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# Private Ordering in the Old Dominion: A Solution to Frivolous Litigation or the Elimination of a Fundamental Shareholder Right?


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# COMMENT

## PRIVATE ORDERING IN THE OLD DOMINION: A SOLUTION TO FRIVOLOUS LITIGATION OR THE ELIMINATION OF A FUNDAMENTAL SHAREHOLDER RIGHT?

### INTRODUCTION

Shareholder litigation is an important mechanism in corporate law for holding directors accountable to shareholders. It provides a method by which shareholders can recover when directors breach their fiduciary duties to the shareholders or the corporation.[1] Additionally, the threat of shareholder litigation acts as a deterrent to future management misconduct.[2] Thus, the right to sue "forms part of the portfolio of monitoring and enforcement tools for policing whether managers are acting as loyal agents."[3]

While shareholder litigation is necessary in corporate law, the costs of litigation for the corporation and, ultimately, the shareholders, as the residual economic claimants to the value of the corporation, are high. Further, shareholders have recently been abusing this right to sue.[4] In recent years, over 96% of publicly announced mergers have been challenged through litigation.[5] Crit-

1. Mark Lebovitch & Jeroen van Kwawegen, *Of Babies and Bathwater: Deterring Frivolous Stockholder Suits Without Closing the Courthouse Doors to Legitimate Claims*, 40 DEL. J. CORP. L. 491, 529 (2016).
2. *Id.* at 528.
3. Verity Winship, *Shareholder Litigation by Contract*, 96 B.U. L. REV. 485, 493 (2016).
4. *See* James D. Cox, *Corporate Law and the Limits of Private Ordering*, 93 WASH. U. L. REV. 257, 262–63 (2015).
5. *See* Matthew D. Cain et al., *The Shifting Tides of Merger Litigation*, 71 VAND. L. REV. 603, 604 (2018).

ics claim that most of these suits are frivolous,[6] unnecessarily increasing the costs of litigation compared to the low value a frivolous lawsuit provides to shareholders.

In response to the frequency of shareholder lawsuits, directors have been private ordering by amending their corporate governance documents with provisions limiting shareholder litigation rights. Private ordering is, in general, the use of contract law to avoid government regulation and public law.[7] In the context of corporate governance, private ordering refers to most provisions in a corporation's bylaws and certificate of incorporation.[8] At issue in this comment are bylaw amendments, which states usually allow to be amended by directors without shareholder approval.[9] There are many types of procedural bylaws directors have adopted unilaterally that limit shareholders' right to sue. For example, one such provision is a minimum stake-to-sue bylaw, which requires the claimant shareholder to have the consent of shareholders owning a particular minimum percentage of the outstanding shares before initiating a claim against the corporation or directors.[10]

Delaware has largely permitted private ordering by directors, reasoning that the bylaws constitute a contract among the shareholders.[11] However, directors have an inherent conflict of interest when adopting these provisions. As the potential defendants in shareholder lawsuits, their incentive is not simply to deter frivolous litigation, but rather to eliminate lawsuits altogether to limit their own liability. Thus, many of these procedural bylaws effectively eliminate shareholders' fundamental right to sue without

6. *See id.* at 604–05.

7. *See* Michael R. Levin, *What Is Private Ordering?*, ACTIVIST INV. (Sept. 29, 2015), http://www.theactivistinvestor.com/The_Activist_Investor/Blog/Entries/2015/9/29_What_is_Private_Ordering.html.

8. *See id.*

9. *See, e.g.*, DEL. CODE ANN. tit. 8, § 109(a) (2011 & Cum. Supp. 2016); VA. CODE ANN. § 13.1-892 (Repl. Vol. 2016). In Delaware, the corporation must first, in its certificate of incorporation, delegate power to its board to unilaterally amend bylaws. DEL. CODE ANN. tit. 8, § 109(a) (2011 & Cum. Supp. 2016).

10. *See, e.g.*, EMERGENT CAPITAL, INC., AMENDED AND RESTATED BYLAWS OF EMERGENT CAPITAL, INC. § 16 (Sept. 1, 2015) (requiring the owners of a minimum of 3% of outstanding shares to give written consent before a shareholder claimant can initiate a claim "on behalf of (1) the corporation and/or (2) any class of current and/or prior shareholders against the corporation and/or against any director and/or officer of the corporation in his or her official capacity").

11. *See, e.g.*, ATP Tour, Inc. v. Deutscher Tennis Bund, 91 A.3d 554, 558 (Del. 2014).

their consent, while the market constrains the ability of shareholders to eliminate these provisions through restricting their own right to amend the bylaws.[12]

The issue with eliminating shareholder litigation is that not every shareholder lawsuit is frivolous. While the bulk of shareholder lawsuits are frivolous, some shareholder lawsuits have merit, and the right to pursue such lawsuits deserves protection. If shareholders were unable to pursue meritorious lawsuits, they would no longer be able to recover when the board breaches its duties to the shareholders. Further, the directors would likely undergo subpar decision-making processes as they would not be acting under the threat of a shareholder lawsuit. Finally, litigation is the vehicle by which courts can issue opinions proscribing the standard of conduct, and therefore provide a social benefit by advising boards of the practices that must be followed in making decisions. Thus, an effective solution to frivolous litigation should not eliminate litigation entirely but rather sort frivolous lawsuits from those lawsuits with merit.

This comment seeks to explain why unilateral private ordering by directors is not a good solution to frivolous shareholder litigation. Part I of this comment will examine the issue of frivolous litigation and the trend in Delaware of permitting private ordering as a solution to frivolous lawsuits. Part II will explain why unilateral private ordering is not a good sorting mechanism for frivolous litigation in general. Part III will first discuss why Virginia will likely be at least as permissive as Delaware, and then explain why Virginia should take a less permissive approach to private ordering than Delaware has taken.

## I. PRIVATE ORDERING AS A SOLUTION TO FRIVOLOUS SHAREHOLDER LITIGATION

This part will begin by explaining the problem of frivolous shareholder lawsuits, before discussing the very permissive approach Delaware has taken to what it has seen as a solution to frivolous lawsuits—private ordering.

12. *See infra* Part II.C.

## A. *The Prevalence of Frivolous Shareholder Litigation*

This subpart will first explain the types of suits shareholders can bring against the corporation. It will then discuss the increase in shareholder litigation in recent years and the outcome of these lawsuits.

### 1. The Types of Suits Brought

When bringing a state law claim against the directors,[13] shareholders typically claim that the directors breached their fiduciary duties.[14] While shareholders may bring suits individually, they rarely do so due to the insignificance of their individual claims.[15] Instead, they either bring a direct suit against the board of directors, typically in the form of a class action, or a derivative suit against the directors on behalf of the corporation.[16]

If the shareholders directly suffer personal harm, they can bring a direct suit against the corporation and its board of directors.[17] Any monetary recovery the shareholders receive will go directly to the shareholders rather than to the corporation.[18] If the shareholders suffer the harm indirectly, via harm to the corporation itself, they can bring a derivative suit on behalf of the corporation against the board of directors.[19]

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13. There are also many federal law claims a shareholder can bring; however, this comment's focus is limited to state law claims.

14. Sean J. Griffith, *Correcting Corporate Benefit: How to Fix Shareholder Litigation by Shifting the Doctrine on Fees*, 56 B.C. L. REV. 1, 6 (2015).

15. *Id*.

16. J.B., Note, *Distinguishing Between Direct and Derivative Shareholder Suits*, 110 U. PA. L. REV. 1147, 1147 (1962).

17. Griffith, *supra* note 14, at 9; *see, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 864 (Del. 1985) (holding that the shareholders were harmed directly because the directors' approval of a cash-out merger impacted the right to sell by forcing the sale for a low price).

18. Stephen P. Ferris et al., *Derivative Lawsuits as a Corporate Governance Mechanism: Empirical Evidence on Board Changes Surrounding Filings*, 42 J. FIN. & QUANTITATIVE ANALYSIS 143, 146 (2007).

19. William B. Monahan & Adam K. Magid, *M&A Litigation: Traits and Trends*, 2016 PRAC. L.J. 42, 44; *see, e.g.*, Brehm v. Eisner (*In re* Walt Disney Co. Derivative Litig.), 906 A.2d 27, 46 (Del. 2006) (discussing appellant's claim that the shareholders were harmed indirectly because the board's approval of an executive compensation and termination plan decreased the assets of the corporation itself which indirectly decreased the value of the shares).

Derivative suits can be more challenging for shareholders to bring than a direct lawsuit due to the numerous procedural hurdles shareholders must go through to bring the derivative suit.[20] These obstacles include "the continuous ownership requirement, the posting of bonds, the demand requirement, and the formation of special litigation committees."[21]

2. The Growing Number and Costs of Shareholder Lawsuits

Shareholder litigation concerning corporate deals has become very prevalent with almost every deal being challenged in court.[22] Now, once a corporation announces a deal, a shareholder lawsuit challenging the deal is "near-automatic."[23] This is in contrast to deal litigation in 2005, when shareholders only challenged approximately half of corporate mergers that were valued over $100 million.[24] Merger litigation reached its highest point in 2013 at a 96% litigation rate.[25] The percentage of deals challenged decreased in 2016 to 76%, likely as a result of *In re Trulia, Inc. Stockholder Litigation*,[26] but in the first ten months of 2017, the litigation rate rose back to 85%.[27]

Of the challenges to mergers that took place in 2017, 89% were dismissed.[28] Dismissals do not provide benefits to shareholders, but rather end up costing the corporation, and ultimately the shareholders, as the corporation prepares for litigation.[29] Additionally, in an overwhelming majority of the cases dismissed, attorneys still collected mootness fees.[30] A mootness fee following a "mootness" dismissal is a fee sought by plaintiffs' attorneys when "the

20. *See* Griffith, *supra* note 14, at 10.

21. *Id*. at 10.

22. Michael J. Kaufman & John M. Wunderlich, *Paving the Delaware Way: Legislative and Equitable Limits on Bylaws After* ATP, 93 WASH. U. L. REV. 335, 339 (2015).

23. *Id.* at 340.

24. *Id.*

25. Cain et al., *supra* note 5, at 608.

26. *See* 129 A.3d 884 (Del. Ch. 2016). *Trulia* reduced litigation rates by limiting court approval of disclosure-only settlements to disclosures that provide a meaningful benefit to shareholders. *See id.* at 887. The holding makes it riskier for attorneys to pursue frivolous suits due to the risk that their fees would not be approved. *See id.*

27. Cain et al., *supra* note 5, at 608.

28. *Id*.

29. *See, e.g.*, Jessica Erickson, *Corporate Governance in the Courtroom: An Empirical Analysis*, 51 WM. & MARY L. REV. 1749, 1791 (2010).

30. Cain et al., *supra* note 5, at 607.

claims asserted by their clients are effectively mooted by the entity against whom the claims are alleged."[31]

The majority of cases that were not dismissed were settled.[32] However, shareholders rarely received any monetary recovery as a result of the settlements. Of the cases that settled, 90% were disclosure-only settlements.[33] The problem with disclosure-only settlements is that the additional disclosures rarely seem "to matter to the deal" and are "not beneficial to investors."[34] Nevertheless, the lawyers still get paid court-awarded settlement fees.[35] In 2017, the average fee award was $300,000.[36] Thus, the Delaware Court of Chancery, the Seventh Circuit, and critics alike agree that these suits are driven not by shareholders with a large economic stake in the outcome of the case, but rather by plaintiffs' attorneys "using the threat of an injunction to extract attorneys' fee awards through a settlement."[37] This leaves the corporation and its shareholders as the "net losers."[38]

In the merger context, the prevalence of multijurisdictional shareholder litigation poses increased costs to the corporation and the shareholders. A challenge to a merger can often be brought in the state of incorporation, usually Delaware,[39] and another forum

31. Michael Greene, *Del. Court Awards 'Mootness' Fee in Comcast Merger Suit*, BLOOMBERG BNA (Feb. 24, 2016), https://www.bna.com/del-court-awards-n57982067694/.

32. Cain et al., *supra* note 5, at 608.

33. *Id.* at 623. Disclosure-only settlements involve no monetary compensation to the shareholders, but rather they just provide for the disclosure of additional information about the proposed deal. *See* Roetzel & Andress, *Disclosure Only Settlements—The Effect of Choice of Law*, JD SUPRA (Mar. 24, 2017), https://www.jdsupra.com/legalnews/disclosure-only-settlements-the-effect-11165/ [hereinafter JD SUPRA].

34. Kaufman & Wunderlich, *supra* note 22, at 344–45. "[C]orrecting typographical errors" and "disclosing information already contained in the proxy" are a few examples of immaterial supplemental disclosures suggested. *Id.* at 345.

35. Cain et al., *supra* note 5, at 632.

36. *Id.* at 625.

37. Allen C. Goolsby & Steven M. Haas, *Virginia Corporate Law Update: Federal Court Rules in Favor of Virginia Corporation in Public Company Merger Litigation*, HUNTON ANDREWS KURTH (Dec. 2014), https://www.huntonak.com/images/content/1/6/v3/1629/virginia-corporate-law-update.pdf; *see In re* Trulia, Inc. Stockholder Litig., 129 A.3d 884, 907 (Del. Ch. 2016) (refusing to approve disclosure-only settlements that do not provide a meaningful benefit to shareholders).

38. Thomas A. Dickerson, *'For a Peppercorn and a Fee': Disclosure-Only Settlements No Longer Routine*, N.Y. L.J. (Mar. 22, 2018, 2:30 PM), https://www.law.com/newyorklawjournal/2018/03/22/for-a-peppercorn-and-a-fee-disclosure-only-settlements-no-longer-routine/.

39. Edward B. Micheletti & Jenness E. Parker, *Multi-Jurisdictional Litigation: Who Caused This Problem, and Can It Be Fixed?*, 37 DEL. J. CORP. L. 1, 5 (2012).

where the company is headquartered.[40] In 2015, the average number of lawsuits that each merger related transaction attracted was 3.6.[41]

There are many costs to the corporation, the shareholders, and the judiciary associated with multi-jurisdictional shareholder litigation. It "[p]oses a costly and inconvenient distraction" to directors and officers, "[r]isks inconsistent results" across different forums, and "discourages plaintiffs' attorneys from investing in claims" vigorously because "they might need to split fee awards with attorneys" pursuing the same claim in another jurisdiction.[42] The costs of multiforum litigation not only extend to the corporation itself and the shareholders, but also "[w]astes judicial resources."[43]

Outside of the merger context, shareholders also file derivative lawsuits. In a study by Professor Jessica Erickson, which covered a twelve-month period, shareholders in public corporations filed more than 180 derivative lawsuits in federal court.[44] In addition, approximately forty derivative suits are filed in the Delaware Court of Chancery each year by shareholders of public corporations.[45] Thus, more than 200 derivative lawsuits are filed in the federal courts and Delaware alone.[46]

Derivative suits, however, do not generally benefit shareholders. In fact, "[e]xtending as far back as the 1940s, a common theme among researchers has been that most derivative lawsuits are frivolous and motivated primarily by the settlement fees that the plaintiff's attorneys hope to extract."[47] Most derivative suits are

40. *Id*.

41. Matthew D. Cain & Steven Davidoff Solomon, Takeover Litigation in 2015, at 3 (Jan. 14, 2016) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2715890.

42. Monahan & Magid, *supra* note 19, at 44.

43. *Id.*

44. Erickson, *supra* note 29, at 1761–62.

45. *Id.* at 1762. The number of derivative lawsuits, like the number of direct class actions, has likely grown in recent years, though, as derivative actions are a growing problem for companies due to the plaintiffs' bar seeking revenue through derivative suits. *See* Judy Greenwald, *Multimillion-Dollar Shareholder Derivative Settlements Drive Litigation Boom*, BUS. INS. (Feb. 1, 2015, 12:00 AM), https://www.businessinsurance.com/article/20150201/NEWS06/302019996.

46. Erickson, *supra* note 29, at 1762.

47. Ferris et al., *supra* note 18, at 144.

either dismissed or settled.[48] Shareholders rarely receive any monetary recovery in these suits.[49] As a result, the only potential benefit to shareholders is a change in corporate governance.[50] But even the value of corporate governance reforms is questionable as the reforms rarely address the misconduct alleged in the complaint.[51]

### B. *Delaware's Approach to Private Ordering*

In response to frivolous shareholder lawsuits, boards have amended their corporate governance documents to limit shareholders' ability to bring lawsuits. The concept of private ordering with respect to procedural provisions came from the Delaware courts via Judge Laster's opinion in *In re Revlon Shareholders Litigation*.[52] Judge Laster's opinion was a response to increasing multiforum shareholder litigation.[53] After that opinion was issued, boards amended their bylaws unilaterally with different procedural bylaws affecting shareholders' right to sue. These amendments have included provisions such as arbitration-only bylaws, fee-shifting bylaws, and forum selection provisions.[54] Delaware has taken a very permissive approach to private ordering by establishing a deferential standard of review when considering the validity of these provisions. Delaware has taken this approach by considering the relationship between directors and shareholders as contractual, with the bylaws representing a contract between the shareholders and directors. As long as the bylaw is adopted for something other than an "improper purpose," unilaterally adopted bylaw amendments affecting shareholders' rights are not invalid under Delaware law.[55]

Delaware first addressed private ordering in the context of forum selection clauses, which require "shareholders to bring claims

48. *See* Gregory DiCiancia, *Limiting Frivolous Shareholder Lawsuits via Fee-Shifting Bylaws: A Call for Delaware to Overturn and Revise Its Fee-Shifting Bylaw Statute*, 56 B.C. L. REV. 1537, 1543 (2015).

49. *Id.*

50. *Id.*

51. Erickson, *supra* note 29, at 1808.

52. 990 A.2d 940, 960 (Del. Ch. 2010) (noting that boards could respond to multiforum shareholder litigation through charter amendments specifying an exclusive forum).

53. *See id.*

54. *Cf.* ATP Tour, Inc. v. Deutscher Tennis Bund, 91 A.3d 554, 558 (Del. 2014); Boilermakers Local 154 Ret. Fund v. Chevron Corp., 73 A.3d 934, 938 (Del. Ch. 2013); Corvex Mgmt. LP v. Commonwealth REIT, No. 24-C-13-001111, 2013 Md. Cir. Ct. LEXIS 3, at *47 (May 8, 2013).

55. *See ATP*, 91 A.3d at 560.

related to internal corporate affairs exclusively in the courts of a particular state, usually the company's state of incorporation."[56] In 2013, the Delaware Court of Chancery in *Boilermakers Local 154 Retirement Fund v. Chevron Corp*. noted that a forum selection bylaw "[r]egulate[s] [a] [p]roper [s]ubject [m]atter" under section 109(b) of the Delaware General Corporate Law ("DGCL") because it relates to the corporation's business and its internal affairs.[57] The court then went on to find that the bylaw was not invalid just because it was approved unilaterally because "bylaws constitute a binding part of the contract between a Delaware corporation and its stockholders," and stockholders are on notice that the board may unilaterally act to address subjects of regulation permissible under section 109(b) of the DGCL.[58]

In *ATP Tour, Inc. v. Deutscher Tennis Bund*, the Delaware Supreme Court followed the reasoning in *Boilermakers* in the context of a fee-shifting provision.[59] The court held that fee-shifting bylaws were not invalid per se.[60] Like forum selection clauses, the Delaware Supreme Court said fee-shifting provisions are a permissible subject of regulation under section 109(b) of the DGCL because "allocat[ing] risk among parties in intra-corporate litigation . . . 'relate[s] to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders.'"[61] The court followed the reasoning in *Boilermakers*, holding that the provisions were valid, even if adopted unilaterally because "bylaws are 'contracts among a corporation's shareholders.'"[62] Even if the provisions were adopted after the shareholder purchased stock in the corporation, the provisions are still part of the binding contract because the shareholder "agreed to be bound by rules 'that may be adopted and/or amended from time to time' by the board."[63]

56. Donald H. Tucker Jr. & Clifton L. Brinson, *The Death of Merger Litigation?*, AM. BAR ASS'N (Aug. 8, 2016), https://www.americanbar.org/groups/litigation/committees/commercial-business/articles/2016/death-of-merger-litigation.html.

57. 73 A.3d at 950–51.

58. *Id.* at 955–56.

59. *See* 91 A.3d at 554, 560.

60. *Id.*

61. *Id.* at 558 (quoting DEL. CODE ANN. tit. 8, § 109(b) (2011 & Cum. Supp. 2016)).

62. *Id.* (quoting Airgas, Inc. v. Air Prods. & Chems., Inc., 8 A.3d 1182, 1188 (Del. 2010)).

63. *Id.* at 560 (quoting Certification of Questions of Law from the United States District Court for the District of Delaware 9 (Oct. 4, 2013)).

The Delaware Court of Chancery did not say that every bylaw amendment that limits shareholders' right to sue is permissible. Instead, these amendments are only permissible if they are adopted for a proper purpose.[64] Notably, however, the court concluded that a purpose to deter litigation was not necessarily improper.[65] Therefore, the Delaware test seems to be an easy standard for directors to satisfy and gives boards broad discretion to enact bylaws affecting shareholders right to sue.

Thus, in general, unilateral private ordering is largely permissible in Delaware due to the interpretation of the shareholder relationship with the corporation as contractual. The legislature has carved out a limited exception: fee shifting for publicly traded companies. In 2015, the Delaware legislature responded to the court's decision in *ATP* by amending section 109(b) of the DGCL to provide that corporate bylaws in stock corporations could not "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."[66] After Delaware adopted the provision, the Delaware Court of Chancery held a fee-shifting bylaw facially invalid as a violation of section 109(b) of the DGCL.[67] Other than this limited exception of fee-shifting provisions, however, procedural bylaws limiting shareholders' right to sue are permissible so long as they are not adopted for an improper purpose.[68]

Other states have taken a similarly permissive approach to private ordering. For example, Maryland has taken a permissive approach to private ordering by utilizing the contract theory. In 2013, a Maryland court upheld a bylaw provision in a real estate investment trust requiring that internal corporate disputes be resolved by arbitration.[69] The Maryland court noted that by purchasing the stock in the corporation, the shareholders consented to the structure in place that allowed unilateral bylaw amendments.[70] The court further reasoned that by consenting to the structure, the shareholders indirectly consented to the specific bylaw provision regarding arbitration.[71] Thus, Delaware is not alone in taking a

64. *See id.*
65. *See id.*
66. DEL. CODE ANN. tit. 8, § 109(b) (2011 & Cum. Supp. 2016).
67. Solak v. Sarowitz, 153 A.3d 729, 743 (Del. Ch. 2016).
68. *See ATP*, 91 A.3d at 560.
69. Corvex Mgmt. LP v. Commonwealth REIT, No. 24-C-13-001111, 2013 Md. Cir. Ct. LEXIS 3, at *47 (May 8, 2013).
70. *Id.* at *29–30.
71. *Id.*

permissive, contractual approach to private ordering. As discussed in the next part, however, this approach risks barring both meritorious and meritless claims alike.

## II. PRIVATE ORDERING IS NOT A SORTING MECHANISM

This part will begin by explaining the importance of sorting in shareholder lawsuits so that meritorious claims are protected. It will then explain why the board's conflict of interest prevents private ordering from being an effective sorting mechanism. It will conclude by explaining why the market does not allow shareholders to effectively repeal bylaw amendments tainted by a conflict of interest, before discussing the costs imposed by unilateral private ordering.

### A. *The Importance of a Sorting Mechanism*

While the costs of frivolous litigation are high and the value of recovery to shareholders is often low, it is important to recognize that shareholder litigation can still be meritorious. Thus, if private ordering is to be a useful tool for corporate boards, it should be a sorting mechanism for frivolous litigation rather than a mechanism to limit shareholder litigation generally. Although rare, shareholder litigation sometimes does provide relief to shareholders other than additional disclosures.

For example, in 2015, the court found that two individual directors breached their fiduciary duties to the shareholders in the context of a merger transaction in *In re Dole Food Co., Inc. Stockholder Litigation*.[72] The shareholders were awarded a large monetary recovery—$148 million in damages—although the individual directors subsequently settled to pay $114 million.[73] Additionally, in another 2015 Delaware case, the Delaware Supreme Court affirmed the Delaware Court of Chancery's $75 million judgment for shareholders against an investment bank for aiding and abetting the breach of fiduciary duty by directors, as a financial advisor.[74]

72. No. 9079-VCL, 2015 Del. Ch. LEXIS 223, at *47 (Aug. 27, 2015); *see also* Christina Carroll & T.J. Hope, Dole Food Co., Inc. Stockholder Litigation: *A Case of an M&A Deal Gone Bananas*, STOUT (Mar. 1, 2016), https://www.stoutadvisory.com/insights/article/dole-food-co-stockholder-litigation-case-ma-deal-gone-bananas.

73. Carroll & Hope, *supra* note 72.

74. RBC Capital Mkts., LLC v. Jervis, 129 A.3d 816, 823, 879 (Del. 2015); *Delaware Supreme Court Affirms* Rural Metro, SIDLEY (Dec. 3, 2015), https://www.sidley.com/en/in

While shareholder litigation may not always provide monetary relief to shareholders, it can serve important oversight functions and act as a deterrent to management misconduct. For example, because corporate boards are acting under the threat of shareholder litigation when structuring or negotiating a merger-related transaction, "the availability of a litigation remedy is likely to affect both the price and procedures of future mergers."[75] Thus, if private ordering is to be a good solution to frivolous shareholder litigation, it should act as a sorting mechanism to limit frivolous suits rather than a mechanism to limit shareholder lawsuits generally. However, as will be shown, the conflict of interest in private ordering prevents private ordering from being an effective sorting mechanism.

### B. *The Conflict of Interest in Private Ordering*

With frivolous litigation as an issue, especially in Delaware, the question is: what is an appropriate solution to the problem and who are the best actors to sort frivolous litigation? Directors are fiduciaries and therefore should encourage the optimal level of litigation, which means not too much litigation, but also not too little. This fiduciary interest, however, conflicts with the directors' personal interests. In private ordering, directors have an inherent conflict of interest when adopting bylaw provisions that limit shareholders' right to sue because they themselves are most often the defendants in shareholder suits.[76] Thus, directors benefit from provisions that "eliminate virtually all prospect of personal liability."[77] Their incentive is not only to sort out frivolous litigation but rather to limit litigation in general to limit their personal liability.

Directors are motivated to limit their liability for three reasons. First, directors can be held personally liable for damages to shareholders.[78] While the company may indemnify directors for a breach of the duty of care, it cannot indemnify a director for a breach of

sights/newsupdates/2015/12/rural-metro.

75. Cain et al., *supra* note 5, at 636.

76. *See* DiCiancia, *supra* note 48, at 1542.

77. Lebovitch & van Kwawegen, *supra* note 1, at 521.

78. *See, e.g.*, Carroll & Hope, *supra* note 72.

the duty of loyalty.[79] Thus, when directors are found to have acted disloyally, they are personally liable for the damages, especially if the company's directors and officers liability insurance policy does not cover them or the specific act. Second, directors want to keep their jobs (i.e., their board seats).[80] However, when shareholders file lawsuits against them, "these claims or . . . evidence [of their misconduct] may threaten their positions within the company—forcing resignation or emboldening rivals in a challenge for power."[81] Finally, directors seek to limit litigation in order to keep their reputations intact.[82] Shareholder litigation often makes claims or evidence of a director's misconduct public information.[83] Thus, directors have an interest in limiting litigation in order to keep their reputations unscathed. Damaging their reputation could have the effect of limiting their job opportunities in the future not only at the corporation whose shareholders are bringing suit, but also at other corporations.[84]

In other areas where directors face a conflict of interest, Delaware law provides special protection to shareholders. For example, Delaware law requires that exculpation provisions be in the certificate of incorporation rather than the bylaws.[85] This is because exculpation provisions excuse directors from breaches of duty of care and limit their liability to the shareholders. Thus, shareholders must approve such provisions as the certificate of incorporation.[86]

Similarly, Delaware also allows plaintiffs to forego the demand requirement[87] if a demand on the board would be futile.[88] There is

79. *See* Kevin M. LaCroix, *Protection for Public Company Directors and Officers: Indemnification and Insurance*, D&O DIARY (Jul. 17, 2013), https://www.dandodiary.com/2013/07/articles/d-o-insurance/protection-for-public-company-directors-and-officers-indemnification-and-insurance/.

80. Kaufman & Wunderlich, *supra* note 22, at 359.

81. *Id.*

82. *See id.* at 360 & n.125.

83. *See id.*

84. *See id.*

85. DEL. CODE ANN. tit. 8, § 102(b)(7) (2011 & Cum. Supp. 2016).

86. *Id*. § 242.

87. This procedural rule requires a shareholder to make a demand on the board for the corporation itself to bring the suit "against those who caused the harm." Thomas P. Kinney, *Stockholder Derivative Suits: Demand and Futility Where the Board Fails to Stop Wrongdoers*, 78 MARQ. L. REV. 172, 175 (1994).

88. *See* Aronson v. Lewis, 473 A.2d 805, 807–08 (Del. 1984).

noticeably a conflict of interest when boards decide whether to pursue a derivative claim on behalf of the corporation because the directors are typically the ones being sued in a derivative suit.[89] Thus, Delaware affords shareholders protections and allows them to waive the demand requirement if they can successfully plead futility due to the board's conflict of interest.[90] As such, Delaware often protects shareholders' rights, and specifically their right to sue when the board would be faced with a conflict of interest.

Due to the conflict of interest boards face when private ordering, there are concerns with directors acting as the mechanism to sort frivolous litigation. Again, this is because their interests lie not in sorting frivolous litigation, but rather in eliminating the prospect of personal liability by eliminating litigation. Generally, Delaware has given shareholders protection when their rights are threatened by a director's conflict of interest. Thus, in the context of private ordering, it would be consistent with Delaware law to give shareholders protections against these bylaw amendments tainted by a conflict of interest so that shareholders' right to sue are not effectively eliminated.

While giving shareholders approval rights could still eliminate litigation rather than sort litigation if the shareholders approved a bylaw like the one at issue in *ATP*,[91] they would be at least given the chance to first approve an action tainted by this conflict of interest. Furthermore, if shareholders are given the right to vote on the provision, it is likely that the provision would sort frivolous litigation rather than eliminate it because the term would have to be one that a requisite majority of shareholders would approve. Directors would likely have to include terms fairer to shareholders such that they do not effectively eliminate their right to bring meritorious claims.[92] Thus, private ordering with shareholder approval

89. *See* DiCiancia, *supra* note 48, at 1542.

90. James M. Wicks, *To Demand or Not Demand, "Futility" Is the Question*, N.Y. COM. DIVISION PRAC. (Nov. 9, 2017), https://www.nycomdiv.com/2017/11/to-demand-or-not-demand-futility-is-the-question/.

91. A provision at issue in *ATP* required the shareholder to pay the corporation's legal fees if they did "not obtain a judgment on the merits that substantially achieves, in substance and amount, the full remedy sought." Peter A. Atkins et al., *Fee-Shifting Bylaws: The Delaware Supreme Court Decision in* ATP Tour, *Its Aftermath and the Potential Delaware Legislative Response*, SKADDEN (May 22, 2014), https://www.skadden.com/insights/publications/2014/05/feeshifting-bylaws-the-delaware-supreme-court-deci.

92. Instead of a bylaw like the one employed in *ATP*, directors may try and make the amendment fairer to shareholders to get their approval. Instead of requiring them to substantively achieve "the full remedy sought," for example, a more proportionate bylaw could

would at least provide a better sorting mechanism to shareholder litigation than unilateral private ordering because shareholder approval would act as a check on the board's conflict of interest.

### C. *The Limits of the Market*

In *Boilermakers*, the Delaware Court of Chancery noted that shareholders were not stuck with bylaw provisions that did not conform to their expectations. The Delaware Court of Chancery reasoned that although "a board may . . . be granted authority to adopt bylaws, stockholders can check that authority by repealing board-adopted bylaws."[93] An important question, however, is whether their right to vote provides an effective mechanism for bylaw repeal. As will be shown, the market has limits which make it difficult for shareholders to utilize their right to vote to repeal bylaws.

There are many hurdles shareholders must go through in order to repeal a bylaw, which makes shareholder repeal both time-consuming and costly.[94] First, the shareholders will have to circulate an amendment proposal.[95] The shareholders will then have to convene a meeting in order to secure a requisite vote on the proposal.[96] They will likely have to wait until the annual stockholder meeting in order to vote and repeal the bylaw. It can end up taking shareholders a while to actually repeal a bylaw that they do not like.[97] Additionally, there is an open question as to whether directors could "promptly undo [the] shareholders' bylaw amendment," which would effectively undermine shareholders' ability to repeal bylaws via their right to vote.[98]

"provide[] a mechanism for a neutral arbiter to award two-way shifting of reasonable fees in response to frivolous litigation tactics." *Id.*; Kaufman & Wunderlich, *supra* note 22, at 357.

93. Boilermakers Local 154 Ret. Fund v. Chevron Corp., 73 A.3d 934, 956 (Del. Ch. 2013).

94. *See* Albert H. Choi & Geeyoung Min, Amending Corporate Charters and Bylaws 22 (Aug. 16, 2017) (unpublished manuscript) (on file with the University of Pennsylvania Law School), https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=2900&context=faculty_scholarship.

95. *Id.* at 25.

96. *Id.*

97. *Id.*

98. *Id.*; *see also* Jill E. Fisch, *Governance by Contract: The Implications for Corporate Bylaws*, 106 CALIF. L. REV. 391 (2018).

Furthermore, there is a practical collective action problem because shareholders, unlike boards, must bear the costs of acting collectively.[99] Because shareholders' interests are dispersed across public companies, they likely do not have the incentive to try and change unfavorable bylaw amendments.[100] Supermajority provisions, requiring a large percentage of shareholders to consent to the amendment, heighten the collective action problem as it would require an even greater number of individuals to show up to meetings and vote on amendments.[101]

Thus, the procedural hurdles and collective action problems shareholders face leave shareholders' right to vote virtually ineffective. Through these means, the market limits allowing shareholders to effectively repeal bylaws with which they do not agree.

### D. *Costs of Broadly Permitting Private Ordering*

Giving directors broad authority to private order would have the effect of deterring meritless and meritorious lawsuits due to the conflict of interest. The harm from elimination of this fundamental right extends to the company's shareholders via the inability to seek redress for management misconduct and worsen decision-making processes via the missing litigation deterrent mechanism. Additionally, the harm from eliminating litigation extends beyond the company being sued because litigation provides a social benefit.

#### 1. The Elimination of Shareholder Litigation Through Procedural Bylaws

Fee-shifting bylaws and arbitration-only provisions provide two examples of procedural bylaws that directors have unilaterally adopted that do not simply deter frivolous litigation, but rather limit litigation generally. The problem with arbitration-only bylaw provisions is that many courts have held class actions are not permissible in arbitration "[w]hen [n]ot [a]uthorized by the [a]rbitration [a]greement."[102] Direct shareholder lawsuits, including challenges to a merger, typically take the form of a class action

99. Fisch, *supra* note 98, at 395.
100. *Id.*
101. *Id.* at 396.
102. Donald J. Spero, *Availability of Class Actions in Arbitration* (pt. 2), 82 FLA. BAR J.

lawsuit.[103] Thus, arbitration-only clauses would have the effect of getting rid of claims that generally take the form of direct shareholder lawsuits. In addition, shareholders likely would not pursue arbitration because individual shareholder action would be cost prohibitive since individual claims are generally insignificant.[104] This is one type of procedural bylaw directors can adopt to limit their personal liability.

A fee-shifting bylaw requires that the individual plaintiff reimburse the defendant corporation for its legal fees if the plaintiff is unsuccessful in the litigation.[105] As mentioned, an individual shareholder's recovery is generally insignificant; on the other hand, the corporation's legal fees can be really expensive.[106]

> In this context, no matter how strong a case, and irrespective of whether a stockholder is willing to bear the cost of paying for its own counsel or chooses to pursue claims through contingency counsel, few, if any, stockholders could initiate or support an action in which the stockholders' personal liability for the company's defense costs is completely out of the stockholders' control and will rise exponentially the longer a case continues.[107]

Thus, a plaintiff likely will not want to bring the suit in the first place because of the potentially great costs with no offsetting large upside as "their individual, pro rata share of the potential benefit or recovery created by the litigation will only be a fraction of the total benefit sought."[108] Delaware lawyers fear that these provisions would completely "wipe out shareholder litigation and the

49 (2008).

103. RAVI SINHA, CORNERSTONE RESEARCH, SHAREHOLDER LITIGATION INVOLVING ACQUISITIONS OF PUBLIC COMPANIES 1 (2016), https://www.cornerstone.com/Publications/Reports/Shareholder-Litigation-Involving-Acquisitions-2016. The Federal Arbitration Act ("FAA") provides that arbitration provisions in contracts are valid and enforceable. 9 U.S.C. § 2 (2012). *Assuming* that bylaws constitute a contract between shareholders and directors, a Maryland state court required the stockholders' claims be arbitrated due to an arbitration-only bylaw. Corvex Mgmt. LP v. Commonwealth REIT, No. 24-C-13-00111, 2013 Md. Cir. Ct. LEXIS 3, at *47 (May 8, 2013). But, as a Florida court stated in *Powertel Inc. v. Bexley*, the FAA only prohibits states from "impos[ing] special limitations on the use of arbitration clauses." 743 So. 2d 570, 574 (Fla. Dist. Ct. App. 1999). The validity of an arbitration clause, however, is a matter of contract law; therefore, the arbitration provision itself can be invalidated using state contract law principles such as unconscionability. *Id.*

104. *See* Griffith, *supra* note 14, at 6.

105. Albert H. Choi, *Fee-Shifting and Shareholder Litigation*, 104 VA. L. REV. 59, 61 (2018).

106. *See* Griffith, *supra* note 14, at 6.

107. Lebovitch & van Kwawegen, *supra* note 1, at 515.

108. *Id.* at 516.

ability to police corporate boards."[109] Thus, like arbitration-only clauses, these procedural bylaws could simply be mechanisms to "wipe out" shareholder litigation and thus limit director liability rather than sort out frivolous lawsuits.

Thus, the initial effect of private ordering is effectively eliminating shareholder litigation. However, the question then becomes: why does this matter?[110] What are the costs of eliminating shareholder litigation? There are both legal costs and social costs to eliminating shareholder litigation.

### 2. Legal Costs of Private Ordering

One of the legal costs of private ordering is the inability of shareholders to receive compensation for management wrongdoing. Even if the majority of suits are frivolous, there are many examples throughout corporate law where shareholders receive substantial economic benefits and "governance-based benefits" when the directors breach their duties to the stockholders.[111] Just because many cases may be frivolous does not mean the law should aim to eliminate all shareholder lawsuits. Instead, shareholders, as owners, should be able to seek redress when directors' conduct does not align with the statutory standards of conduct.

Additionally, directors will not be acting under as great a threat of litigation when making decisions for the corporation, which could result in worse decisions and a bad process.[112] The threat of litigation "can serve as a deterrent to [the directors] who may have to contribute to the compensation and who want to avoid the 'shaming effect' of adverse judicial rulings."[113]

109. Tom Hals, *Delaware Bans 'Loser-Pays' Rules in Corporate Class Actions*, REUTERS (June 25, 2015, 12:51 PM), https://www.reuters.com/article/delaware-corporatelaw/delaware-bans-loser-pays-rules-in-corporate-class-actions-idUSL1N0ZB1JN20150625.

110. Lebovitch & van Kwawegen, *supra* note 1, at 528.

111. *Id.* at 529. For example, "[i]n *Southern Peru*, the Court of Chancery issued a post-trial opinion ruling in October 2011 that the stockholder class was entitled to recover damages of $1.347 billion plus interest, which resulted in a payout of $2 billion, for breach of fiduciary duties in connection with an interested transaction." *Id.* at 530.

112. *See id.* at 528.

113. *Id.*

### 3. Social Costs of Private Ordering

Even if 99% of cases are frivolous, shareholder litigation can still provide a social benefit extending beyond the shareholders of the company in litigation. Through court opinions based on shareholder lawsuits, the litigation "elicits judicial guidance regarding the propriety of corporate practices, thus providing boards and their legal and financial advisors acting in good faith critical information about how to conduct themselves when making critically important decisions affecting the corporation and its stockholders."[114] Even if the plaintiff is ultimately not successful in his or her claim, courts can still issue valuable opinions advising boards of the required standard of conduct.[115] Thus, litigation not only benefits the shareholder being compensated via the litigation or the corporation whose directors are being deterred from misconduct, but it also provides benefits for the future to boards of other corporations by giving them guidance on how to conduct themselves.[116] Eliminating litigation would then eliminate the social benefit that judicial guidance provides to boards and their advisors.

In sum, because of the conflict of interest in private ordering, directors do not seek to deter only frivolous litigation, but rather limit meritorious and meritless claims alike. Furthermore, eliminating all shareholder litigation has both legal costs and social costs. Thus, private ordering is not the right sorting mechanism for frivolous shareholder litigation.

## III. PRIVATE ORDERING IN THE COMMONWEALTH

While Delaware has taken a very permissive approach to private ordering, Virginia has not yet determined the scope of permissible private ordering. This part will begin by explaining why Virginia will likely take an approach to private ordering as permissive as Delaware's approach. However, as this part will contend, Virginia should not take such an approach. In general, private ordering is not a good mechanism to sort frivolous litigation. And, as Part B

114. *Id.*

115. *See, e.g.*, *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 961 (Del. Ch. 1996) (giving guidance regarding the standard for the board's duty of care with respect to monitoring and oversight even though the court ultimately found no breach of the duty).

116. *Id.*

will discuss, Virginia does not currently have a frivolous litigation problem. Furthermore, Virginia already has procedural mechanisms in place to deter shareholder lawsuits. Thus, not only does Virginia not need private ordering to limit litigation, but as with the costs of permitting private ordering in general, the Commonwealth would risk overdeterring meritorious litigation by decreasing incentives a shareholder may have to bring the suit.

### A. *Virginia Will Likely Take an Approach Similar to Delaware*

Like the Delaware courts looking to the DGCL, Virginia would first look to the Virginia Stock Corporation Act ("VSCA") to determine both who can amend bylaws and what is the permissible scope of subjects that bylaws can regulate. The VSCA grants directors the power to unilaterally amend bylaws by default.[117] The permissible scope of subjects bylaws can regulate in Virginia corporations is very broad. Essentially, the bylaws can contain any provision that "is not inconsistent with law or articles of incorporation."[118] Thus, the VSCA puts very few limits on permissible subject matter that bylaws may address, excluding only provisions inconsistent with the law or articles of incorporation. This is perhaps even broader than the scope permissible in Delaware because it does not require that the bylaw relate to the business of the corporation.[119] Thus, Virginia courts would likely find that procedural provisions affecting shareholders' litigation rights are consistent with section 13.1-624 of the VSCA as Delaware courts have held them consistent with section 109(b) of the DGCL.

Even if a provision is permissible subject matter for bylaws, the manner in which it was adopted must be valid for the provision to be enforceable. The Delaware Supreme Court's test for determining the enforceability of a bylaw provision, that is also consistent with section 109(b) of the DGCL, is whether it was adopted for an improper purpose.[120] Virginia is likely to apply a similar test by sticking closely to the language of section 13.1-690 of the VSCA in determining the validity of the bylaw. Section 13.1-690 of the VSCA is a subjective standard only requiring that directors act in

117. VA. CODE ANN. § 13.1-714 (Repl. Vol. 2016).

118. *Id.* § 13.1-624 (Repl. Vol. 2016).

119. Any bylaw would presumably relate to the business of the corporation though, so this would not make much difference in practice.

120. *See* ATP Tour, Inc. v. Deutscher Tennis Bund, 91 A.3d 554, 560 (Del. 2014).

good faith for the best interest of the corporation.[121] Thus, under section 13.1-690 of the VSCA, the court would evaluate whether the provision was adopted by directors acting in the best interest of the corporation.[122] Even when acting in situations that involve known conflicts of interest, such as implementing antitakeover mechanisms, the Virginia courts have stuck to the language of section 13.1-690 of the VSCA to determine the validity of the directors' actions rather than applying a heightened standard.[123] Thus, the court is likely to stick closely to the language of section 13.1-690 of the VSCA in determining the validity of the procedural bylaw in question.

Delaware noted that the intent to deter litigation is not necessarily an improper purpose.[124] Virginia courts have often given directors broad deference in determining what is in the best interests of the corporation when evaluating conduct under section 13.1-690 of the VSCA.[125] Thus, it is likely that Virginia, similarly to Delaware, would also grant deference to boards and allow them to adopt bylaws even with the intent to deter litigation if they subjectively believe that is in the best interests of the corporation. Virginia boards could easily meet this standard by claiming that these provisions were adopted to limit only frivolous lawsuits and thus preserve corporate assets by deterring litigation. Thus, given the deferential standard of section 13.1-690 of the VSCA, Virginia courts will likely take a similar approach to Delaware to private ordering.

### B. *Virginia Should Not Follow the Approach Delaware Has Taken*

In general, private ordering with respect to unilateral bylaw amendments is not the best mechanism to sort frivolous litigation because of the conflict of interest directors face.[126] Virginia does not

121. Laurence V. Parker Jr., *Virginia Is for Lovers and Directors*: *Important Differences Between Fiduciary Duties in Virginia and Delaware*, 2 WM. & MARY BUS. L. REV. 51, 64 (2011).

122. VA. CODE ANN. § 13.1-690 (Repl. Vol. 2016).

123. Parker, *supra* note 121, at 66.

124. *ATP*, 91 A.3d at 560.

125. For example, Virginia has allowed a board to accept a lower offer price in the sale of a corporation if the board subjectively believes the lower offer is in the best interest of the corporation. Willard v. Moneta Bldg. Supply, Inc., 258 Va. 140, 146–50, 515 S.E.2d 277, 282–84 (1999).

126. *See supra* Part II.B.

have a frivolous litigation problem, especially not to the extent experienced in Delaware. Because private ordering is not generally a good solution to frivolous litigation and Virginia does not have a frivolous litigation problem, Virginia should take a less permissive approach to private ordering to avoid deterring beneficial shareholder litigation.

### 1. Virginia Does Not Have a Frivolous Litigation Problem

There are three reasons that explain why: (1) Virginia does not experience the prevalence of frivolous lawsuits to the extent in Delaware, and (2) Virginia specifically should not allow private ordering substantially affecting shareholders' right to sue. First, Virginia is the legal home to a much smaller number of corporations than Delaware. Second, Virginia has not been a popular destination when shareholders have decided which forum to bring their lawsuit. Third, Virginia already has more procedural hurdles before a shareholder can bring a lawsuit against the company or the company's board of directors. Because Virginia makes it hard for shareholders to bring suits, making a more elaborate screening mechanism through private ordering would risk overdeterring beneficial litigation. Therefore, Virginia should take a less permissive approach to private ordering than Delaware.

#### a. Virginia Is the Legal Home to Few Corporations

Compared to Delaware, there are few corporations incorporated in Virginia.[127] This is likely one of the reasons that Virginia sees fewer shareholder lawsuits than Delaware.[128] Furthermore, because Virginia is the legal home to fewer corporations, Virginia law will apply to fewer corporations than Delaware law. The state of incorporation typically provides the law that governs a dispute in

127. In 2016, Delaware was the state of incorporation for more than 1.2 million corporate entities. DEL. DIV. OF CORPS., 2016 ANNUAL REPORT (2016), https://corp.delaware.gov/2016AnnualReport.pdf. More than half of the public companies traded in the U.S. are incorporated in Delaware. Suzanne Raga, *Why Are the Majority of U.S. Companies Incorporated in Delaware?*, MENTAL FLOSS (Mar. 11, 2016), http://www.mentalfloss.com/article/76951/why-are-so-many-us-companies-incorporated-delaware. These numbers stand in stark contrast to the number of entities incorporated in the Commonwealth. In 2016, only 168,056 business entities were incorporated in Virginia. VA. STATE CORP. COMM'N, ANNUAL REPORT OF THE STATE CORPORATION COMMISSION 581 (2016), https://www.scc.virginia.gov/comm/anrept/2016_AR.pdf/. This amounts to only slightly more than 10% of the number of business entities incorporated in Delaware. *Compare id. with* DEL. DIV. OF CORP., *supra*.

128. *See infra* Part III.B.1.b.

the event of an internal legal dispute. For example, "the law of the state of incorporation will determine the validity of a corporate forum-term as a matter of corporate law."[129] Virginia law could therefore not be used to limit frivolous litigation from shareholders of companies incorporated in Delaware and other states, even if they are headquartered in the Commonwealth. Thus, Virginia should not worry about sorting frivolous litigation in cases where the company is incorporated outside of the Commonwealth because even if cases were filed by companies with their principal place of business in Virginia, for example, their laws regarding private ordering could not be used to sort out frivolous lawsuits as the law of the state of incorporation would govern.

Virginia may also want to take a less permissive approach to private ordering to attract more corporations. Some may argue that because Virginia has a much smaller number of businesses incorporated in the Commonwealth compared to the number in Delaware, it should follow the path Delaware has taken with respect to private ordering to attract more businesses. In some respects, limiting frivolous shareholder lawsuits would add to the reasons a business would want to incorporate in Delaware.[130] For example, Delaware took steps to decrease frivolous filing by ending the possibility of disclosure-only settlements that did not provide a meaningful benefit for shareholders.[131] However, this decision sought to limit only frivolous filings rather than shareholder lawsuits generally.[132]

A state that allows directors to effectively wipe out all shareholder litigation, including meritorious lawsuits, might give investors pause before investing in a corporation incorporated in that state. If Virginia acts too permissively with respect to private ordering, the balance may tip too far against shareholders, and investors may refuse to invest in a business incorporated in a state that does not adequately protect their rights as owners.

Thus, if Virginia does want to attract more businesses, it is likely that a less permissive approach to private ordering could actually

129. Marcel Kahan & Helen Hershkoff, *Forum-Selection Provisions in Corporate "Contracts"* 13 (N.Y.U. L. & Econ., Working Paper No. 17-28, 2017), https://www.lsr.nellco.org/cgi/viewcontent.cgi?article=1464&context=nyu_lewp.

130. *See* JD SUPRA, *supra* note 33.

131. *Id.*

132. *Id.*

help the Commonwealth. Once the *ATP* decision came out, institutional investors began to complain about the implications of the decision. A group of investors claimed that fee-shifting bylaws deterred "the filing of even the most meritorious of stockholder claims and effectively clos[ed] the courthouse doors to investors, eliminating their ability to bring suit to prevent and remedy unlawful conduct among corporate fiduciaries."[133] Thus, if Virginia follows in Delaware's footsteps with regards to private ordering, it could actually end up decreasing the incentives a company may have to incorporate in Virginia due to the lack of investors willing to invest in a business incorporated in a state that effectively eliminates their ability to remedy unlawful director conduct. Thus, even in this respect, Virginia should take a less permissive approach to private ordering in order to attract more businesses.

b. Virginia State Courts See Relatively Few Shareholder Lawsuits

Virginia also should not broadly permit private ordering related to shareholder litigation because frivolous suits are not a significant problem in Virginia. In 2015, Delaware was the most active state court for challenges to a merger.[134] Ninety-one deals were litigated in the state.[135] Virginia, however, was not active in 2015, and did not even see six deals in its courts.[136] The number filed in Delaware in 2016 declined substantially to ten cases.[137] However, Virginia did not even see three.[138] Thus, even though more cases are moving out of Delaware, Virginia still does not see a number close to that being filed in Delaware. This is likely due in part to the fact that Virginia is the legal home to fewer corporations than Delaware, so Delaware has jurisdiction over more shareholder lawsuits, especially with the adoption of exclusive forum selection provisions in Delaware.

133. Winship, *supra* note 3, at 488 n.13 (quoting Letter from Guus Warringa, Chief Counsel, APG Asset Mgmt. NV et al., to Martha Carter, Glob. Head of Research, Inst'l S'holders Servs., Inc. (Nov. 24, 2014), http://www.cii.org/files/issues_and_advocacy/legal_issues/Letter%20to%20ISS%20(Final).pdf [https://perma.cc/XB8Y-5LRA]).

134. SINHA, *supra* note 103, at 3.

135. *Id.*

136. *Id.*

137. *Id.*

138. *Id.*

Virginia could potentially see fewer cases because, as will be discussed, cases are harder for shareholders to bring in the Commonwealth. There are more procedural hurdles in derivative suits, and the requirement that shareholder lawsuits be brought derivatively prevents a "multiplicity of lawsuits."[139] Because Virginia does not see as many cases as Delaware, shareholder lawsuits are not overburdening the Commonwealth's courts to the same extent as Delaware.

Furthermore, because Virginia has not been a popular forum for litigation, there are relatively few cases in Virginia interpreting a director's standard of conduct. As discussed, one of the general costs associated with private ordering is losing the social benefit of shareholder lawsuits. Even when a shareholder is not successful in a lawsuit, courts can still write long opinions explaining standards for director conduct which can be helpful in advising boards on how to act to avoid liability.[140] Because Virginia has relatively few corporate law opinions, corporations in the Commonwealth could benefit from more opinions describing a director's standard of conduct. As just one example, Virginia courts have never decided a case including a *Caremark* claim or a *Disney* claim.[141] Thus, further limiting shareholder lawsuits in the Commonwealth would eliminate the possibility of the social benefit a shareholder lawsuit could have for corporate boards in explaining what their standard of conduct should be in these circumstances. Furthermore, eliminating shareholder litigation would eliminate shareholders' rights to oversee that directors conform to the standard of conduct proscribed.

#### c. Virginia Has More Procedural Hurdles Than Delaware

The Commonwealth makes it harder for shareholders to bring cases in comparison to Delaware. Essentially, Virginia's procedural hurdles for shareholder litigation already acts as a screening mechanism to limit frivolous litigation. The procedural hurdles in Virginia is likely one of the reasons that Virginia just does not have a frivolous litigation issue. Furthermore, because Virginia already

139. Simmons v. Miller, 261 Va. 561, 576, 544 S.E.2d 666, 675 (2001).

140. *See, e.g.*, *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996) (establishing both an aspirational standard and a liability standard for directors conduct in regard to its duty to oversee the corporation).

141. *Cf. id.* at 971 (discussing directors liability for oversight); Brehm v. Eisner (*In re* Walt Disney Co. Derivative Litig.), 906 A.2d 27, 66–67 (Del. 2006) (discussing directors liability for consciously disregarding a known risk).

has a screening mechanism for shareholder lawsuits, it should use a less permissive approach to private ordering than Delaware because it would simply make it even harder for shareholders to bring lawsuits. Virginia would then risk overdeterring litigation, resulting in the elimination of beneficial shareholder lawsuits.

Virginia courts have consistently categorized shareholder lawsuits as derivative suits rather than direct suits.[142] Even as recently as 2014, the Fourth Circuit, interpreting Virginia law, held that claims for a breach of fiduciary duty belongs to the corporation rather than individual shareholders; thus, the claims must be brought in a derivative action rather than in a direct lawsuit.[143] The Fourth Circuit relied on a Supreme Court of Virginia opinion which held that shareholders cannot bring a direct suit against the board but rather must bring a derivative action.[144] This limits litigation in the Commonwealth in two ways. First, it cuts down on frivolous litigation involving duplicative lawsuits regarding the same transaction or breach of fiduciary duty. Preventing a "multiplicity of lawsuits by shareholders" was one of the reasons the Supreme Court of Virginia in *Simmons v. Miller* declined to depart from the general rule that claims for breach of fiduciary duty be brought derivatively.[145]

Second, because shareholder lawsuits must be brought derivatively, it is harder for shareholders to bring lawsuits in the Commonwealth because of the procedural hurdles involved in a derivative suit.[146] Allen Goolsby and Steven Haas claim that "[t]his is beneficial for corporations [and ultimately directors] because the Virginia Stock Corporation Act imposes various conditions on bringing derivative suits, in part to deter frivolous claims."[147] In fact, the conditions imposed by the VSCA potentially make a derivative suit even harder to bring against a Virginia corporation

142. *See, e.g.*, DCG & T *ex rel.* Battaglia/Ira v. Knight, 68 F. Supp. 3d 579, 585 (E.D. Va. 2014).

143. *Id*.

144. *Id.*; *see also* Remora Investments, L.L.C. v. Orr, 277 Va. 316, 323 673 S.E.2d 845, 848 (2009).

145. 261 Va. 561, 576, 544 S.E.2d 666, 675 (2001).

146. Allen C. Goolsby & Steven M. Haas, *Virginia Court Refuses to Dismiss Derivative Lawsuit Challenging Merger Involving Conflicts of Interest*, HUNTON ANDREWS KURTH, (Feb. 3. 2015), https://www.lexology.com/library/detail.aspx?g=0865d0df-0e98-40e2-8a20-97cbf9736dd7.

147. *Id*.

than those conditions imposed by the DGCL in bringing a derivative suit against a Delaware corporation.

In Virginia, a shareholder must make a demand on the board before it can bring a lawsuit, regardless of whether that demand would be futile.[148] In Delaware, however, there is a futility exception.[149] The problem under the Virginia rule is that boards rarely decide to accept the demand,[150] and the shareholders do not have the futility exception. This makes shareholder derivative litigation harder to bring because "[o]nce a demand of a derivative suit has been made and rejected by the board, courts will generally follow the deferential business judgment rule and almost never allow shareholders to proceed further."[151] Thus, Virginia should take a less permissive approach to private ordering than Delaware does, as taking Delaware's approach would make it even harder for shareholders to bring suits. This would risk overdeterring beneficial shareholder litigation.

Private ordering by directors through a corporation's bylaws in general is not a good sorting mechanism for frivolous litigation. Virginia does not suffer from a frivolous litigation issue to the extent that Delaware does. This is due to the smaller number of companies governed by Virginia law, the smaller number of cases filed in Virginia courts, and the additional procedural hurdles Virginia places on shareholders trying to bring a lawsuit. Because Virginia does not currently have a big frivolous litigation issue, it should generally not allow boards to private order. Private ordering is a questionable sorting mechanism, and if Virginia takes an overly permissive approach to private ordering, it risks overdeterring meritorious litigation. Thus, Virginia should not take an approach to private ordering as permissive as Delaware's approach.

However, Virginia should continue to permit forum selection provisions. A forum selection clause is different from some of the other procedural bylaws boards adopt because it is not a mechanism to limit their personal liability. Rather, these provisions were

148. VA. CODE ANN. § 13.1-672.1(B) (Repl. Vol. 2016).

149. *See* Aronson v. Lewis, 473 A.2d 805, 807–08 (Del. 1984).

150. *See* Kinney, *supra* note 87, at 176.

151. Yongqiang Chu & Yijia Zhao, The Dark Side of Shareholder Litigation: Evidence from Corporate Takeovers 13 (Aug. 3, 2018) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2593134.

adopted by boards as a response to the expense of multiforum litigation rather than shareholder litigation in general.[152] Thus, the inference of a conflict of interest generally involved in private ordering by directors is not as strong in the case of forum selection bylaws. Furthermore, it does not limit the rights of shareholders to the extent that other procedural bylaws have the potential to do, and it is likely that all shareholders would approve a forum selection bylaw in the first place.[153] However, many of the other procedural bylaws that have either been addressed by courts or are currently being experimented on by corporate boards are geared toward limiting litigation rather than sorting out frivolous litigation.[154]

### 2. The Legal Authority to Take a More Narrow Approach

Virginia has already addressed private ordering narrowly in the context of forum selection clauses, and the Commonwealth has said that boards may include these provisions in their bylaws.[155] Beyond forum selection clauses, however, Virginia has not weighed in on the limits of private ordering. While Virginia will likely grant deference to boards and broadly permit private ordering, it could legally take a narrower approach. There are different paths Virginia could utilize to take a less permissive approach to private ordering by directors: it could act through the General Assembly or through the state courts.

The cleanest way for Virginia to take a less permissive approach to private ordering is through the General Assembly. It could write a statute like Delaware's, which prohibits fee-shifting bylaws,[156] except Virginia could write this more broadly to prohibit unilaterally amended bylaws that would substantially affect shareholders' rights to sue the board or the corporation. The Virginia courts could apply this statute then to any provision that substantially affects shareholder's litigation rights, without requiring the shareholder

152. *See* John C. Jorgenson, Note, *Drafting Effective Delaware Forum-Selection Clauses in the Shadow of Enforcement Uncertainty*, 102 IOWA L. REV. 353, 356 (2016).

153. *See* Cox, *supra* note 4, at 291.

154. *See supra* notes 100–07 and accompanying text.

155. VA. CODE ANN. § 13.1-624 (Repl. Vol. 2016).

156. *See* DEL. CODE ANN. tit. 8, § 109(b) (2011 & Cum. Supp. 2016).

to show that the board acted in bad faith, for example, when adopting the bylaw.[157]

Virginia could still take a less permissive approach to private ordering through its courts if the legislature does not act. The relationship between shareholders and the directors of the corporation is not purely a contractual one. While section 13.1-690 of the VSCA may suggest that private ordering would be permissible in Virginia, there are some areas that the directors of a corporation just cannot reach through the corporation's bylaws due to mandatory state corporation laws. Thus, one way the Virginia courts could invalidate procedural bylaws that affect shareholder litigation rights is by analyzing the procedural effect on mandatory corporate laws. Essentially, "parties should not be allowed to circumvent mandatory substantive law by shaping procedure, particularly where one party dictates the contractual terms. If a party cannot contract around a substantive obligation, then the party should not be able to eliminate it by disabling enforcement."[158]

Virginia corporate law imposes fiduciary duties on the directors of corporations—a director is required to act "in accordance with his good faith business judgment of the best interests of the corporation."[159] Virginia allows directors to be exculpated for breach of fiduciary duty, but only if shareholders approve this in a shareholder adopted bylaw or in the certificate of incorporation.[160] Thus, this cannot be waived unilaterally by boards. Furthermore, Virginia does not allow exculpation if the director engaged in willful misconduct.[161]

As discussed, many of the procedural bylaws boards have unilaterally adopted act to effectively eliminate shareholder litigation.[162] If there is no litigation right, there would be no way for shareholders to enforce a substantive, mandatory obligation—the obligation for directors to avoid willful misconduct. Furthermore, if shareholders did not approve any form of exculpation in either its bylaws or certificate, this would also be a substantive obligation

157. VA. CODE ANN § 13.1-690 (Repl. Vol. 2016).
158. Winship, *supra* note 3, at 522.
159. VA. CODE ANN. § 13.1-690 (Repl. Vol. 2016).
160. *Id*. § 13.1-692.1 (Repl. Vol. 2016).
161. *Id.*
162. *See supra* notes 100–07 and accompanying text.

on the board that could not be eliminated substantively unilaterally. Thus, by eliminating an enforcement mechanism, Virginia courts could find that boards are contracting around the substantive mandatory law through procedural bylaws that affects litigation rights.

These bylaw provisions could then simply be viewed as inconsistent with corporate law by procedurally eliminating mandatory rules, and section 13.1-624 of the VSCA provides that the bylaws may not contain provisions inconsistent with the law.[163] By analyzing the effects of procedural bylaws on substantive corporate law, Virginia could take a less permissive approach to private ordering by invalidating provisions that eliminate shareholders' rights to enforce substantive obligations.

## CONCLUSION

Because of the increase of frivolous shareholder litigation in recent years, different actors in corporate law have tried to find a solution to sort the meritorious shareholder lawsuits from the frivolous. Through private ordering, boards of corporations have sought to act as the sorting mechanism by limiting litigation through procedural bylaws. The issue, however, is that boards have an inherent conflict of interest when writing their own rules of procedure—essentially writing the rules by which they can be sued. The boards do not seek to simply sort out the frivolous litigation, but rather seek to limit shareholders' ability to sue them personally. Private ordering then is not the best mechanism to sort frivolous litigation. Rather, it limits shareholder litigation without regard to whether the lawsuits are beneficial or frivolous.

Because private ordering with respect to procedural bylaws is not a good sorting mechanism in general for frivolous litigation, it is certainly not a useful device in a state without a big frivolous litigation issue in the first place. Therefore, because Virginia is a state that does not suffer from frivolous litigation nearly to the extent experienced in Delaware, the Virginia courts and legislature should not be as concerned with limiting frivolous litigation. Furthermore, Virginia already has other procedural mechanisms in

163. VA. CODE ANN § 13.1-624 (Repl. Vol. 2016).

place, such as a universal demand requirement and categorizing all shareholder suits as derivative, that already act as a screening mechanism for shareholder litigation. The costs of private ordering then in the Commonwealth would be too high, as there would be a large threat of overdeterrence, which encompasses the risk of deterring beneficial shareholder litigation. Thus, Virginia should not follow Delaware's permissive approach to private ordering.

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