

Fee-Shifting Bylaw Found Invalid by Delaware Court

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The Delaware Court of Chancery recently ruled that a form of fee-shifting bylaw linked to exclusive forum provisions is invalid.

Six months after Delaware adopted DGCL Section 109(b) to restrict fee-shifting bylaws, by providing that the bylaws of Delaware corporations 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, Paylocity Holding Corporation adopted two new bylaws.

The company adopted an exclusive forum bylaw that requires internal corporate claims to be filed in a state or federal court located in Delaware. The second bylaw applies if a stockholder does file such a claim outside of Delaware, in violation of the exclusive forum bylaw. In that case, the litigation expenses (including attorneys' fees) shift to any stockholder who brings, substantially assists, or has any direct financial interest in any action brought in a forum outside of Delaware, unless the stockholder obtains a judgment on the merits that substantially achieves the full remedy sought.

A Paylocity stockholder brought suit challenging the facial validity of the fee-shifting bylaw. The company moved to dismiss the complaint as unripe because no stockholder had filed or stated an intention to file an internal corporate claim outside of Delaware. The Court disagreed, finding that the presence of the fee-shifting bylaw acts as a deterrent and its validity may never be subject for review. So long as the bylaw remains in place, stockholders would not file claims outside of Delaware for fear of triggering the fee-shifting bylaw and assuming personal liability. The Court was also concerned that declining to review the bylaw could encourage other corporate boards to adopt similar bylaws to take advantage of their potential deterrent effect on stockholders, without regard to whether such provisions are legally permissible.

The Court ultimately held that the plain text of the company's fee-shifting bylaw violated Section 109(b) because the statute unambiguously prohibits the inclusion of "any provision" in a company's bylaws that would shift to a stockholder the attorneys' fees or expenses incurred by the company "in connection with an internal corporate claim," irrespective of where such a claim is filed.

The Court rejected the company's argument that the legislative amendments to Section 109(b) should be read in tandem with the DGCL amendment permitting exclusive forum bylaws, such that fee-shifting is not prohibited when limited to claims filed outside of Delaware, in connection with a company's adoption of an exclusive forum bylaw. The Court also rejected arguments that fee-shifting is permissible at common law and that the company's fee-shifting bylaw contained a savings clause that makes it enforceable only to the fullest extent permitted by law.

The Court dismissed the plaintiff's other two claims, that the fee-shifting bylaw violates when a corporation's "debts" may be imposed on stockholders and that the company's directors acted in bad faith.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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