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Fee-Shifting Corporate Bylaws: What's the Law in Maryland? [Ober|Kaler]

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2014

In May 2014, the Supreme Court of Delaware held that a non-stock corporation could enact bylaws that could force a shareholder to pay the corporation's legal fees, costs, and expenses if the shareholder sues the corporation and loses.[1] This controversial decision — which may discourage shareholders from initiating corporate governance lawsuits against corporations that adopt such a provision — has sparked debate and elicited divergent opinions as to its applicability for stock corporations. For example, after the case was decided, the Corporation Law Section of the Delaware Bar Association proposed legislation to invalidate fee-shifting bylaws for stock-corporations; however, ostensibly due to the lobbying efforts of affiliates of the United States Chamber of Commerce, the legislation was withdrawn.[2] More recently, SEC Investor Advisory Committee debated — but did not decide — the issue of fee-shifting bylaws at its October 9, 2014 meeting.[3] A definitive resolution on whether Delaware corporations can rely on such bylaw provisions may not be reached until the Delaware Legislature again takes up the issue.[4]

While this question percolates in Delaware and is being considered by the SEC, Maryland-based corporations and their shareholders may be left wondering: “Can Maryland corporations adopt similar fee-shifting bylaws?” This article explores the Supreme Court of Delaware's opinion, examines applicable Maryland statutes and court precedent, and discusses how Maryland courts may approach the fee-shifting bylaw question.

The Delaware Decision

In 2006, ATP Tour, Inc. (“ATP”), a Delaware non-stock membership corporation that operates a global professional men's tennis tour, adopted a fee-shifting bylaw.[5] Sometime later, two ATP members sued ATP in the United States District Court for the District of Delaware alleging that ATP and its board had committed antitrust violations and breached fiduciary duties when it voted to alter the tennis tour schedule and format.[6] The case went to trial, and the plaintiff members lost on all counts. ATP then moved to recover its legal fees under the fee-shifting bylaw. Because Delaware Courts had not previously ruled on whether to allow corporations to fee-shift via bylaws, the federal court certified the question to the Supreme Court of Delaware.[7]

The Supreme Court of Delaware then held that a fee-shifting bylaw is generally permissible under Delaware law, that a fee-shifting bylaw could shift fees if a plaintiff lost outright, and that a bylaw amendment to shift fees and costs to members of the corporation who sue the corporation and lose is generally enforceable even against members who joined before the bylaw was enacted. As support, the court first looked to Delaware General Corporation Law (DGCL) § 109(b), which provides that a corporation's “bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation...” The *ATP Tour* court pointed out that no Delaware statute or common law forbids the enactment of fee-shifting bylaws. According to the court, such fee-shifting bylaws “would also appear to satisfy the DGCL's requirements that bylaws must 'relat[e] to the business of the corporation, the conduct of its affairs, and... the rights or powers of its stockholders, directors, officers or employees.”[8]

Next, the court explained that while Delaware follows the American Rule (requiring a party to foot its own legal fees), parties can contractually obligate a losing party to pay the winning party's fees and costs. Furthermore, because bylaws are essentially contracts,[9] a bylaw can allow for fee-shifting. Finally, the court explained that

members who joined the corporation *before* the enactment of the fee-shifting provision were nonetheless bound by it because "they agreed to be bound by rules that may be adopted and/or amended from time to time" by the board of directors.[10]

The court did not, however, answer the ultimate question of whether ATP could recover its legal fees from the members who sued it. Instead, the court found that the inquiry was dependent on facts and circumstances not before it but that related to the bylaw's "adoption and use"[11] such as:

- Was the bylaw adopted by the appropriate corporate procedure?
- Was the bylaw enacted for a proper corporate purpose?[12]
- Was the bylaw properly applied?
- Was the bylaw adopted for any inequitable reason?

Thus, *ATP Tour* holds that Delaware law allows fee-shifting bylaws, at least in the case of a non-stock corporation, but the case does not answer the question of whether the ATP members that sued and lost must actually pay ATP's litigation costs.

The Legal Framework in Maryland

What does the *ATP Tour* decision mean for Maryland non-stock and stock corporations and their members or stockholders? To date, there have been no reported Maryland rulings or guidance on the topic. Maryland corporate statutes and case law, however, are at least somewhat analogous to the Delaware law applied in *ATP Tour*. For example, Maryland Code, Corporations and Associations § 2-110(a) provides that a corporation's "bylaws may contain any provisions not inconsistent with law or the charter of the corporation for the regulation and management of the affairs of the corporation." This statute is largely parallel to the language of DGCL § 109(b). Further, courts interpreting § 2-110 have found that it does not contain a closed list of permissible bylaw subjects.[13] Maryland courts have also held that while attorneys' fees are not ordinarily recoverable under the American Rule, a fee-shifting provision can be agreed to as a matter of contract law.[14] Finally, Maryland courts have also treated bylaws like contracts under certain circumstances.[15]

With respect to non-stock corporations, § 5-201 of the Corporations and Associations Article provides: "The provisions of the Maryland General Corporation Law apply to nonstock corporations unless: (1) The context of the provisions clearly requires otherwise; or (2) Specific provisions of this subtitle or other subtitles governing specific classes of corporations provide otherwise." Because the governing statute about "charters or bylaw provisions" does not state otherwise,[16] a non-stock corporation's bylaws likewise "may contain any provisions not inconsistent with law or the charter of the corporation for the regulation and management of the affairs of the corporation."[17]

How Will a Maryland Court Rule?

Equipped with statutory provisions and court precedents similar to those used in *ATP Tour*, it is certainly possible that a Maryland court could conclude that a Maryland corporation's fee-shifting bylaws are facially permissible. When this issue is considered more closely, though, particularly in the context of a stock corporation, questions abound.

Conventional wisdom in Maryland is that a corporation's charter or even its bylaws can rest exclusive power to amend or adopt bylaws in the corporation's board of directors.[18] In contrast, Section 109(a) of the DGCL, which the *ATP Tour* court cited for a different proposition, expressly provides that the right to amend bylaws

cannot be divested from the stockholders of a stock corporation or members of a non-stock corporation. Thus, the court in *ATP Tour* knew that the members of ATP could always amend the bylaws to remove the fee-shifting provision. If the members did not have that power, would the result have been different?

ATP Tour effectively holds that because parties to a contract may vary what would otherwise apply under common law, and because bylaws are a type of contract, ATP's bylaws may vary common law. But how far should that argument go? Parties can unilaterally alter the statute of limitations by contract. Could a board adopt bylaws shortening the statute of limitations to one year or six months? If enforceable, how would such a provision apply in the context of a shareholder plaintiff about to sue the corporation on an older matter? Could bylaws eliminate the demand futility exception in Maryland (however limited it may be)?[19] At some point, public policy must come into play.[20] Of course, these are just some of the problems when one equates bylaws, which can be unilaterally changed, with "real" contracts, which require at least some sort of mutuality. (And we have difficulty agreeing with the argument that the purchase of stock constitutes some sort of blanket shareholder agreement to allow a board through bylaw amendments to change all of the rules at any time and for any reason.)

Viewed another way, might fee-shifting bylaws violate the Corporations and Associations Article? In general, all capital stock of a corporation is common stock, and all common stock is the same. A corporation's charter, however, may provide for "preferences, rights, restrictions... and qualifications not inconsistent with law."[21] Can the obligation to pay a corporation's legal fees be characterized as a "restriction" or a "qualification"?

A lack of personal liability for the obligations of the corporation is part of the essence of being a stockholder.[22] There are only two provisions of the Corporations and Associations Article that impose liability on a stockholder for the obligations of a corporation. Section 2-312(c) provides that a director that authorizes an unlawful dividend or distribution may receive contribution from each stockholder for the amount "the stockholder accepted knowing the distribution was made in violation of the charter or [the Corporations and Associations Article]." Section 2-505(b) permits a corporation to collect the costs of preparing and mailing the notice of a special meeting called by a stockholder. Yet, applying *ATP Tour's* logic, by a mere bylaw amendment, can a corporation require a stockholder to pay the corporation's legal fees? If yes, why not other fees under the theory that a "contract" can generally allocate fees in any manner agreed upon by the parties. Again, if yes, would the stock be "non-assessable"?[23]

Even more questions exist. Assuming fee-shifting bylaws are permissible, the bylaws in *ATP Tour* didn't actually shift fees to whichever party lost. Rather, if the ATP member lost, the ATP member paid its legal fees and the corporation's legal fees. If the ATP member had won, the ATP member would still have to pay its own legal fees so the "shift" only favors the corporation. And what does it mean to lose — lose on all claims? Only the important ones? Would the rule apply in class actions — such that a stockholder who joins a class action — say a class action for disclosure violations in a merger agreement — might somehow be liable to the corporation if the litigation is dismissed? Since much shareholder litigation is pursued on contingency — does the plaintiffs' bar get around the whole fee-shifting issue by finding a judgment proof shareholder to serve as plaintiff? More problems/questions likely exist, but we've run out of room.

Until case law or a revision to the Corporations and Associations Article addresses the question, a Maryland corporation deciding whether to adopt fee-shifting bylaws will need to think hard about these issues, but will still be left with many unanswered questions.

For more information, or if you have any questions, please contact Ken Abel, Co-Chair of Ober|Kaler's Business Group (kbabel@ober.com | 410. 347.7394) or Diane Festino Schmitt, Principal in Ober|Kaler's Litigation Group (dfschmitt@ober.com | 410.347.7371). Ken has extensive experience in M&A and corporate governance matters and Diane litigates corporate governance cases involving Maryland corporations.

NOTES

1. *ATP Tour, Inc. v. Duetscher Tennis Bund*, 91 A.3d 554 (Del. 2014).
2. *See* Tom Hals, Business presses Delaware for loser-pays option in class actions, REUTERS (Jun. 10, 2014).
3. *See* U.S. Securities and Exchange Commission, Investor Advisory Committee Meeting (Oct. 9, 2014), *available at*http://www.sec.gov/news/otherwebcasts/2014/iac100914.shtml.
4. *See* Jeff Mordock, *Fee-Shifting Bill Vote Postponed by Del. General Assembly Until 2015*, THE LEGAL INTELLIGENCER (Jun. 26, 2014), *available at* http://www.thelegalintelligencer.com/id=1202660907172/FeeShifting-Bill-Vote-Postponed-by-Del-General-Assembly-Until-2015?slreturn=20140725121223
5. The ATP bylaw provided, in relevant part:
   (a) In the event that (i) any [current or prior member... or anyone on their behalf ("Claiming Party")] initiates or asserts any [claim or counterclaim ("Claim")]... against [ATP] or any member... (including any Claim purportedly filed on behalf of [ATP] or any member), and (ii) the Claiming Party... 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 [ATP] and any such member . . . 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.
6. *Deutscher Tennis Bund v. ATP Tour, Inc.*, 2009 WL 3367041 (D.Del. Oct. 19, 2009).
7. *ATP Tour, Inc.*, 91 A.3d 554.
8. *Id.* at 558.
9. *See Airgas, Inc. v. Air Prods. & Chems., Inc.*, 8 A.3d 1182, 1188 (Del. 2010).
10. *ATP Tour, Inc.*, 91 A.3d 560.
11. *Id.* at 559.
12. On this question, the Court discussed *Schnell v. Chris-Craft Industries*, 285 A.2d 437, 439 (Del. 1971), in which a bylaw amendment moving the date of the corporation's annual meeting forward was disallowed as an impermissible corporate purpose: "inequitable action does not become permissible simply because it is legally possible."
13. *See, e.g., Badlands Trust Co. v. First Financial Fund, Inc.*, 65 F. App'x 876, 880 (4th Cir. 2003).
14. *See, e.g., Hess Const. Co. v. Bd. of Educ. of Prince George's Cnty.*, 341 Md. 155, 160 (1996).
15. *See Tackney v. U.S. Naval Acad. Alumni Ass'n, Inc.*, 408 Md. 700, 716 (2009). Certainly bylaws are not contracts in any real sense, but that is a discussion for another day.
16. *See* Md. Code, Corps. & Ass'ns § 5-202.
17. *Id.* § 2-110(a).
18. James J. Hanks, Jr., MARYLAND CORPORATION LAW, § 3.12 (2013) ("It is common practice for the bylaws, and sometimes the charter, to vest in the board of directors the exclusive, or at least concurrent, power to alter and repeal the bylaws.").
19. *See Werbowsky v. Collomb*, 362 Md. 581 (2001).
20. *See, e.g., State Farm Mut. v. Nationwide Mut.*, 307 Md. 631, 643 (1986) ("A contractual provision that violates public policy is invalid, but only to the extent of the conflict between the stated public policy and the contractual provision.") (citations omitted).
21. Md. Code, Corps. & Assn's, § 2-105(9).
22. *Ace Dev. Co. v. Harrison*, 196 Md. 357, 365 (1950) ("The purpose of a corporation is limited liability to its stockholders.").
23. *See* Md. Code, Corps. & Ass'ns, § 2-206(c).