DELAWARE CHANCERY COURT CONFIRMS THE INVALIDITY OF FEE-SHIFTING BYLAWS FOR STOCK CORPORATIONS

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By: Taylor B.Bartholomew, Lisa R. Stark

In *Solak v. Sarowitz*, C.A. No. 12299-CB (Del. Ch. Dec. 27, 2016), the Delaware Court of Chancery held that plaintiff stated a claim that a stock corporation's fee-shifting bylaw was facially invalid under Section 109(b) of the General Corporation Law of the State of Delaware (the "DGCL"). The fee-shifting bylaw purported to apply to a stockholder who sought to litigate claims involving the corporation's internal corporate governance in a forum other than Delaware in violation of the corporation's forum-selection bylaw. No stockholder had violated the forum-selection bylaw at the time of the decision, and the plaintiff successfully overcame a ripeness defense. In rendering its decision, the Court of Chancery confirmed that fee-shifting bylaws relating to internal corporate claims are impermissible for stock corporations following the 2015 amendments to the DGCL (the "2015 DGCL Amendments").

BACKGROUND OF FEE-SHIFTING BYLAWS

Fee-shifting bylaws shift the expense of stockholder litigation to stockholders who unsuccessfully bring claims against the corporation. Not strictly "loser pays" provisions, fee-shifting bylaws, which gained some popularity following the Delaware Supreme Court's 2014 decision in *ATP Tour, Inc. v. Deutscher Tennis Bund*,[1] typically only shift fees to the plaintiff and to stockholders who assist plaintiff in the litigation if the plaintiff does not obtain a judgment that substantially achieves the remedy sought. In *ATP Tour, Inc.*, the Delaware Supreme Court upheld the validity of fee-shifting bylaws when adopted by a nonstock corporation. The following year, Delaware's legislature amended Section 109(b) of the DGCL to prohibit stock corporations from enacting fee-shifting bylaws or certificate of incorporation provisions, in each case, relating to "internal corporate claims."[2] Under Section 115 of the DGCL, "internal corporate claims" are claims, including derivative claims, (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."[3]

The 2015 DGCL Amendments did not displace *ATP Tour Inc.* with regard to nonstock corporations, nor did the amendments purport to regulate contractual agreements between a corporation and its stockholders that allocate liability for litigation-related expenses. The 2015 DGCL Amendments also added Section 115 of the DGCL, which permits bylaw and certificate of corporation provisions that require stockholders to litigate internal corporate claims in a Delaware state or federal court.[4]

SOLAK: FACTUAL BACKGROUND

Approximately six months after the 2015 DGCL Amendments became effective, on February 2, 2016, the Board of Directors of Paylocity Holding Corporation ("Paylocity") amended Paylocity's bylaws to provide for (i) a forum-selection bylaw selecting Delaware as the sole and exclusive forum for internal corporate claims (the "Forum Selection Bylaw") and (ii) a fee-shifting bylaw that purported to shift to stockholders who file an internal corporate claim *outside* of Delaware the fees and expenses that Paylocity incurs in connection with such a claim if the stockholder does not obtain a judgment that substantially achieves the remedy sought (the "Fee-Shifting Bylaw"). Effectively, the Fee-Shifting Bylaw applied only if a stockholder violated the Forum Selection Bylaw. On February 5, 2016, Paylocity disclosed its adoption of the two provisions in a Form 8-K, filed with the Securities and Exchange Commission (the "SEC"), but did not disclose whether the Fee-Shifting Bylaw might be invalid in light of the 2015 DGCL Amendments.

SOLAK: PARTIES' ARGUMENTS

The plaintiff, a stockholder of Paylocity, sought a declaration that Paylocity's Fee-Shifting Bylaw was invalid under Sections 109(b) and 102(b)(6) of the DGCL.[5] The plaintiff also asserted that the members of the Paylocity board had breached their fiduciary duties in adopting the Fee-Shifting Bylaw and by making material omissions in connection with the Form 8-K filing with the SEC.

Defendants moved to dismiss the plaintiff's complaint, contending that (i) the plaintiff's claims were not ripe because no Paylocity stockholder had filed an action that triggered the Fee-Shifting Bylaw, and (ii) even if plaintiff's claims were ripe, the plaintiff failed to state a claim that the Fee-Shifting Bylaw was invalid. The defendants' arguments as to the validity of the Fee-Shifting Bylaw were threefold. First, the defendants asserted that because the Delaware legislature adopted Section 115 (allowing forum-selection bylaws) at the same time that it amended Section 109(b) (addressing fee-shifting bylaws), that Section 109(b) must be construed to permit the adoption of a fee-shifting bylaw that is triggered when a stockholder violates a validly adopted forum-selection bylaw. Second, the defendants argued that fee-shifting bylaws are permissible because, at common law, fee-shifting provisions are allowable, and that the 2015 DGCL Amendments were not meant to displace the common law. Finally, the defendants contended that the Fee-Shifting Bylaw was valid because it contained a savings clause, rendering the Fee-Shifting Bylaw enforceable only "[t]o the fullest extent permitted by law," and therefore preserving any part of the bylaw that did not violate Delaware law.[6]

SOLAK: THE COURT'S HOLDING

The Court rejected the defendants' ripeness contention and recognized the "practical reality" that a rational stockholder would be unlikely to file a claim outside of Delaware because of the risk of liability that the Fee-Shifting Bylaw imposed.[7] The Court reasoned that, "[t]o decline to review the Fee-Shifting Bylaw thus would mean, as a practical matter, that its validity under the DGCL would never be subject to judicial review."[8] Accordingly, the Court held that the plaintiff's challenge to the validity of the Fee-Shifting Bylaw was ripe for judicial review.

As to the validity of the Fee-Shifting Bylaw under Section 109(b) of the DGCL, the Court agreed with the plaintiff's argument, holding that the plaintiff had stated a claim that the Fee-Shifting Bylaw was facially invalid under the

DGCL because Section 109(b) “prohibits 'any' bylaw that purports to shift a corporation's litigation expenses to a stockholder in connection with the pursuit of an internal corporate claim without regard to where such a claim is filed.”[9]

In so holding, the Court rejected each of defendants' arguments in turn, finding first that because Section 109(b) does not distinguish between internal corporate claims brought inside or outside of Delaware, the legislature did not intend to create an exception to the proscription of fee-shifting bylaws for such claims brought outside of Delaware in violation of forum-selection provisions. In addressing defendants' argument that the common law allowed for fee-shifting provisions, the Court distinguished decisional law interpreting the validity of fee-shifting provisions in private contracts under the common law, which the Court explained are not precluded by Section 109(b). Finally, the Court rejected defendants' argument in connection with the Fee-Shifting Bylaw's savings clause because, according to the Court, the Fee-Shifting Bylaw was entirely invalid, and thus, the savings clause preserved nothing.

Next, the Court rejected the plaintiff's argument that the Fee-Shifting Bylaw was invalid under Section 102(b)(6) of the DGCL, primarily because the plaintiff had not provided authority interpreting the term “debts” as used in that section. Explaining that the plaintiff was required to show that Section 102(b)(6) of the DGCL rendered the Fee-Shifting Bylaw invalid under “any circumstances,” the Court held that the plaintiff had failed to carry that burden.[10]

The Court also rejected plaintiff's argument relating to the Paylocity board's alleged breach of fiduciary duty in adopting the Fee-Shifting Bylaw. Noting that Paylocity's certificate of incorporation contained an exculpatory provision pursuant to Section 102(b)(7) of the DGCL, the Court explained that the plaintiff would have to show that the board had acted in bad faith in its adoption of the Fee-Shifting Bylaw. According to the Court, bad faith could mean an authorized transaction that is known to be a violation of applicable positive law. The Court held that the simple fact that the board adopted the Fee-Shifting Bylaw a mere six months after the effectiveness of the 2015 DGCL Amendments did not establish a knowing violation of the law. In so holding, the Court noted that the plaintiff's complaint did not contain any factual allegations relating to the board's process in adopting the Fee-Shifting Bylaw, which might have showed that the board acted in bad faith by, for example, failing to receive (or ignoring) legal advice or by failing to engage in a deliberative process. Moreover, the Court explained that the presence of the savings clause in the Fee-Shifting Bylaw “negates the notion that the directors knew that they would be violating the law by approving the provision,” which further undercut the plaintiff's ability to show the required scienter.[11]

The Court also rejected plaintiff's claim that the Paylocity board breached its fiduciary duty of disclosure by failing to disclose the board's rationale for adopting the Fee-Shifting Bylaws six months after the 2015 DGCL Amendments.

Accordingly, the Court denied the defendants' motion to dismiss with respect to the validity of the Fee-Shifting Bylaw under Section 109(b) of the DGCL but granted defendants' motion with respect to the Fee-Shifting Bylaw's alleged invalidity under Section 102(b)(6) of the DGCL and the board's alleged breach of fiduciary duty.

IMPLICATIONS

To the extent it was unclear following the 2015 DGCL Amendments, the Court of Chancery's decision in *Solak*

confirms to practitioners that *any* fee-shifting bylaw (or charter provision) adopted by a stock corporation and relating to internal corporate claims is invalid. Indeed, in its decision, the Court discussed at length the motivations behind the 2015 DGCL Amendments, including the Corporation Law Council of the Delaware State Bar Association's desire to limit fee-shifting following the Delaware Supreme Court's decision in *ATP Tour, Inc*.

The Court's decision also highlights the difficulty faced by a plaintiff in sustaining a claim for breach of fiduciary duty on the basis of bad faith in the face of a 102(b)(7) exculpatory provision. In its decision, the Court found the assertion unavailing that the Paylocity board "must have known" it was violating positive law when, six months after the 2015 DGCL Amendments became effective, the board adopted the Fee-Shifting Bylaw because the assertion was not supported by any factual allegations. [12] Such factual allegations that might constitute bad faith in this context include: a board of directors with a "nefarious purpose," a less-than-diligent deliberation process or a failure to receive legal advice (or ignoring legal advice).[13] The Court's decision provides to corporations an important roadmap for satisfying a judicial inquiry into a board's process and good faith in connection with the consideration of any fundamental corporate transaction or governance matter. At the same time, the Court affirmed the importance of books and records actions for plaintiffs seeking to challenge a board's decision on the grounds of bad faith: "[i]t was within plaintiff's power to explore [the] board's internal deliberations through a books and records inspection, but there is no indication in the record that he attempted to do so."[14]

Notes:

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

[2] 8 *Del. C.* § 109(b). Section 102(f) similarly provides that "[t]he 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 internal corporate claim, as defined in § 115 of this title." 8 *Del. C.* § 102(f).

[3] 8 *Del. C.* § 115.

[4] Specifically, Section 115 provides that the certificate of incorporation or bylaws of a corporation "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…." 8 *Del. C.* § 115.

[5] Section 102(b)(6) states that stockholders "shall not be personally liable for the payment of the corporation's debts except as they may be liable by reason of their own conduct or acts" unless expressed in the corporation's certificate of incorporation. 8 *Del. C.* § 102(b)(6).

[6] *Mem. Op.* at 24.

[7] *Id*. at 12.

[8] *Id*. at 12–13.

[9] *Id*. at 2.

[10] *Id*. at 27. Moreover, the Court explained that, because it had already found the Fee-Shifting Bylaw to be invalid under Section 109(b), it relieved the Court of any "practical need to resolve plaintiff's challenge under 102(b)(6)." *Id*. at 27 n.56.

[11] *Id.* at 30.

[12] *Id.* at 29.

[13] *Id.*

[14] *Id.* at 30.

