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Delaware Court of Chancery Holds that Fee-Shifting Bylaw Does Not Apply to Former Stockholder

In *Strougo v. Hollander*, the Delaware Court of Chancery held that a fee-shifting bylaw did not apply to a former stockholder's challenge to the fairness of a 10,000-to-1 reverse stock split that the corporation undertook in connection with a going-private transaction because (i) the bylaw was adopted after the stockholder's interest in the corporation ceased to exist due to the reverse stock split and (ii) Delaware law does not authorize a bylaw that regulates the rights or powers of former stockholders. While the proposed 2015 amendments to the Delaware General Corporation Law, if adopted, would themselves invalidate fee-shifting provisions in corporate charters and bylaws, Delaware corporations should consider the implications of this opinion's holding that former stockholders are not bound by bylaws (or, by implication, charter provisions) adopted after their interests as stockholders cease to exist.

Background

On May 16, 2014, defendant First Aviation Services, Inc. ("First Aviation") announced that its board of directors approved a 10,000-to-1 reverse stock split at a pre-split price of \$8.40 per share. The transaction closed on May 30, 2014, after which First Aviation became a privately held corporation that was owned primarily by defendant Aaron Hollander (First Aviation's Chairman and CEO) and entities controlled by Mr. Hollander.

On June 3, 2014, First Aviation's board of directors adopted a fee-shifting bylaw that purported to apply to current or former stockholders, as well as anyone acting on their behalf who "joins, offers substantial assistance to, or has a direct financial interest in," any claim against First Aviation, its directors, officers, or employees. The bylaw was purportedly modeled on the bylaw at issue in *ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554 (Del. 2014).

Plaintiff Robert Strougo commenced an action to challenge the reverse stock split and the fee-shifting bylaw, and moved for partial judgment on the pleadings on the narrow issue as to whether the bylaw applied to this action because it was adopted after Mr. Strougo ceased to be a First Aviation stockholder.

Analysis

In granting Mr. Strougo's motion for partial judgment on the pleadings, the Court held that the fee-shifting bylaw did not apply because it was adopted after Mr. Strougo's interest as a stockholder was terminated by the reverse stock split. The Court further held that:

- *The “governing bylaws are those in effect when the former stockholder’s interest as a stockholder was eliminated.”* Relying on principles of Delaware contract law and the opinion in *Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934 (Del. Ch. 2013), the Court reasoned that a stockholder like Mr. Strougo, “whose equity interest in the corporation is eliminated in a cash-out transaction is, after the effective time of that transaction, no longer a party to” the “flexible contract” between a Delaware corporation and its current stockholders. Instead, such a stockholder “is equivalent to a non-party to the corporate contract.”
- *Section 109(b) of the Delaware General Corporation Law only authorizes bylaws that regulate the rights or powers of current stockholders.* Construing the statute’s plain language and comparing it to other provisions of the Delaware General Corporation law that explicitly reference “former” stakeholders, the Court reasoned that Section 109(b) contemplates that the term “stockholder” refers only to current stockholders. As a result, First Aviation’s attempt to adopt the bylaw, which purported to regulate the rights and powers of former stockholders who were not stockholders when the bylaw was adopted, was beyond the scope of Section 109(b) and inconsistent with Delaware law.
 - In *dicta*, the Court observed that an “equivalent limitation would apply to charter provisions” because “[n]othing in Section 102(b)(1) authorizes a charter provision regulating the powers of former investors who were no longer stockholders when the provision was adopted.”

Proposed 2015 Amendments to the Delaware General Corporation Law

The debate over the validity of fee-shifting bylaws may be put to rest with the coming session of the Delaware legislature. On March 6, 2015, the Corporation Law Council, a committee of the Corporation Law Section of the Delaware State Bar Association, proposed two amendments to the Delaware General Corporation Law to prohibit fee-shifting provisions in charters and bylaws. More specifically, those amendments would:

- Revise Section 102 to add a new subsection (f), stating that a Delaware corporation’s charter “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” claims pertaining to the corporation’s internal affairs; and
- Revise Section 109(b) to include a new clause, providing that the “bylaws 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” claims pertaining to the corporation’s internal affairs.

If the proposed amendments are ultimately adopted, fee-shifting charter and bylaw provisions, such as First Aviation's bylaw, will become invalid. Nonetheless, the Court's holding that former stockholders are not bound by bylaws (and, by implication, charter provisions) adopted after their interests in the corporation cease to exist will likely continue to have ramifications for Delaware corporations considering amendments to their charters and bylaws.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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