FEE-SHIFTING: DELAWARE'S SELF-INFLICTED WOUND

BY STEPHEN M. BAINBRIDGE[·]

ABSTRACT

In its 2014 ATP Tour, Inc. v. Deutscher Tennis Bund *opinion, the Delaware Supreme Court upheld a fee-shifting bylaw, which required unsuccessful shareholder litigants in either derivative or direct actions to reimburse the corporation for its legal expenses. Although the entity in question was a nonprofit, nonstock corporation, most observers expected the Delaware courts to extend that holding to for-profit stock corporations. In the months that followed, about fifty Delaware corporations adopted such bylaws.*

In its 2015 legislative session, however, the Delaware General Assembly adopted amendments to the Delaware General Corporation Law—S.B. 75—that effectively bans such bylaws. This Article argues that the ban on fee-shifting bylaws is contrary to sound public policy and adverse to Delaware's own interests. It then advances an interest group analysis, focusing on the power of the Delaware bar to explain why the Delaware legislature would have inflicted such a serious wound on itself.

This analysis leads to two take-home lessons. First, if it wishes to ensure that future legislation advances both sound public policy and the State's financial interests, the Delaware legislature needs to free itself from the bar's influence. In addition, the business community needs to invest lobbying resources in Delaware so as to counter the bar's influence in cases such as this. Second, states in which the corporate bar wields less legislative influence thus may have a significantly easier time adopting legislation authorizing such bylaws. If so, the likelihood that S.B. 75 will significantly reduce Delaware's dominance of corporate law will go up substantially.

TABLE OF CONTENTS

[·] William D. Warren Distinguished Professor of Law, UCLA School of Law.

I. INTRODUCTION

Shareholder litigation long has been controversial.[1] In recent years, however, the problem has reached crisis proportions.[2] The situation is probably worst in mergers and acquisitions, where more than 90% of transactions are now challenged by shareholder lawsuits,[3] often in multiple suits filed in multiple jurisdictions.[4] The problem is not isolated to that context, however, as there has been a marked increase in shareholder litigation generally over the last decade.[5]

If shareholder litigation were an effective means of compensating shareholders for wrongdoing by managers or directors, these trends might be less objectionable. The evidence, however, is that shareholder

---

[1]*See* Note, *Shareholder Intervention in Corporate Litigation*, 63 HARV. L. REV. 1426, 1426 (1950) ("[T]he shareholder's derivative suit has been a familiar and controversial topic for a hundred years . . . ."). In this Article, I use the term "shareholder litigation" generically to encompass direct suits brought by shareholders under state corporate law against any combination of the corporate entity and its officers and directors, derivative suits brought under state corporate law on behalf of the corporation against its officers and directors, and federal securities litigation brought by shareholders under state corporate law against any combination of the corporate entity and its officers and directors. Both direct state law claims and securities actions typically are brought as class actions with any monetary recovery going to the shareholders in the class. *See* Schaefer v. Overland Express Family of Funds, 169 F.R.D. 124, 127 (S.D. Cal. 1996) ("Class actions are commonly used in securities fraud cases."). In contrast, derivative suits are "brought on behalf of the corporation" and "the recovery, if any, must go to the corporation." Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1036 (Del. 2004).

[2]*See, e.g.*, Sean J. Griffith, *Correcting Corporate Benefit: Curing What Ails Shareholder Litigation*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Mar. 19, 2015), *archived at* https://perma.cc/GZ34-XULH (noting that "there is plenty of evidence that American corporations are suffering under an epidemic of shareholder litigation"); Lisa A. Rickard, *Delaware Flirts With Encouraging Shareholder Lawsuits*, WALL ST. J. (Nov. 14, 2014), http://www.wsj.com/articles/lisa-rickard-delaware-flirts-with-encouraging-shareholder-lawsuits-1416005328 ("[S]hareholder litigation is reaching epidemic levels.").

[3]Jill E. Fisch, Sean J. Griffith & Steven Davidoff Solomon, *Confronting the Peppercorn Settlement in Merger Litigation: An Empirical Analysis and a Proposal for Reform*, 93 TEX. L. REV. 557, 558-59 (2015) ("In 2012, 93% of deals over $100 million and 96% of deals over $500 million were challenged in shareholder litigation. In 2013, the frequency was even higher—97.5% of deals over $100 million were challenged through litigation, and each transaction triggered an average of seven separate lawsuits.").

[4]*Id.* at 559; *see also* John Armour, Bernard Black & Brian Cheffins, *Is Delaware Losing Its Cases?*, 9 J. EMPIRICAL LEGAL STUD. 605, 605 (2012) (documenting trend towards filing merger lawsuits in multiple jurisdictions).

[5]Robert Kelly et al., *Recent Developments in Insurance Coverage Litigation*, 46 TORT TRIAL & INS. PRAC. L.J. 435, 442 (2011) ("This past decade has seen a marked increase in shareholder lawsuits.").

lawsuits mainly benefit the lawyers who bring them.[6] Few lawsuits result in a monetary recovery by the shareholders, but most result—typically by way of a carefully negotiated settlement—in substantial payments to the lawyers who filed the suit.[7] Not surprisingly, there is little evidence that shareholder litigation deters misconduct by corporate officers and directors.[8]

There have been many efforts to reform shareholder litigation, but most have not been adopted and those that have made it into law often proved ineffectual or produced various unintended consequences.[9] In 2014, however, the Delaware Supreme Court introduced a potential game changer by upholding a so-called fee-shifting bylaw.[10] Such "bylaws impose a 'loser pays' rule that transfers a company's costs and expenses in shareholder litigation to the plaintiff shareholder if the plaintiff is unsuccessful."[11] Although the Court's decision in *ATP Tour, Inc. v. Deutscher Tennis Bund* ("*ATP*")[12] facially involved only nonprofit corporations, most observers predicted that it would be extended to for-profit corporations in short order.[13]

The *ATP* decision immediately generated considerable controversy, which triggered an initially abortive effort on the part of the

---

[6]*See, e.g.*, Roberta Romano, *The Shareholder Suit: Litigation without Foundation*?, 7 J.L. ECON. & ORG. 55, 84 (1991) (observing that plaintiffs' attorneys generally benefit more from derivative litigation than their shareholder clients).

[7]*See* Sean J. Griffith, *Correcting Corporate Benefit: How to Fix Shareholder Litigation by Shifting the Doctrine on Fees*, 56 B.C. L. REV. 1, 2 (2015) ("The vast majority of shareholder litigation settles for no monetary recovery to the shareholder class. Why? Because non-pecuniary relief nevertheless entitles plaintiffs' counsel to recover their fees from the corporate defendant under the 'corporate benefit' doctrine.").

[8]*See* Romano, *supra* note 6, at 84 (arguing that evidence shows that "shareholder litigation is a weak, if not ineffective, instrument of corporate governance").

[9]*See* Brian JM Quinn, *Shareholder Lawsuits, Status Quo Bias, and Adoption of the Exclusive Forum Provision*, 45 U.C. DAVIS L. REV. 137, 153-54 (2011) ("Many reform efforts at the federal and state levels have attempted to control agency costs associated with shareholder litigation; however, the outcomes of those efforts have been mixed, often resulting in unintended consequences as litigants seek to find ways around restrictions.").

[10]ATP Tour, Inc. v. Deutscher Tennis Bund, 91 A.3d 554, 555 (Del. 2014). Existing public companies have typically adopted fee-shifting provisions through unilateral amendments to the corporation's bylaws by the board of directors, while companies going public in an IPO typically have included them in the articles of incorporation. *See* John C. Coffee, Jr., *Fee-Shifting and the SEC: Does It Still Believe in Private Enforcement?*, CLS BLUE SKY BLOG (Oct. 14. 2014), *archived at* https://perma.cc/QD6P-N9TX.

[11]Ning Chiu, *The Latest on Fee-Shifting Bylaws*, BRIEFING: GOVERNANCE (Davis, Polk & Wardwell LLP), Oct. 23, 2014, *archived at* https://perma.cc/M8M3-7LL8.

[12]91 A.3d at 554-55.

[13]*See infra* note 43 and accompanying text (discussing the probable extension of *ATP* to for-profit corporations).

Delaware General Assembly to overturn the decision by statute.[14] The proposed bill would have effectively banned for-profit corporations from adopting fee-shifting bylaws.[15] The 2014 bill, however, triggered a significant backlash from business groups supporting such bylaws.[16] In a compromise, the legislature requested that the Delaware bar study the problem and report back to the legislature in time for the 2015 legislative session.[17]

In March 2015, the Delaware bar proposed legislation that would limit the availability of fee-shifting bylaws to nonprofit corporations.[18] The proposal was swiftly introduced as Senate Bill 75.[19] It passed the Delaware Senate on May 12, 2015.[20] It was approved by the Delaware House on June 11, 2015,[21] and signed by Governor Jack Markell on June 24, 2015.[22] The bill became effective on August 1, 2015.[23]

In the wake of the *ATP* decision, some informed observers predicted that the availability of fee shifting would attract substantial numbers of corporations to reincorporate in Delaware.[24] Conversely, S.B. 75 prompted speculation that it will cause Delaware to lose incorporations.[25] Given the importance of corporate chartering to the Delaware economy,[26] the prospect of corporate flight threatens the

---

[14]*See* Rickard, *supra* note 2 ("Weeks after the [Delaware Supreme Court's *ATP*] ruling, the Delaware legislature, cheered on and supported by the powerful state plaintiffs bar, attempted to pass a law 'fixing' the Delaware Supreme Court's decision.").

[15]*Id.*

[16]*See id.* (noting the "[l]oud protests from national, state and local business groups, as well as individual companies," triggered by the proposed legislation).

[17]*Id.*

[18]*See* Hazel Bradford, *Delaware Bar Association Law Council Recommends Fee-Shifting Limits*, PENSIONS & INVS. (Mar. 9, 2015), *archived at* https://perma.cc/99NF-RJF8.

[19]S.B. 75, 2015 Leg., 148th Gen. Assemb., Reg. Sess. (Del. 2015).

[20]*See* M. Norman Goldberger & David J. Margules, *Delaware Senate Upholds Ban on Fee-Shifting Provisions in Corporate Governing Documents*, BALLARD SPAHR LLP (May 15, 2015), *archived at* https://perma.cc/W2JR-3X8H.

[21]Brian T. Frawley et al., *Sullivan & Cromwell Discusses Delaware Legislation Saying No to "Loser-Pays" Fee-Shifting Bylaws But Yes to Forum-Selection Bylaws for Stock Corporations*, CLS BLUE SKY BLOG (June 16, 2015), *archived at* https://perma.cc/2AA2-5JWW.

[22]*Delaware Governor Jack Markell Signs Legislation Amending the Delaware General Corporation Law*, RICHARDS, LAYTON & FINGER (June 24, 2015), *archived at* https://perma.cc/DUY7-DD9H.

[23]*See* Frawley et al., *supra* note 21.

[24]*See, e.g.*, *Delaware High Court Endorses 'Losing Party Pays' Corporate Bylaws*, WESTLAW J. DERIVATIVES, May 23 2014, at *1, *2 (quoting Delaware attorney Francis G.X. Pileggi as stating that the *ATP* decision "could lead to a mass movement of companies changing their bylaws to make losing shareholders pay").

[25]*See infra* note 126 and accompanying text (discussing the potential for fee shifting to trigger interjurisdictional competition for corporate charters).

[26]*See infra* note 112 and accompanying text (discussing the economic impact of incorporations for Delaware).

interests of multiple stakeholders. In light of Delaware's status as the leading corporate law jurisdiction,[27] the bill's passage has significant national implications.

This Article argues that Delaware's legislature erred significantly by passing S.B. 75. Part II traces the background, reviewing the development of fee-shifting bylaws, the *ATP* decision, and the legislative process that led to S.B. 75. Part III reviews the evidence and theory of shareholder litigation, concluding that fee-shifting bylaws were a legitimate response to a longstanding crisis. Finally, Part IV uses interest group analysis to explain why the Delaware legislature would pass a bill that simultaneously constitutes bad public policy and risks harm to the Delaware economy.

II. BACKGROUND

In 2006, the board of directors of ATP Tour, Inc. ("ATP"), a Delaware nonstock membership corporation[28] that operates a professional men's tennis tour, amended ATP's bylaws to provide in pertinent part that:

> In the event that (i) any [current or prior member or Owner or anyone on their behalf ("Claiming Party")] initiates or asserts any [claim or counterclaim ("Claim")] or joins, offers substantial assistance to or has a direct financial interest in any Claim against the League or any member or Owner (including any Claim purportedly filed on behalf of the League or any member), and (ii) the Claiming Party (or the third party that received substantial assistance from the Claiming Party or in whose Claim the Claiming Party had a direct financial interest) does not obtain a judgment on the merits that substantially achieves, in substance and amount,

---

[27] *See infra* note 110 and accompanying text (discussing Delaware's position as the leading corporate law jurisdiction).

[28] The Delaware General Corporation Law ("DGCL") defines a nonstock corporation as "any corporation organized under [the DGCL] that is not authorized to issue capital stock." DEL. CODE ANN. tit. 8, § 114(d)(4) (2011). A nonstock corporation can be either for profit or nonprofit. *See id.* § 114(d)(3) (defining a "nonprofit nonstock corporation" as "a nonstock corporation that does not have membership interests"). Members of a for-profit nonstock corporation have a "membership interest," which is defined as "a member's share of the profits and losses of [the] nonstock corporation, or a member's right to receive distributions of [the] nonstock corporation's assets, or both." *Id.* § 114(d)(2). ATP is a nonprofit nonstock corporation. *See* Deutscher Tennis Bund v. ATP Tour Inc., 480 F. App'x 124, 125 (3d Cir. 2012) ("ATP is a not-for-profit Delaware membership corporation . . . .").

> 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) (collectively, "Litigation Costs") that the parties may incur in connection with such Claim.[29]

In 2007, ATP members sued ATP and six of its directors in federal court alleging various federal antitrust and Delaware corporate law claims.[30] After the members lost at trial, ATP invoked its fee-shifting bylaw to recover the legal expenses and costs it incurred in defending the suit.[31] The district court certified four questions of law to the Delaware Supreme Court, collectively addressing the validity of fee-shifting bylaws both on their face and as applied.[32]

The Delaware Supreme Court held that fee-shifting bylaws are facially valid.[33] Although Delaware generally follows the American Rule on legal fees,[34] Delaware law permits parties to modify that rule by contract.[35] Because the bylaws amount to a contract between the corporation and its shareholders, a bylaw could validly create an exception to the American Rule.[36] Finally, the Court held that such a bylaw was binding even on persons who became members of the corporation before the bylaw was adopted.[37]

---

[29]ATP Tour, Inc. v. Deutscher Tennis Bund, 91 A.3d 554, 556 (Del. 2014) (alterations in original) (quoting ATP Bylaw Article 23.2(a)).

[30]*Id.*

[31]*Id.* The district court initially held that the bylaw was preempted by federal law, but on appeal the Third Circuit reversed and remanded for an initial determination of whether the bylaw was valid as a matter of state law. *See id.* at 556-57 (describing procedural history of case).

[32]*Id.* at 557 (listing the certified questions).

[33]*ATP Tour, Inc.*, 91 A.3d at 560 ("Under Delaware law, a fee-shifting by-law is not invalid *per se* . . . . ").

[34]*See id.* at 558 (explaining that under the American Rule, "parties to litigation generally must pay their own attorneys' fees and costs").

[35]*Id.*

[36]*See id.* As Professor Hamermesh has pointed out, ATP's fee-shifting bylaw did not create a "loser pays" rule, because it "prescribed a one-sided rule—only the plaintiff has to pay the other side's costs—and it has to pay those costs not just if it loses, but even if it wins many of its claims but fails to get substantially all the relief it sought." Lawrence A. Hamermesh, *Consent in Corporate Law*, 70 BUS. LAW. 161, 166 (2014).

[37]*ATP Tour, Inc.*, 91 A.3d at 560. As support for that proposition, the Court cited *Boilermakers*, which held that "stockholders have assented to a contractual framework established by the DGCL and the certificates of incorporation that explicitly recognizes that stockholders will be bound by bylaws adopted unilaterally by their boards." Boilermakers Local 154 Ret. Fund v. Chevron Corp., 73 A.3d 934, 956 (Del. Ch. 2013). *Boilermakers* further explained that the contract created by the corporation's articles and bylaws "is, by

The Court recognized that an otherwise valid fee-shifting bylaw would be unenforceable if adopted for an improper purpose,[38] but did not define with specificity what would constitute an improper purpose.[39] Critically, however, the Court did hold that seeking to deter shareholder litigation was "not invariably an improper purpose."[40]

In the wake of the Court's decision, some observers argued that fee-shifting bylaws had been validated only with respect to nonprofit and/or nonstock corporations.[41] The Court's opinion cited both statutes and cases governing for-profit stock corporations, however.[42] Accordingly, it seems likely that the decision would be extended to for-profit stock corporations.[43]

---

design, flexible and subject to change in the manner that the DGCL spells out and that investors know about when they purchase stock in a Delaware corporation." *Id.* at 939. For a critical analysis of this holding's application for fee-shifting bylaws, see Hamermesh, *supra* note 36, at 170-71. For an argument that the *ATP* decision "overturned longstanding core principles of corporate law without any meaningful authority or analysis," see J. Robert Brown, Jr., *Shifting Back the Focus: Fee Shifting Bylaws and a Need to Return to Legislative Intent* 14 (Univ. of Denver Sturm Coll. of Law, Working Paper No. 14-65, 2015), *available at* http://ssrn.com/ abstract=2547094.

[38]*ATP Tour, Inc.*, 91 A.3d at 560 ("Legally permissible bylaws adopted for an improper purpose are unenforceable in equity.").

[39]*See id*. at 559 ("The Certification does not provide the stipulated facts necessary to determine whether the ATP bylaw was enacted for a proper purpose or properly applied.").

[40]*Id.* at 560.

[41]*See, e.g.*, Herbert F. Kozlov & Lawrence J. Reina, *Delaware Supreme Court Approves Fee-Shifting Bylaw for Non-Stock Corporations*, BUS. L. TODAY, June 2014, at 1 ("[S]ome might suggest the reach of the court's decision should be limited to only non-stock corporations or to other membership organization[s] such as LLCs.").

[42]*See id.*; *see also ATP Tour, Inc.*, 91 A.3d at 559-60 (citing Boilermakers Local 154 Ret. Fund v. Chevron Corp., 73 A.3d 934, 956 (Del. Ch. 2013); Hollinger Int'l, Inc. v. Black, 844 A.2d 1022 (Del. Ch. 2004), *aff'd*, 872 A.2d 559 (Del. 2005); Frantz Mfg. Co. v. EAC Indus., 501 A.2d 401 (Del. 1985)).

[43]As one post-*ATP* commentary observed:

> Although *ATP* involved a closely held nonstock corporation, and the certified questions were framed accordingly, the reasoning in *ATP* should be equally applicable to stock corporations. The court's interpretation of the Delaware General Corporation Law, the contract theory of bylaws endorsement, and the precedents cited were not limited to non-stock corporations. Moreover, there does not appear to be any principled basis to suggest that the decision does not apply to Delaware companies generally.

Robert W. Gaffey et al., *Break Point? Delaware Supreme Court Upholds Validity of Fee-Shifting Bylaw*, JONES DAY (May 2014), *archived at* https://perma.cc/K72K-DF7A; *see also* Henry duPont Ridgely, *The Emerging Role of Bylaws in Corporate Governance*, 68 SMU L. REV. 317, 327 (2015) ("Since the Court's decision in *ATP Tour*, a number of commentators have assumed that it applies equally to for-profit, stock corporations.").

Anticipating such a result, over fifty Delaware corporations adopted fee-shifting bylaws by April 2015.[44] That such a small number of companies had done so reflected concern by corporate directors over opposition from shareholder activists.[45] The legal uncertainty created by the General Assembly's effort to overturn the *ATP* decision also loomed as a potential deterrent, as many observers expected that the legislature would ultimately opt to ban fee shifting.[46]

As proposed by the Corporate Law Council of the Delaware State Bar Association,[47] and subsequently adopted by the Delaware legislature, S.B. 75 was intended to limit *ATP* to its factual setting—i.e., nonstock corporations—by amending § 102 of the DGCL to provide that "the certificate of incorporation may not contain any provision that would impose liability on a stockholder for the attorneys' fees or expenses of the corporation or any other party in connection with an intracorporate claim, as defined in § 115 of this title."[48] The bill likewise bans such provisions from being contained in the bylaws of a stock corporation.[49]

---

[44]*See* Lee Rudy, *A Hostile Takeover of Shareholder Litigation*, TRIAL, Apr. 2015, at 28, 30 ("[M]ore than 50 companies adopted fee-shifting bylaws that apply to shareholder litigation.").

[45]*See* Griffith, *supra* note 7, at 36 ("The greatest constraint on boards' ability to adopt fee-shifting bylaws ultimately may be . . . the ability of shareholders to vote against directors who adopt fee-shifting bylaws.").

[46]*See, e.g.*, Pamela Park, *SEC Committee to Consider Preliminary Voting Results, Fee-Shifting Bylaws*, WESTLAW DAILY BRIEFING, Oct. 7, 2014, *available at* 2014 WL 4977341 (suggesting that "the Delaware state legislature will likely consider legislation to prohibit [fee-shifting bylaws] when it convenes in January 2015"); *Muscular Bylaws: ATP's Lessons of Continuing Relevance*, CLEARLY GOTTLIEB STEEN & HAMILTON LLP (June 12, 2014), *archived at* https://perma.cc/96R2-8MQ8 ("[I]t appears that the Delaware legislature may soon foreclose fee-shifting bylaws for stock corporations . . ."); *see also* Abigail Pickering Bomba et al*., Fried Frank Discusses Delaware Corporations' Expansive Powers with Respect to Bylaws*, CLS BLUE SKY BLOG (Feb. 25, 2015), *archived at* https://perma.cc/C82W-BDGX (noting "uncertainty about the fate of the legislation"); Brown, *supra* note 37, at 18 ("Whether the Delaware legislature will overturn the decision remains to be seen.").

[47]The Corporate Law Council of the Delaware State Bar Association annually submits proposed changes to the Delaware corporation statute to the Delaware legislature. *See* Francis G.X. Pileggi, *Delaware Proposes New Fee-Shifting and Forum Selection Legislation*, DEL. CORP. & COM. LITIG. BLOG (Mar. 6, 2015), *archived at* https://perma.cc/TP2C-8YJ3. These proposals are usually rubber stamped by the legislature. *See id.* (explaining in more delicate terms that "'routine' amendments are often passed by the Delaware Legislature 'routinely'").

[48]Proposed Amendments to DEL. CODE. ANN. tit 8, § 102, adopted as S.B. 75, 2015 Leg., 148th Gen. Assemb., Reg. Sess. (Del. 2015). Section 115 defines intracorporate claims as

> [C]laims, including claims in the right of the corporation, (i) that are based upon a violation of a duty by a current or former director or officer or stockholder in such capacity, or (ii) as to which this title confers jurisdiction upon the Court of Chancery.

Proposed Amendments to DEL. CODE. ANN. tit 8, § 115, adopted as S.B. 75, 2015 Leg., 148th Gen. Assemb., Reg. Sess. (Del. 2015). The legislative synopsis accompanying the bill made

There are several important things the bill does not do. First, it does not prevent nonstock corporations from continuing to adopt fee-shifting bylaws.[50] Second, it does not overturn the underlying principles that corporate bylaws are contracts subject to unilateral amendment by the board of directors—assuming the articles of incorporation so provide—and that such amendments validly may apply retroactively to persons who became shareholders before the amendment was adopted.[51] Third, the bill does not preclude companies from adopting fee-shifting bylaws that apply to federal securities law claims.[52] There is a substantial likelihood, however, that federal securities law would preempt such bylaws.[53]

These gaps will create substantial opportunities for creative counsel on both the plaintiff and defense side of cases. In particular, because the ban on fee shifting is limited to "intracorporate claims," which are defined as those "(i) that are based upon a violation of a duty by a current or former director or officer or stockholder in such capacity, or (ii) as to which [the DGCL] confers jurisdiction upon the Court of Chancery,"[54] defense counsel likely will expend much effort to assist their clients in drafting bylaws that impose fee shifting on claims falling outside those categories, while plaintiff counsel will seek to characterize

---

clear that the bill is not intended to "disturb [the *ATP*] ruling in relation to nonstock corporations." S.B. 75, 2015 Leg., 148th Gen. Assemb., Reg. Sess. (Del. 2015).

[49]Proposed Amendments to DEL. CODE. ANN. tit 8, § 109, adopted as S.B. 75, 2015 Leg., 148th Gen. Assemb., Reg. Sess. (Del. 2015).

[50]*See* S.B. 75, 2015 Leg., 148th Gen. Assemb., Reg. Sess. (Del. 2015) ("In combination with the amendments to Sections 109(b) and 114(b)(2), new subsection (f) [to Section 102] does not disturb [the *ATP*] ruling in relation to nonstock corporations.").

[51]*See* John C. Coffee, Jr., *Delaware Throws a Curveball*, CLS BLUE SKY BLOG (Mar. 16, 2015), *archived at* https://perma.cc/BE9G-S8CE.

[52]*See id*. Professor Coffee explains that the bill's prohibition applies only to fee-shifting bylaws that affect intracorporate claims, which are defined so as to include "(1) derivative actions, (2) merger class actions based on *Weinberger* or similar breach of fiduciary duty claims; and (3) appraisal actions." *Id.* (footnote omitted). Because federal securities law claims typically do not fall within those categories, the bill does not preclude fee-shifting bylaws that apply to such claims. *Id.* For an argument that S.B. 75 does not—implicitly or explicitly—authorize corporations to adopt fee-shifting bylaws applying to claims falling outside the definition of intracorporate claims, see J. Robert Brown, Jr., *Staying in the Delaware Corporate Governance Lane: Fee Shifting Bylaws and a Legislative Reaffirmation of the Rules of the Road* 13-15 (Univ. of Denver Sturm Coll. of Law, Working Paper No. 15-23, 2015), *available at* http://ssrn.com/abstract=2611746.

[53]*See* Coffee, *supra* note 51 (opining on preemption of a fee-shifting bylaw in federal litigation); *see also* Coffee, *supra* note 10 (analyzing possible effects of fee-shifting bylaws on SEC private actions).

[54]Proposed Amendments to DEL. CODE. ANN. tit 8, § 115, adopted as S.B. 75, 2015 Leg., 148th Gen. Assemb., Reg. Sess. (Del. 2015).

any claims they bring as falling within them.[55] The precise impact of S.B. 75 on the volume and settlement value of Delaware corporate litigation thus remains uncertain. For purposes of the analysis that follows, however, it is assumed herein that widespread adoption of fee-shifting bylaws as authorized by *ATP* would have resulted in a significant decrease in both the volume and settlement value of shareholder litigation and that the passage of S.B. 75 will essentially restore the status quo ante.

III. THE ECONOMIC IMPACT OF SHAREHOLDER LITIGATION

The problems associated with shareholder litigation are well known,[56] of course, but a review of the evidence is both useful and necessary to explain why public policy favored allowing fee shifting. One significant concern is the substantial increase in the volume of shareholder litigation in recent years, such that in some transactional areas virtually every deal is now subjected to one or more shareholder lawsuits.[57] Cornerstone Research reported, for example, that 94% of merger and acquisition transactions valued over $100 million were subject to at least one shareholder suit in 2013.[58] In most cases, multiple plaintiffs' attorneys filed multiple suits for the same transaction, with an average of five suits per deal.[59] Additional evidence of a rush to the courtroom by plaintiffs' counsel is provided by the speed with which such suits were filed; on average, 11.7 days after the deal was announced, although this was slightly longer than in earlier years.[60] This remarkably high volume of mergers and acquisition-related litigation

---

[55] *See* Coffee, *supra* note 51 (discussing how counsel on both sides may change their behavior in response to S.B. 75).

[56] *See, e.g.*, Griffith, *supra* note 7, at 2 ("The defects of shareholder litigation have long been known. Basically, the problem is one of too much and not enough: too much in the way of filings, and not enough consideration at settlement."); Emily Farinacci, Note, *In a Bind: Mandatory Arbitration Clauses in the Corporate Derivative Context*, 28 OHIO ST. J. ON DISP. RESOL. 737, 748 (2013) (noting, for example, that "derivative suits have become heavily criticized due to shareholders frequently abusing their right to sue").

[57] Edward J. Waitzer & Douglas Sarro, *Fiduciary Society Unleashed: The Road Ahead for the Financial Sector*, 69 BUS. LAW. 1081, 1105 (2014) ("[F]rivolous shareholder lawsuits . . . have become endemic in the United States, and deliver few tangible benefits to investors.").

[58] OLGA KOUMRIAN, CORNERSTONE RESEARCH, SHAREHOLDER LITIGATION INVOLVING MERGERS AND ACQUISITIONS: REVIEW OF 2013 M&A LITIGATION 1 (2014) ("In 2013, 94 percent of M&A deals were challenged by shareholders."). For an analysis of the comparable increase in securities litigation, see INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 75-78 (2006) [hereinafter PAULSON COMMITTEE INTERIM REPORT], *archived at* https://perma.cc/YX6P-QX9C.

[59] KOUMRIAN, *supra* note 58, at 2.

[60] *Id.*

might be justified if such deals were pervasively fraudulent or otherwise deleterious to shareholder interests, but Cornerstone Research reported that none of the 612 suits they studied went to trial and "all judgments ([including] summary judgments or judgments on the pleadings) were granted to the defendants,"[61] suggesting that the pervasive problem in this area is not breaches of duty by directors and officers but rather strike suits filed by the plaintiffs' bar.[62]

A. *Impact of Shareholder Litigation on Corporations and Investors*

A seminal study of shareholder litigation by Roberta Romano likewise found that shareholder-plaintiffs almost invariably lose those few suits that go to trial.[63] As for the vast majority of suits that settled pre-trial, only about half of those in Romano's sample resulted in a monetary recovery.[64] Of the thirty-nine cases in which there was a financial recovery that could be valued, the average recovery was $9 million and the median was only $2 million.[65] Because these recoveries amounted to a tiny fraction of the target firms' assets, Romano concluded "that a significant proportion of shareholder suits are without merit."[66]

Even in the handful of cases in which there is a substantial monetary recovery, however, it may not be advantageous to the typical

---

[61] *Id.* at 4.

[62] As long ago as 1949, the U.S. Supreme Court recognized that while the derivative suit was a "remedy born of stockholder helplessness [that] was long the chief regulator of corporate management," "the remedy itself provided opportunity for abuse which was not neglected. Suits sometimes were brought not to redress real wrongs, but to realize upon their nuisance value." Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 548 (1949); *see also* Allegaert v. Perot, 78 F.R.D. 427, 430 (S.D.N.Y. 1978) (quoting 5 WRIGHT & MILLER, FEDERAL PRACTICE AND PROCEDURE § 1298, at 413 (1969)) (noting that "strike suits are especially common" in the shareholder derivative suit context); Tim Oliver Brandi, *The Strike Suit: A Common Problem of the Derivative Suit and the Shareholder Class Action*, 98 DICK. L. REV. 355, 357 (1994) ("Practical experience and empirical studies have led courts and commentators to conclude that in the United States, shareholder litigation appears to be more open to abuse by strike suits brought for their mere nuisance and settlement value than other fields of civil litigation.").

[63] Romano, *supra* note 6, at 60 (finding a plaintiff "success rate of 6 percent of adjudicated cases," but also finding that in those cases the "plaintiffs actually won no judgments for damages or equitable relief").

[64] *Id.* at 61 (explaining that "46 of 83" settled cases resulted in a monetary recovery).

[65] *Id.*

[66] *Id.* More recent research found that "[o]nly [two] percent of lawsuits filed in response to M&A deals and that settled in 2013 resulted in any cash payment for shareholders . . . ." *News in Brief*, 29 No. 22 WESTLAW J. CORP. OFFICERS & DIRECTORS LIAB. 12, at *1 (2014).

investor. There is a serious circularity problem inherent in much shareholder litigation.[67] Consider the cases of class actions brought either as a direct action under state corporate law or the federal securities laws. The vast majority of settlement payments in shareholder class actions historically have been made either by issuers or their insurers, rather than by individual defendants.[68] As a result, the vast bulk of settlement payments come out of the corporate treasury, either directly or indirectly in the form of higher insurance premiums.[69] In either case, settlement payments reduce the value of the residual claim on the corporation's assets and earnings.[70] In effect, the company's current shareholders pay the settlement, not the directors or officers who actually committed the alleged wrongdoing.[71]

The effect of shareholder class actions thus is a wealth transfer from the company's current shareholders to those who held the shares at the time of the alleged wrongdoing.[72] In the case of a diversified investor, such transfers are likely to be a net wash, as the investor is unlikely to be systematically on one side of the transfer rather than the other.[73] Because there are substantial transaction costs associated with such transfers, moreover, the diversified investor is likely to experience an overall loss of wealth as a result of the private securities class actions.[74]

---

[67]*See* Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 WIS. L. REV. 333, 334 (discussing the claim "that private securities litigation is socially wasteful because it merely transfers funds from one set of shareholders to another" and noting this transfer is referred to as the "circularity problem").

[68]*See Statement of the Financial Economists Roundtable on the International Competitiveness of U.S. Capital Markets*, J. APPLIED CORP. FIN. (Morgan Stanley), Sept. 7, 2007, at 54, 55 (noting that securities class action settlements "were paid 68.2% by insurers").

[69]*See* A.C. Pritchard, *'Basic' Error is Focus on Loss*, NAT'L L.J., Sept. 22, 2008, at 26 ("[T]he dollars paid in these suits come from the corporation, either directly in the settlement or indirectly in the form of premiums for insurance policies. . . . Shareholders effectively take a dollar from one pocket, pay about half of that dollar to lawyers on both sides, and then put the leftover change in their other pocket.").

[70]*See* Stephen M. Bainbridge, *How American Corporate and Securities Law Drives Business Offshore*, *in* THE AMERICAN ILLNESS: ESSAYS ON THE RULE OF LAW 381, 385 (F.H. Buckley ed., 2013).

[71]*See id.*

[72]*See id.*

[73]*See* Amanda M. Rose & Richard Squire, *Intraportfolio Litigation,* 105 NW. U. L. REV. 1679, 1688 (2011) ("[T]o the extent that most investors are diversified, fraud-on-the-market class actions do not promote compensatory goals, for the simple reason that diversified shareholders suffer no net loss that requires compensation.").

[74]*See* A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 952 (1999) ("[T]he ability of plaintiffs' lawyers to extract an excessive share of settlements means that class actions impose high transaction costs on shareholders, while fostering limited deterrent value as a result of plaintiffs' lawyers' aversion to pursuing good claims to trial, or pursuing small claims at all.").

Derivative litigation presents much the same sort of circularity problem when derivative suit settlements provide for any monetary recovery to be paid out of the corporate treasury, which is often the case.[75] Even if there is a monetary recovery from individual defendants, however, it will not be paid to the purportedly wronged shareholders, because the recovery in such cases typically goes to the corporate entity rather than the shareholders.[76]

Although the evidence shows that the monetary returns to investors from shareholder litigation are modest, it is possible that shareholder litigation produces nonmonetary benefits.[77] A more recent analysis of derivative suits brought in federal court, for example, found that settlements of such suits involving public corporations frequently resulted in corporate governance reforms being adopted by the firm in question.[78] Such settlements do not appear to benefit shareholders, however, because they "typically included a long list of . . . reforms that have no proven impact on corporate performance."[79] Little seems to have changed in the almost twenty-five years since Romano opined that the gains from settlements enacting structural reforms "seem inconsequential."[80]

---

[75]*See* Reinier Kraakman, Hyun Park & Steven Shavell, *When Are Shareholder Suits in Shareholder Interests?*, 82 GEO. L.J. 1733, 1751-52 n.48 (1994) ("[C]orporations fund settlement or damage payments either indirectly (through settlement costs paid by insurers and passed back to the corporation in the form of increased premia) or directly (out of the corporate treasury)."). The problem is somewhat abated by the limits indemnification statutes place on the ability of corporations to indemnify officers and directors in derivative litigation. *See* Arnold v. Soc'y for Sav. Bancorp, Inc., 678 A.2d 533, 540 n.18 (Del. 1996) (quoting 1 BALOTTI & FINKELSTEIN, DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.19, at 4-359 (Supp. 1996)) ("Amending Section 145(b) to allow indemnification of judgments or amounts paid in settlement in derivative suits was rejected as circular since the corporation would simply be paying itself for injury caused to it by the very directors being indemnified by the corporation.").

[76]*See* PRINCIPLES OF CORPORATE GOVERNANCE § 7.16 (1994) (noting that "the recovery in a derivative action should accrue exclusively to the corporation"). For a discussion of the exceptions to the general rule, see *id.* § 7.18 cmt. e.

[77]*See* Jessica Erickson, *Corporate Governance in the Courtroom: An Empirical Analysis*, 51 WM. & MARY L. REV. 1749, 1808-09 (2010) (discussing some of the nonmonetary benefits derived from shareholder litigation).

[78]*See id.* at 1798-99 ("The settlements in 18 suits (42.9 percent) included the payment of money or other financial consideration, as well as corporate governance reforms. In another 17 suits (40.5 percent), the only consideration for the settlement was corporate governance reforms."). Professor Erickson's study further reported, however, "nearly 70 percent of the resolved cases in my study ended with an involuntary or voluntary dismissal—resolutions that do not provide any significant tangible benefit to the plaintiff corporations." *Id.* at 1794.

[79]*Id.* at 1822.

[80]*See* Romano, *supra* note 6, at 63 (opining that the gains from structural settlements "seem inconsequential").

If shareholder litigation cannot be justified on compensatory grounds, can it still be justified as a useful deterrent against managerial shirking and self-dealing? In short, no. To the contrary, the evidence suggests that shareholder litigation is not an effective deterrent.[81] In addition, there also is evidence that derivative suits do not have significant effects on the stock price of the subject corporations, which suggests that investors do not believe derivative suits deter misconduct.[82] Finally, adoption of a charter amendment limiting director liability has no significant effect on the price of the adopting corporation's stock, which suggests that investors do not believe that duty of care liability has beneficial deterrent effects.[83]

In sum, shareholder litigation mainly serves as a means of transferring wealth from investors to lawyers.[84] At best, such suits take money out of the firm's residual value—at the expense of current shareholders—and return it to former shareholders, minus substantial legal fees.[85] In many cases, moreover, no money is returned to the

---

[81]*See, e.g.*, Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. 569, 605 (2001) ("[D]erivative suits do not generally appear to be a strong check on executive pay levels."); *see also In re* Citigroup Inc. Sec. Litig., 965 F. Supp. 2d 369, 385 (S.D.N.Y. 2013) ("The Court shares Professor Coffee's concern that securities class actions in which the corporation and its insurers pay for the release of claims against its corporate officers and executives have essentially no deterrent value for those executives—the ones whose actions matter.").

[82]*See* Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 282 (1986).

[83]*See, e.g.*, Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 69 (1989) (explaining that Delaware firms that adopted an amendment limiting director liability experienced decreases in their stock's value); *see also* Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1183, 1185 (1990) (explaining that firms that propose limited liability amendments experience insignificant returns, and that the announcement of the amendment may have no effect because investors have already discounted the amendment's value).

[84]*See* Robert Allen, *Securities Litigation as a Coordination Problem*, 11 U. PA. J. BUS. L. 475, 513 (2009) ("Shareholders lose value as a whole because [shareholder] litigation reduces the prices of their shares and transfers a large amount of their wealth to lawyers."); ANDREW J. PINCUS, U.S. CHAMBER INST. FOR LEGAL REFORM, THE TRIAL LAWYERS' NEW MERGER TAX: CORPORATE MERGERS AND THE MEGA MILLION-DOLLAR LITIGATION TOLL ON OUR ECONOMY 1, (2012), *archived at* https://perma.cc/PVK6-PVMR ("Trial lawyers hold transactions hostage until they collect a 'litigation tax,' draining a share of the merger's economic benefit away from shareholders and into the lawyers' own pockets.").

[85]*See In re Citigroup*, 965 F. Supp. 2d at 385 ("The Court also laments that the shareholders, as owners, effectively pay the insurance premiums and any settlement amounts over the insurance coverage, such that most settlements are essentially transfers of wealth from all present shareholders to a subset of past and present shareholders, with significant sums siphoned off in the form of lawyers' fees and litigation costs.").

shareholders or the corporate entity, but legal fees are almost always paid.[86]

B. *Impact of Shareholder Litigation on the Economy*

In 2008, the United States Supreme Court handed down one of the most consequential securities cases to come before it in many years, *Stoneridge Investment Partners v. Scientific-Atlanta*.[87] What makes *Stoneridge* instructive for our purposes is not the specific legal issues or the holding, but rather the Supreme Court majority's analysis of the economic impact of shareholder litigation:

> The practical consequences of an expansion [of Rule 10b-5 liability] . . . provide a further reason to reject petitioner's approach. In *Blue Chip*, the Court noted that extensive discovery and the potential for uncertainty and disruption in a lawsuit allow plaintiffs with weak claims to extort settlements from innocent companies. Adoption of petitioner's approach would expose a new class of defendants to these risks. As noted in *Central Bank*, contracting parties might find it necessary to protect against these threats, raising the costs of doing business. Overseas firms with no other exposure to our securities laws could be deterred from doing business here. This, in turn, may raise the cost of being a publicly traded company under our law and shift securities offerings away from domestic capital markets.[88]

There is substantial evidence that the Court was correct, suggesting that shareholder litigation is not only adverse to the interests of investors, but also constitutes a substantial drag on the economy as a whole. In 2006-2007, there were three major reports studying the declining competitiveness of U.S. capital markets: The Bloomberg-

---

[86]*See* Romano, *supra* note 6, at 61 (reporting that legal fees were recovered in 75 out of 83 settlements in her sample).

[87]Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148 (2008); *see* Linda Greenhouse, *Supreme Court Restricts Securities Lawsuits*, N.Y. TIMES (Jan. 15, 2008), http://www.nytimes.com/2008/01/15/washington/15cnd-scotus.html?_r=0 (stating that *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.* is the most important securities fraud case in years).

[88]*In re Citigroup*, 965 F. Supp. 2d at 163-64 (citations omitted).

Schumer Report,[89] the Paulson Committee Interim Report,[90] and the Chamber Report.[91] Taken together, and evaluated in light of subsequent developments, the evidence they gathered confirmed that the U.S. capital markets became less competitive vis-à-vis other markets in the preceding decade.[92]

All three reports blamed shareholder litigation, in part, for that decline. The Chamber of Commerce, for example, argued that "[c]orporations are owned by their shareholders, and monies they are forced to pay out to lawyers and other[s] are the property of the shareholders."[93] The Bloomberg-Schumer Report observed that "the legal environments in other nations, including Great Britain, far more effectively discourage frivolous litigation."[94] Finally, the Paulson Committee Interim Report concluded that "the solution to the competitive problem of U.S. capital markets lies, on the one hand, in reducing the burden of litigation and regulation and, on the other hand, increasing shareholder rights."[95]

The perception that exposure to the U.S. capital markets significantly increases an issuer's litigation risk has a measurable impact on the attractiveness of those markets. A study of domestic issuers found, for example, that issuers with prior experience with securities fraud class actions and those in standard industry classifications having a high incidence of such litigation tended to resort to offshore financing more often than other issuers.[96] As for foreign issuers, they are "deeply"

---

[89] *See* MICHAEL R. BLOOMBERG & CHARLES E. SCHUMER, SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP, at i (2007) [hereinafter BLOOMBERG-SCHUMER REPORT], *archived at* https://perma.cc/3E83-8FV7 ("We must take a cold, hard look at the industry, identifying our weaknesses, learning from the best practices of other nations, and drawing upon strategies that will allow us to adapt to the changing realities of the market. That is exactly why we commissioned this report.").

[90] *See* PAULSON COMMITTEE INTERIM REPORT, *supra* note 58, at vii (stating that the purpose of the report is to explore the issues related to the competitiveness of the U.S. capital markets).

[91] *See* U.S. CHAMBER OF COMMERCE, CAPITAL MARKETS, CORPORATE GOVERNANCE, AND THE FUTURE OF THE U.S. ECONOMY (2006) [hereinafter CHAMBER REPORT], *archived at* https://perma.cc/4HRW-Z87C (stating that the purpose of the report is to provide information regarding the risks to the capital markets, implying that they are declining).

[92] *See* BLOOMBERG-SHUMER REPORT, *supra* note 89, at i (discussing that other competitive markets in the world are challenging the U.S.' position as the most competitive capital markets); PAULSON COMMITTEE REPORT, *supra* note 58, at 1-2 (stating that the U.S. capital markets have lost some of their competitiveness); CHAMBER REPORT, *supra* note 91, at 7, 22 (explaining that the U.S. capital markets, while still competitive, are declining).

[93] CHAMBER REPORT, *supra* note 91, at 21.

[94] BLOOMBERG-SCHUMER REPORT, *supra* note 89, at ii.

[95] PAULSON COMMITTEE INTERIM REPORT, *supra* note 58, at xii.

[96] *See* Stephen J. Choi, *Assessing the Cost of Regulatory Protections: Evidence on the Decision to Sell Securities Outside the United States* 1, 56 (Yale Law Sch. Program for Studies

concerned by the "cost of litigation" associated with securities class actions and "risk of huge enforcement actions."[97]

> When asked which aspect of the legal system most significantly affected the business environment, senior executives surveyed indicated that propensity toward legal action was the predominant problem. Worryingly for New York, the city fares far worse than London in this regard: 63 percent of respondents thought the UK (and by extension London) had a less litigious culture than the United States, while only 17 percent felt the US (and by extension New York) was a less litigious place than the United Kingdom (Exhibit 20). This is a dramatic result, and it is echoed even more strongly by the CEOs surveyed: 85 percent indicated that London was preferable, and not a single one chose New York.
>
> . . . .
>
> . . . Only about 15 percent [of surveyed senior executives] felt that the US system was better than the UK's in terms of predictability and fairness, while over 40 percent favored the UK in both these regards. The CEOs interviewed also shared this sentiment, although they felt that London's advantage was particularly strong in terms of the predictability. Legal experts indicated that this is a major reason why many corporations now choose English law to govern their international commercial contracts.[98]

Because "the only way foreign companies can protect themselves" from litigation risk "is to move out of the United States altogether—. . . a lot of companies are doing" precisely that.[99]

---

in Law, Econ. & Pub. Policy, Working Paper No. 253, 2001), *available at* http://ssrn.com/abstract=267506.

[97]Howell E. Jackson, *Summary of Research Findings on Extra-Territorial Application of Federal Securities Law*, *in* GLOBAL CAPITAL MARKETS & THE U.S. SECURITIES LAWS, 2009: STRATEGIES FOR THE CHANGING REGULATORY ENVIRONMENT 1243, 1253 (Practising Law Institute 2009).

[98]BLOOMBERG-SCHUMER REPORT, *supra* note 89, at 75, 77.

[99]Jackson, *supra* note 97, at 1253-54.

C. *Fee Shifting as a Solution*

In the absence of legal reforms at the state or federal level, fee shifting emerged as a means of addressing the litigation crisis by private ordering.[100] There is substantial reason to believe that widespread adoption of fee-shifting bylaws would have substantially reduced the volume and settlement value of shareholder litigation. In an early test of fee-shifting bylaws, for example, the plaintiffs and their counsel argued that "continued litigation would be too financially risky" if the bylaw were upheld.[101] Numerous commentators agreed that proliferation of fee-shifting bylaws would "result in the non-filing of many, if not most, derivative suits."[102] To be sure, some observers worried that meritorious suits might also be deterred.[103] Even if that proved to be the case, however, it might have been a price worth paying given the pervasive defects of shareholder litigation.[104] Fee shifting could have been "a gut check for plaintiffs' lawyers," who would have had "to ask—for the first time, really—how good is my case?"[105] But that is not a question this Article needs to resolve. As we shall see in the next question, the key point is the effect S.B. 75 would have had on the volume and settlement

---

[100] *See* Griffith, *supra* note 7, at 26 ("Fee-shifting bylaws emerged . . . as a structural response to the crisis in shareholder litigation.").

[101] *Pharma Directors, Investors Agree to Truce in 'Loser Pays' Bylaw Battle*, 29 No. 6 WESTLAW J. DEL. CORP. 3, at *1 (2014) (discussing outcome of Katsis v. Carter, No. 8657 (Del. Ch. Sept. 16, 2014)).

[102] Brown, *supra* note 37, at 16; *see also* Claudia H. Allen, *Bylaws Mandating Arbitration of Stockholder Disputes?*, 39 DEL. J. CORP. L. 751, 766-67 n.90 (2015) ("The deterrent effect of some fee-shifting bylaws is amplified by additional clauses, such as those prohibiting the award of attorneys' fees, requiring the posting of a bond, or requiring the payment of interest."); Pamela Park, *More Delaware Companies Adopt Fee-Shifting Bylaws to Deter Shareholder Litigation*, WESTLAW DAILY BRIEFING, Sept. 29, 2014, *available at* 2014 WL 4798882 (suggesting that "companies will begin adopting fee-shifting bylaws to deter ever-increasing litigation from investors").

[103] *See, e.g.*, Peter Allan Atkins, Allison L. Land, Edward B. Micheletti & Edward P. Welch, *Fee-Shifting Bylaws: The Delaware Supreme Court Decision in* ATP Tour*, Its Aftermath and the Potential Delaware Legislative Response [to] the Decision*, INSIGHTS (Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates, Wilmington, Del.) Oct. 22, 2014, *archived at* https://perma.cc/9EAC-H3RW ("[T]here is the risk that adoption of fee-shifting bylaws could significantly deter, or eliminate, even meritorious claims.").

[104] The evidence seems clear "that the system is broken, that shareholder suits are being filed regardless of the merits, and that shareholder plaintiffs are imposing a dead weight on society and an unwarranted burden on corporate America and the courts." Marc Wolinsky & Ben Schireson, *Deal Litigation Run Amok: Diagnosis and Prescriptions*, REV. SEC & COMMODITIES REG., Jan. 8, 2014, at 1, 1-2, *archived at* https://perma.cc/U97U-X6QZ. The authors offer a number of solutions, including an endorsement of fee-shifting bylaws. *Id.* at 7.

[105] Liz Hoffman, *Shareholder Suits May Prove Costly*, WALL ST. J. (May 18, 2014), http://www.wsj.com/articles/SB10001424052702304908304579565850165670972.

value of shareholder litigation, not whether the benefits of doing so outweigh the costs.

IV. WILL S.B. 75 BE ONE OF DELAWARE'S SISTERS?

Although Delaware's domination of corporate law seems well entrenched, it has not always been the case. At the end of the Nineteenth Century, New Jersey was the center of the corporate law world.[106] As is the case in Delaware today, New Jersey law then provided both tax and doctrinal advantages giving it significant competitive advantages in attracting incorporations from out-of-state businesses.[107] In 1913, however, New Jersey adopted the so-called "Seven Sisters Acts," a package of legislation that collectively made New Jersey much less attractive to incorporators.[108] Delaware swooped in and attracted a flow of New Jersey corporations to Delaware.[109] Today, 64% of the Fortune 500 companies are incorporated in Delaware, as are more than half of all companies listed on the New York Stock Exchange, NASDAQ, and other major stock exchanges.[110]

Whether Delaware's domination resulted from a race to the top or to the bottom has been the subject of much argument.[111] In either case, however, there is no doubt that Delaware benefits greatly from its dominance. Delaware gets a significant percentage of state revenues from incorporation fees and franchise taxes, typically over 20% of the

---

[106] *See* Charles M. Yablon, *The Historical Race Competition for Corporate Charters and the Rise and Decline of New Jersey: 1880-1910*, 32 J. CORP. L. 323, 333 (2007) ("As early as 1881, New Jersey was receiving a disproportionate number of incorporations.").

[107] *See id.* at 334-35 (reviewing New Jersey's "liberal" legal rules).

[108] *See* Christopher J. Bebel, *Why the Approach of* Heckmann v. Ahmanson *Will Not Become the Prevailing Greenmail Viewpoint: Race to the Bottom Continues*, 18 TEX. TECH L. REV. 1083, 1116-17 (1987) ("The Seven Sisters Acts made New Jersey a less desirable home for incorporators.").

[109] *See* E. Norman Veasey, *Musings from the Center of the Corporate Universe*, 7 DEL. L. REV. 163, 167 (2004) (observing that the "Seven Sisters Act that taxed and regulated New Jersey corporations caused a migration to Delaware").

[110] *See* John L. Reed, *2013 Delaware Decisions and What They Mean for 2014*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Feb. 20, 2014), *archived at* https://perma.cc/L3M2-E3NY; Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 565-68 (2002).

[111] *Compare* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 666 (1974) (offering the seminal statement of race to the bottom hypothesis), *with* Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 256 (1977) (offering the seminal version of the race to the top hypothesis).

State's budget.[112] Delaware's government thus has a very strong interest in maintaining Delaware's dominant position.[113]

Accordingly, it seems counterintuitive that the Delaware General Assembly would voluntarily pass legislation that might do to it what the Seven Sisters did to New Jersey. Yet, there is considerable reason to think S.B. 75 might significantly change the cost-benefit calculus of incorporation decisions. In turn, that could trigger "an interjurisdictional competition, as other, more conservative states (think, Texas)" adopt statutes authorizing fee-shifting bylaws in order "to lure companies to reincorporate there to exploit their tolerance for such provisions."[114]

In fact, the first step towards such a competition has already occurred. In September 2014, Oklahoma passed legislation "providing that in a shareholder initiated derivative action against a domestic or foreign corporation, the court 'shall require the nonprevailing party or parties to pay the prevailing party or parties the reasonable expenses including attorneys' fees, taxable as costs, incurred as a result of such action.'"[115] The Oklahoma legislation differs from the pre-S.B. 75 Delaware law in two respects. First, it applies only to derivative suits, leaving the fee rules for class actions for both direct corporate law and securities law claims unchanged.[116] Second, it is a genuine loser pays provision, because prevailing shareholders also can recover their expenses.[117]

Oklahoma may not pose much of a threat to Delaware's dominance, but what if the Model Business Corporation Act ("MBCA") adopted a provision authorizing fee-shifting bylaws? There is a school of thought that the MBCA is already a more innovative and determinate statute than is the Delaware code, which means that incorporation in Delaware rather than an MBCA state "increases the costs for corporations attempting to comply with the uncertain body of [Delaware] law."[118] Delaware possesses other advantages besides the purported quality of its law that help it maintain its dominance, but there

---

[112] Alex Righi, *Shareholders on Shaky Ground: Section 271's Remaining Loophole*, 108 NW. U. L. REV. 1451, 1462 (2014) ("[C]orporate franchise taxes typically constitute well over 20% of Delaware's annual budget.").

[113] *See, e.g.*, *id.*

[114] Coffee, *supra* note 10.

[115] Kevin LaCroix, *Oklahoma Legislature Adopts Derivative Litigation Fee-Shifting Provision*, D&O DIARY (Sept. 25, 2014), *archived at* https://perma.cc/P7GA-FUV5.

[116] *See* J. Robert Brown, Jr., *Fee Shifting in Derivative Suits and the Oklahoma Legislature*, THERACETOTHEBOTTOM.ORG (Sept. 24, 2014), *archived at* https://perma.cc/Y6ZT-6EJD.

[117] *See id*.

[118] William J. Carney & George B. Shepherd, *The Mystery of Delaware Law's Continuing Success*, 2009 U. ILL. L. REV. 1, 75.

nevertheless is some evidence that Delaware's dominance is less complete than it was in earlier periods.[119] Adoption of a statute authorizing fee-shifting bylaws by a major MBCA state could further weaken Delaware's competitive position. The odds of such a statute being adopted by a major Delaware competitor likely would be enhanced if the ABA Committee on Corporation Laws amended the MBCA itself.[120] Although there is no public information on the likelihood of the Committee doing so, it is noteworthy that the MBCA is already more favorable to fee shifting than is Delaware law.[121]

S.B. 75 is especially likely to trigger a migration away from Delaware because it is one of those rare corporate law changes that directly affects the potential personal liability of corporate officers and directors.[122] An analogy here might be drawn to the significant controversy over the American Law Institute's ("ALI") Principles of Corporate Governance. ALI members who were practicing corporate lawyers reportedly came under strong pressure from the business clients to oppose proposals that would have increased those clients' personal liability exposure.[123]

> Unlike most ALI projects, the Corporate Governance Project directly affected the prerogatives and pocketbooks of senior corporate managers. Despite all the denials and

---

[119] *See id.* at 11 ("There is some evidence that Delaware's market power may be weakening."). As one commentator observes, "other states may already be eyeing Delaware's lucrative revenue stream. Connecticut has empaneled a commission 'to develop a 10-year plan to challenge Delaware by enhancing [] corporate law and creating even better business institutions to attract businesses to Connecticut.'" Anthony Rickey, *Fee Shifting May Disrupt Delaware's Dominance,* LAW360 (Mar. 13, 2015, 12:17 PM), http://www.law360.com/articles/631222/fee-shifting-may-disrupt-delaware-s-dominance.

[120] *See, e.g.*, Craig Eastland, *Survey of Fee-Shifting Bylaws Suggests DGCL Amendments Won't End Debate*, CLS BLUE SKY BLOG (June 24, 2015), *archived at* https://perma.cc/J765-9L73 ("Section 109(a) of the DGCL provides that stockholders have the power to adopt and amend bylaws, but adds that that power may be bestowed on the board via the company's charter. Section 10.20 of the Model Business Corporation Act . . . goes further, giving the board power by default to make bylaws unless the charter takes that power away.").

[121] MBCA § 7.46 authorizes a court to order the plaintiff to reimburse the corporation's expenses if the plaintiff's suit was brought "without reasonable cause or for an improper purpose." MODEL BUS. CORP. ACT § 7.46(2) (2010). In contrast, Delaware's statute has no such "attorney fee reimbursement provisions." George S. Geis, *Shareholder Derivative Litigation and the Preclusion Problem*, 100 VA. L. REV. 261, 309 (2014).

[122] *See* Coffee, *supra* note 10 ("[T]he permissibility of automatic fee-shifting is a major difference that will fuel interjurisdictional competition because it protects corporate managers and directors from potential personal liability.").

[123] *See* Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1048-49 (1993) (discussing the reasons many ALI members opposed such provisions).

> qualifications offered by the Project's proponents, increasing management accountability was the Project's central goal.…
>
> Is it not particularly suggestive that much of the business community's opposition centered on the liability provisions of the *Principles*? . . . [E]arly drafts of the *Principles*' substantive provisions would have increased significantly the likelihood of personal liability on the part of officers or directors. Granted, plausible policy arguments can be advanced against the liability provisions proposed in the early drafts. Because of the significantly greater risk of personal liability if those drafts had been adopted, however, self-interest is an equally plausible explanation for the vehemence of the business community's opposition.[124]

If directors and officers come to perceive S.B. 75 as having eliminated a significant protection against personal liability, their self-interest likewise would motivate a migration away from Delaware.[125]

In light of the foregoing considerations, it is not surprising that some informed commentators are predicting that S.B. 75 has the potential to substantially weaken Delaware's competitive position.[126] Assuming *arguendo* they are correct, the question arises why Delaware's legislature would inflict such a serious wound on its self-interest? If permitting fee-shifting bylaws was the superior public policy outcome, as I believe to be the case, the question becomes even more salient, because S.B. 75 thus was swimming upstream against both policy and the State's self interest.

---

[124] *Id.* at 1051-52.

[125] To be sure, there are other factors that encourage directors and officers to prefer incorporating in states that protect shareholder interests, but at the very least it seems plausible that managerial self-interest will change the incorporation decision analysis at the margins. *See* Stephen M. Bainbridge, *Why the North Dakota Publicly Traded Corporations Act Will Fail*, 84 N.D. L. REV. 1043, 1043-44 (2008) (explaining that officers and directors "have strong incentives to incorporate the business in a state offering rules preferred by investors").

[126] *See, e.g.*, Keith Paul Bishop, *SB 75 May Prove To Be Delaware's Seven Sisters*, CAL. CORP. & SEC. L. (Allen, Matkins, Leck, Gamble, Mallory & Natsis LLP, Orange County, Cal.), May 14, 2015, *archived at* https://perma.cc/Q97Q-D8T6 ("Delaware should understand that its primacy is not guaranteed and can be quickly lost. Will SB 75 reprise the role of New Jersey's seven sisters for the benefit of the next Delaware?"); Kevin M. LaCroix, *Battle Builds in Delaware Over Fee-Shifting Bylaws*, D&O DIARY (Dec. 1, 2014), *archived at* https://perma.cc/68VE-WHHX ("Oklahoma's legislature recently adopted a provision authorizing Oklahoma corporations to extend loser-pays to all shareholder suits involving board members. It is entirely possible that these kinds of developments could simply overtake legal developments in Delaware, as companies could seek to form or reconstitute themselves in jurisdictions that allow fee-shifting bylaw."); Rickey, *supra* note 119 ("Fee-shifting may . . . unlock competition in the market for corporate charters unprecedented since Delaware took the lead from New Jersey in the early 1900s.").

The basic problem was that S.B. 75 presented an unprecedented conflict between the interests of the State and those of Delaware lawyers, the interest group that dominates corporate lawmaking in Delaware.[127] In their classic analysis of Delaware corporate lawmaking, Professors Jonathan Macey and Geoffrey Miller demonstrated that the Delaware bar is the group with the most influence over the General Assembly when it comes to Delaware corporate law.[128] Larry Ribstein ably summarized Macey and Miller's thesis as follows:

> Delaware lawyers have all of the attributes of a politically powerful interest group: they are already organized into bar associations and maintain an advantage over other groups because they continually learn about the law as a consequence of their profession; they are centered in a single city (Wilmington), in a small state and, therefore, can communicate with each other at minimal costs; and they provide an important service for legislators in drafting legislation on complex commercial and corporate matters.
>
> Delaware lawyers, in essence, *are* the Delaware legislature, at least insofar as corporate law is concerned. Delaware has one of the three smallest legislatures in the country. Its legislative committees are virtually inactive. Most striking, however, is that few of Delaware's legislators are lawyers. Such legislators are likely to rely on lawyers to supply sophisticated commercial and business legislation. As a result, virtually all of Delaware corporate law is proposed by the Delaware bar, and the bar's proposals invariably pass through the legislature.[129]

Macey and Miller therefore argue that "the rules that Delaware supplies often can be viewed as attempts to maximize revenues to the bar, and more particularly to an elite cadre of Wilmington lawyers who practice corporate law in the state."[130]

---

[127] *See* Coffee, *supra* note 10 ("Never before have the interests of the Delaware bar and its clients clashed so directly.").

[128] Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 472 (1987) (reviewing the various interest groups that might influence the production of Delaware law and concluding that "the bar is the most important interest group within this equilibrium").

[129] Larry E. Ribstein, *Delaware, Lawyers, and Contractual Choice of Law*, 19 DEL. J. CORP. L. 999, 1009-10 (1994) (emphasis in original).

[130] Macey & Miller, *supra* note 128, at 472.

In most cases, the interests of Delaware lawyers and those of the state government are aligned. Just as the State wants to maximize the number of firms incorporated in Delaware, so as to maximize franchise and other tax revenues, Delaware lawyers also want to maximize in-state incorporations, because all else being equal, an increasing number of firms will generate an increasing volume of legal work.[131] In some cases, however, the interests of the Delaware bar and those of the State will diverge. As Macey and Miller explain, the bar can "benefit from legal rules that increase the amount of expected legal fees per corporation, even if such rules, by imposing additional costs on Delaware corporations, reduced the absolute number of firms chartered in the state."[132] Accordingly the bar would support a rule that reduces the number of in-state incorporations and, thereby, the State's revenues if that rule would increase—or at least prevent a decrease—in legal fees.[133] In turn, the bar's domination of the state legislature enables it to force adoption of rules contrary to the State's self-interest.[134]

Because of the litigation deterrent effect of fee-shifting bylaws *ATP* obviously posed a risk to the workload, and consequently the fees of the Delaware shareholder plaintiffs' bar, but it also threatened those of Delaware corporate defense counsel.[135] Both sides of the litigation bar had a strong interest in banning fee-shifting bylaws. Such bylaws would raise plaintiff costs, deterring lawsuits, and reducing fees for all litigators.[136]

Widespread adoption of fee-shifting bylaws could also adversely affect transactional lawyers. Litigation risk is a major driver in the level of advisory work.[137] As Jonathan Macey observed, Delaware case law has given corporate directors "significant incentives to cloak their

---

[131] *See id*. at 503-04 ("The Delaware bar is interested in maximizing one specific portion of the indirect costs of Delaware incorporation—fees to Delaware lawyers paid for work on behalf of Delaware corporations. These legal fees are functionally related to the number of charters in Delaware in the sense that the expected legal revenues will increase as the number of corporations chartered in the state increases.").

[132] *Id.* at 504.

[133] *See id.* ("If the legal fees gained exceed the fees lost by deterring Delaware incorporation, the bar would prefer to adopt rules that did not serve the interests of the other interest groups within the state.").

[134] *See* Macey & Miller, *supra* note 128, at 504 (noting that "the [Delaware] bar's interests are opposed to the interests of all other groups").

[135] *See id.* ("The bar . . . does benefit from increasing the amount of litigation and accordingly would tend to favor litigation-increasing rules . . . .").

[136] *See id.* ("Delaware could stimulate litigation . . . [by making] litigation cheaper by reducing the costs to the parties, especially plaintiffs who make the initial choice of forum.").

[137] *See* Stephen M. Bainbridge, *Delaware's Decision: Viewing Fee Shifting Bylaws Through a Public Choice Lens*, PROFESSORBAINBRDIGE.COM (Nov. 18, 2014), *archived at* https://perma.cc/KB9R-4KJN.

decisions in a dense shroud of process and to take other steps that will generate high fees for lawyers, investment bankers, and other advisors (who, incidentally, are precisely the same people who advise companies to incorporate in Delaware in the first place)."[138] Fee-shifting bylaws would reduce those incentives and thus decrease the demand for advisory work by lawyers.[139]

In sum, all corporate lawyers—litigators and transactional—have a strong incentive to oppose fee-shifting bylaws. Hence, it was no surprise that the General Assembly—dominated in this area by the Delaware bar—leaped to ban such bylaws.

This analysis leads to two take-home lessons. First, if it wishes to ensure that future legislation advances both sound public policy and the State's financial interests, the General Assembly needs to free itself from the bar's influence. In addition, the business community needs to invest lobbying resources in Delaware so as to counter the bar's influence in cases such as this. Second, states in which the corporate bar wields less legislative influence thus may have a significantly easier time adopting legislation authorizing such bylaws. If so, the likelihood that S.B. 75 will significantly reduce Delaware's dominance of corporate law will go up substantially.

V. CONCLUSION

By authorizing fee-shifting bylaws, the *ATP* decision opened the door to a viable private ordering solution to the shareholder litigation crisis.[140] At the same time, because bylaws are subject to shareholder amendment, the most likely result was a process of give and take between directors and investors that would have resulted in bylaws whose terms were broadly acceptable to the corporation's key constituencies.[141] S.B. 75 overrode that process to impose a suboptimal

---

[138] Jonathan Macey, *Delaware: Home of the World's Most Expensive Raincoat*, 33 HOFSTRA L. REV. 1131, 1137 (2005).

[139] *See* Bainbridge, *supra* note 137.

[140] *See* James D. Cox, *Corporate Law and the Limits of Private Ordering* 6 (Duke Law Sch. Public Law & Legal Theory, Working Paper No. 2015-47, 2015), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2671850 ("In a world of private ordering, the state corporate statute is understood to have the limited role of providing default rules in those instances where the parties have not otherwise specified how their affairs or activities are to occur.").

[141] *See* DEL. CODE. tit. 8, § 109(a) (2011). Under § 109(a), a corporation can "confer the power to adopt, amend or repeal bylaws upon the directors," but that power "shall not divest the stockholders or members of the power, nor limit their power to adopt, amend or repeal bylaws." *Id.*

outcome on all Delaware corporations, even those whose shareholders might have preferred limiting litigation that burdens the corporate treasury. In doing so, moreover, S.B. 75 threatens to undermine Delaware's profitable position as the leading state of incorporation. Understanding why the General Assembly would have opted for such a serious self-inflicted wound, however, becomes easier when one recognizes that the local bar has captured the State's legislative process. As S.B. 75 demonstrates, the bar is willing to put its interests ahead of both sound public policy and the economic interests of the State as a whole.