for an inequitable purpose." The intent to deter litigation is not an improper purpose.

The court ruling faced a great deal of opposition, including from the Delaware corporate bar and the Delaware legislature.

The Delaware legislature in turn drafted a bill to make it unlawful to include fee-shifting provisions in corporate charters and bylaws. The bill was tabled until January 2015 and finally was passed into law on June 24, 2015. The two primary proxy advisory firms, Institutional Shareholder Services, Inc., and Glass Lewis & Co., both recommended that

shareholders vote against fee-shifting provisions and generally against forum selection provisions subject to a consideration of certain facts related to the company's rationale and history with shareholder lawsuits.

The DGCL amendment adds new Sections 102(f) and 115, and amends current section 109(b) to invalidate any provision in the certificate of incorporation or bylaws that shifts the corporation's or any other party's attorney's fees or expenses to the shareholder in an "internal corporate claim." New Section 115 defines an "internal corporate claim" as "claims including claims in the right of the corporation, (i) that are based upon a violation of a duty by a current or former director of officer or stockholder in such capacity, or (ii) as to which this title confers jurisdiction upon the Court of Chancery."

My Thoughts on Fee Shifting

I agreed with the Delaware Supreme court and think the provisions should be allowed, though their scope may have needed an adjustment. Shareholder lawsuits have become so commonplace that they are practically a method of communication—sue now, talk later. Predatory plaintiffs' attorneys comb for pending merger transactions and/or decreases in stock prices and then solicit shareholders looking for a plaintiff or representative plaintiff for a class action. Whether there has actually been a corporate wrongdoing is secondary and often not even a consideration. As a transactional attorney, I think litigation should be a last, not first, option.

I'm not insensitive to the counter-argument. Fee-shifting provisions can have a chilling effect on valid cases to enforce real securities law violations or breaches of corporate fiduciary duty. Broad provisions that include potential attorneys' fee liability for plaintiffs' counsel and expert witnesses could effectively wipe out private lawsuits against Delaware corporations.

However, by narrowing the scope of allowable fee-shifting provisions to limit liable non-prevailing parties to the parties themselves, or their counsel only in egregious cases, and by limiting the definition of "success," a balance could be reached.

Some opponents of the fee-shifting provisions called for SEC intervention. Professor John Coffee and Professor Lawrence Hammermesh both gave testimony to the SEC's Investor Advisory Committee pushing for SEC action. In other words, some called for greater federal regulation of corporate law. I disagree with this approach. Over the years the federal government, or quasi-governmental regulators, has enacted regulations that have the effect of imposing on state corporate law. The result has been a piecemeal corporate federalism, often with unintended results. A prime example is illustrated in my blog regarding FINRA's Rule 6490, which can be read HERE.

The amendments to the DGCL take the issue out of the hands of the courts (absent a challenge to the amendment itself) and the SEC. However, corporations resorted to these provisions for a reason, and that reason still exists. I'm interested to see what the next defensive measure brings.

Forum Selection

A forum selection clause limits the jurisdiction in which a corporation can sue or be sued in certain types of actions, including but not limited to (i) derivative actions or proceedings brought on behalf of the corporation, (ii) actions asserting a claim of breach of fiduciary duty owed by a director, officer or other employee of the corporation to the corporation or its shareholders, (iii) actions asserting a claim under the applicable state corporate law, or (iv) actions asserting a claim governed by the internal affairs doctrine.

In 2013, the Delaware Chancery Court found that forum selection provisions are facially valid and may be adopted unilaterally by a board of directors as long as they are reasonable and fair. The court concluded that enforceability should be assessed on a case-by-case basis using a reasonableness standard of analysis.

The newly enacted legislation will allow Delaware corporations to include a Delaware choice of law provision in their certificates of incorporation and bylaws provided that a Delaware corporation cannot designate a state other than Delaware as the exclusive forum for an internal corporate claim. In particular, the DGCL amendment includes a provision in new Section 115 that "the certificate of incorporation or the bylaws may require, consistent with applicable jurisdictional requirements, that any or all internal corporate claims shall be brought solely and exclusively in any or all of the courts in this State, and no provision of the certificate of incorporation or the bylaws may prohibit bringing such claims in the courts of this State."

The Author

Attorney Laura Anthony
Founding Partner
Legal & Compliance, LLC
Corporate, Securities and Going Public Attorneys
LAnthony@LegalAndCompliance.com

Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

Contact Legal & Compliance, LLC. Inquiries of a technical nature are always encouraged. Follow me on Facebook, LinkedIn, YouTube, Google+, Pinterest and Twitter.

Download our mobile app at iTunes and Google Play.