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The case for allowing fee shifting bylaws as a privately ordered solution to the shareholder litigation epidemic

I had been planning on writing a law review article on fee shifting bylaws, but I suspect that events will overtake the inevitably lengthy publishing process. This seems to be one of those times when blog publishing is the most effective way of getting the ideas out there.

In 2006, the board of directors of ATP Tour, Inc. (ATP), a Delaware nonstock membership corporation[1] 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, 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.[2]

The Delaware Supreme Court upheld the bylaw as valid.

These fee shifting "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."[3] At least 24 for profit Delaware business corporations have now adopted them. It is widely assumed that the legal basis for upholding such a bylaw in the context of a membership corporation will carry over to a stock corporation.

As a WSJ opinion column recently reminded us, however, the Delaware legislature may yet intervene:

> 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. Far from a fix, the bill would have outlawed a company's ability to use the fee-shifting tool to protect itself against frivolous litigation.
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> Loud protests from national, state and local business groups, as well as individual companies caused the legislature to rethink its approach. But the legislature hit only the pause button, asking the Delaware Bar's leadership to "study" the matter this fall before recommending to the legislature a revised provision to be considered early next year.[4]

The purpose of this essay is to explain the case for fee shifting bylaws and, accordingly, to argue that the Delaware legislature should not ban them legislatively.

Why are Fee Shifting By Laws Needed?

In 2006-2007, there were three major reports studying the declining competitiveness of U.S. capital markets: the Bloomberg-Schumer Report,[5] the Paulson Committee Interim Report, [6] and the Chamber Report.[7] 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 last decade. By why?

In 2008, the Supreme Court handed down one of the most consequential securities cases to come before it in many years, *Stoneridge Investment Partners v. Scientific-Atlanta*.[8] What makes *Stoneridge* instructive for our purposes is not the specific legal issues or the holding, but rather the Supreme Court majority's explicit reliance on policy considerations and the content of those considerations:

> 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.[9]

Like all three of the capital market competiveness reports, the Supreme Court majority thus explicitly recognized the risk that our expansive securities anti-fraud legal regime poses to the competitiveness of our markets.

The point is not that we should live in a world of caveat emptor. An effective anti-fraud regime has obvious benefits. It serves to compensate defrauded investors. It deters fraud. It provides a bond making issuer disclosures more credible and thereby lowers the cost of capital. The question remains, however, whether the current U.S. anti-fraud regime imposes costs that may outweigh or, at least, reduce these benefits.

An affirmative answer to that question is suggested by a survey of global financial services executives, which found that the litigious nature of U.S. society and capital markets has a negative impact on the competitiveness of those markets.[10] The key problem appears to be the prevalence of private party securities fraud class actions, which do not exist in most other major capital market jurisdictions.

Between 1997 and 2005 there was a steady increase in both the number of securities class action filings and the average settlement value of those suits.[11] The total amount paid in securities class actions peaked in 2006 at over $10 billion, even excluding the massive $7 billion Enron settlement.[12] The vast majority of such settlement payments historically have been made either by issuers or their insurers, rather than by individual defendants.[13] As a result, the vast bulk of securities settlement payments come out of the corporate treasury, either directly or indirectly in the form of higher insurance premia. In either case, settlement payments reduce the value of the residual claim on the corporation's assets and earnings. In effect, the company's current shareholders pay the settlement, not the directors or officers who actually committed the alleged wrongdoing.

The effect of securities 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. 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. 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. Legal fees to plaintiff counsel typically take 25-35% of any monetary class action settlement, for example, and the corporation's defense costs are likely comparable in magnitude.[14]

The circularity inherent in the securities class action process reduces the effectiveness of private anti-fraud litigation as both a deterrent and means of compensation. As to deterrence, because it is the company and not the individual wrongdoers that pays in the vast majority of cases, the system fails to directly punish those individuals. As to compensation, the transaction costs associated with securities litigation ensure that investors are unlikely to recover the full amount of their claims. Indeed, there is evidence that investors recover only two to three percent of their economic losses through class actions.

The analysis to this point has implicitly assumed that all securities fraud class actions are meritorious. When one considers the potential for frivolous or nuisance litigation, the potential impact of litigation on the capital markets is compounded. To be sure, the Private Securities Litigation Reform Act of 1995 and the Securities Litigation Uniform Standards Act of 1998 heightened the pleading standards for securities fraud claims, allowed an automatic stay of discovery while a motion to dismiss is pending, created a uniform federal cause of action, and otherwise tried to reduce frivolous securities class action. While there is some empirical evidence that the PSLRA and SLUSA have reduced—but not eliminated—the number of frivolous suits, there is also evidence that they have had the unintended effect of reducing meritorious suits in which pre-filing indicia of fraud are more difficult to identify and plead with particularity as required by the new pleading standard.[15]

The accurate 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.[16] As for foreign issuers, they are "deeply" concerned by the "cost of litigation" associated with securities class actions and "risk of huge enforcement actions."[17]

> 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. …
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> … 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.[18]

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.[19]

The litigation risk problem is not limited to securities class actions. We see essentially identical concerns in areas such as state corporate law derivative litigation. In a seminal empirical study of derivative litigation, Professor Roberta Romano found that derivative litigation is relatively rare.[20] Of those cases that go to trial, shareholder-plaintiffs almost always lose. As is generally true of all litigation, however, most derivative suits settle. Only half of the settled derivative suits resulted in monetary recoveries, with an average recovery of about $6 million. In almost all cases, the legal fees collected by plaintiff counsel exceeded the monetary payments to shareholders. Romano further concluded that nonmonetary relief typically was inconsequential in nature.

Like securities class actions, derivative litigation mainly serves as a means of transferring wealth from investors to lawyers. At best, derivative suits take money out of the corporate treasury and return it to shareholders minus substantial legal fees. In many cases, moreover, little if any money is returned to the shareholders, but legal fees are almost always paid.

As for deterrence, there is no compelling evidence that derivative litigation deters a substantial amount of managerial shirking and self-dealing. To the contrary, there 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.[21] There is also substantial evidence that 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.[22]

Conclusion

There is a serious litigation crisis in American corporate law. As Lisa Rickard recently noted, "where shareholder litigation is reaching epidemic levels. Nowhere is this truer than in mergers and acquisitions. According to research conducted by the U.S. Chamber Institute for Legal Reform, lawsuits were filed in more than 90% of all corporate mergers and acquisitions valued at $100 million since 2010." There simply is no possibility that fraud or breaches of fiduciary duty are present in 90% of M&A deals. Instead, we are faced with a world in which runaway frivolous litigation is having a major deleterious effect on U.S. capital markets.[23]

Fee shifting bylaws are an appropriate means of addressing the problem through private ordering. On the one hand, they likely will prove an effective deterrent to frivolous litigation:

> Fee-shifting bylaws, if widely adopted, would raise the risk associated with filing these lawsuits and could weed out the weakest ones, said Sean Griffith, a professor at Fordham University's law school.
>
> "This could be a gut check for plaintiffs' lawyers," Mr. Griffith said. "They would have to ask—for the first time, really—how good is my case?"[24]

It is, of course, a question that plaintiff lawyers should have been asking all along. The problem, of course, is that they never do.

On the other hand, bylaws are subject to shareholder amendment, so the most likely result will be a process of give and take between directors and shareholders that results in bylaws whose terms are broadly acceptable to the key constituencies (other than lawyers, of course).

Delaware should uphold these bylaws. But will it? That will be the subject of my next essay.

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[1] The Delaware General Corporation Law (DGCL) defines a nonstock corporation as "any corporation organized under [the DGCL] that is not authorized to issue stock." Del. Code Ann., tit. 8, § 114(d)(4). A nonstock corporation can be either for-profit or nonprofit. *See id.* § 114(c)(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] corporation, or a member's right to receive distributions of [the] corporation's assets, or both." *Id.* § 114(d)(3). ATP is a nonprofit nonstock corporation. *See* Deutscher Tennis Bund v. ATP Tour Inc., 480 F. App'x 124, 125 (3d Cir. 2012) (explaining that "ATP is a not-for-profit Delaware membership corporation").

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

[3] DavisPolf Briefing: Governance, The Latest on Fee-Shifting Bylaws (Oct. 23, 2014).

[4] Lisa A. Richard, Delaware Flirts With Encouraging Shareholder Lawsuits, Wall St. J., Nov. 14, 2014.

[5] Michael R. Bloomberg & Charles E. Schumer, Sustaining New York's and the U.S.' Global Financial Services Leadership (2007) [hereinafter the Bloomberg-Schumer Report].

[6] Comm. on Capital Mkts. Reg., Interim Report of the Committee on Capital Markets Regulation (2006). The Committee on Capital markets regulation—or, as it is better known—the Paulson Committee subsequently issued a follow up report

identifying thirteen competitive measures that the Committee tracks on a quarterly basis. Comm. on Capital Mkts. Regulation, The Competitive Position of the U.S. Public Equity Market (2007) [hereinafter the Paulson Committee Report].

[7] U.S. Chamber of Comm., Capital Markets, Corporate Governance, and the Future of the U.S. Economy (2006) [hereinafter the Chamber Report].

[8] Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148 (2008).

[9] Id. at 163-64 (citations omitted).

[10] Bloomberg Schumer Report, supra note 1, at 73.

[11] See Paulson Committee Report, supra note 2, at 75. A mid-decade dip in filings was probably caused by the lack of volatility in U.S. stock markets during the period and the fading of the substantial litigation generated by the bursting of the dot-com bubble. Bloomberg-Schumer Report, supra note 1, at 74.

[12] Statement of the Financial Economists Roundtable on the International Competitiveness of U.S. Capital Markets, 19 J. Applied Corp. Fin. 54, 55 (2007) [hereinafter FER].

[13] Id.

[14] Id.

[15] Stephen J. Choi, The Evidence on Securities Class Actions, 57 Vand. L. Rev. 1465 (2004).

[16] Stephen J. Choi, Assessing the Cost of Regulatory Protections: Evidence on the Decision to Sell Securities Outside the United States (Yale Law & Economics Research Paper No. 253, March 21, 2001), available at SSRN: http://ssrn.com/abstract=267506.

[17] Howell E. Jackson, Summary of Research Findings on Extra-Territorial Application Of Federal Securities Law, 1743 PLI/Corp 1243, 1253 (May 20, 2009).

[18] Bloomberg-Schumer Report, supra note 1, at 75, 77.

[19] Jackson, supra note 13, at 1254.

[20] Roberta Romano, The Shareholder Suit: Litigation without Foundation?, 7 J. L. Econ. & Org. 55 (1991).

[21] 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 (1986).

[22] See, e.g., Michael Bradley & Cindy A. Schipani, The Relevance of the Duty of Care Standard in Corporate Governance, 75 Iowa L. Rev. 1 (1989); Roberta Romano, Corporate Governance in the Aftermath of the Insurance Crisis, 39 Emory L.J. 1155 (1990).

[23] The evidence seems clear that "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, 47 Rev. Sec. & Comm. Reg. 1 (Jan. 8, 2014). The authors offer a number of solutions, including an endorsement of fee shifting bylaws.

[24] Liz Hoffman, Shareholder Suits May Prove Costly, Wall St. J., May 18, 2014.

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