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A Fresh Look at Exclusive Forum Provisions

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One common feature of large M&A transactions is the almost inevitable stockholder litigation challenging the transaction. Initially, this litigation focused on allegations under state law - that the directors failed to satisfy their *Revlon* obligations and their duty of candor. Such litigation often was brought in multiple forums, forcing the target to devote significant resources attempting to avoid or litigate a multi-front conflict with the associated risks and expense. One way that companies exercised self-help against this onslaught was to adopt provisions in their governing documents that require such litigation to be brought in a specific forum. This strategy was foreshadowed in a 2010 Delaware Court of Chancery opinion in which Vice Chancellor Laster noted "if boards of directors and stockholders believe that a particular forum would provide an efficient and value-promoting locus for dispute resolution, then corporations are free to respond with charter provisions selecting an exclusive forum for intra-entity disputes."[1] Many companies have taken this advice, and Delaware companies in particular have typically designated the Delaware Court of Chancery as the exclusive forum for such disputes.

A typical exclusive forum provision might read as follows:

> Unless the Company consents in writing to the selection of an alternative forum, the sole and exclusive forum for (i) any derivative action or proceeding brought on behalf of the Company, (ii) any action asserting a claim of breach of fiduciary duty owed by any director or officer or other employee of the Company to the Company or the Company's stockholders, (iii) any action asserting a claim against the Company or any director or officer or other employee of the Company arising pursuant to any provision of the Delaware General Corporation Law or the Certificate of Incorporation or these By-Laws (in each case, as they may be amended from time to time), or (iv) any action asserting a claim against the Company or any director or officer or other employee of the Company governed by the internal affairs doctrine shall be the Delaware Court of Chancery (or if the Delaware Court of Chancery does not have subject matter jurisdiction, a state court located within the State of Delaware or, if no state court located within the State of Delaware has subject matter jurisdiction, the federal district court for the District of Delaware).

It did not take long for the plaintiff's bar to challenge these provisions. In one early decision, a California federal court struck down a bylaw provision adopted unilaterally by the board, noting that a board-adopted bylaw did not have the same contractual force and that Vice Chancellor Laster's opinion referred expressly to charter provisions.[2] The Delaware Court of Chancery took up the issue in 2013 and upheld the validity of a board-adopted exclusive forum bylaw provision in *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*[3] In that case, then Chancellor Strine held that a board-adopted bylaw was both facially valid under § 109(b) of the Delaware General Corporation Law[4] and valid as a matter of contract law. The Delaware Supreme Court never heard the case, as the plaintiff dismissed its appeal and voluntarily dismissed its remaining claims. In 2015, the Delaware legislature cemented the validity of these bylaws by amending the Delaware General Corporation Law to provide that a corporation's certificate of incorporation or bylaws may require that "any or all internal corporate claims shall be brought solely and exclusively in any or all of the courts in this

[1] *In re Revlon, Inc. S'holders Litig.*, 990 A.2d 940, 960-61, n.8 (Del. Ch. 2010).
[2] *See, e.g., Galaviz v. Berg*, 763 F. Supp. 2d 1170 (N.D. Cal. 2011) (declining to enforce a board-adopted exclusive forum bylaw).
[3] 73 A.2d 934, 941 (Del. Ch. 2013).
[4] 8 Del. C. § 109(b) (2010).

State . . . ."[5] The statute defines "internal corporate claim" as claims "that are based upon a violation of a duty by a current or former director or officer or stockholder in such capacity."

In recent years courts outside of Delaware have generally enforced exclusive forum provisions in the face of challenges by stockholder plaintiffs.[6] Such provisions – whether in the charter or a bylaw - have now become a standard part of the governance package that public companies consider, whether at the time of going public or thereafter.

Federal Forum Provisions addressing Securities Act Claims

Several years ago, another species of exclusive forum provision sprung up. This type sought to address jurisdiction over claims brought under the Securities Act of 1933. Section 22 of the Securities Act grants concurrent jurisdiction over claims by private plaintiffs to the federal and state courts and prevents defendants from removing to federal court cases brought in state court. The Securities Litigation Uniform Standards Act (SLUSA) had amended this provision in the Securities Act as it related to certain "covered" class actions, but the scope of the amendment was a matter of dispute. Plaintiffs' lawyers found certain state courts a more favorable and welcoming venue for Securities Act claims than the federal courts in the district. Defendants had mixed success in getting federal courts to adopt their view that SLUSA took away concurrent state court jurisdiction.[7] Taking a page from the playbook for state exclusive forum provisions, some companies began to include in their charter or bylaws a provision addressing this issue. A typical exclusive federal forum provision might read as follows:

> Unless the Company consents in writing to the selection of an alternative forum, the federal district courts of the United States of America shall be the exclusive forum for the resolution of any complaint asserting a cause of action arising under the Securities Act of 1933. Any person or entity purchasing or otherwise acquiring any interest in any security of the Corporation shall be deemed to have notice of and consented to this provision.

In March 2018, in *Cyan, Inc. v. Beaver County Employees Retirement Fund*,[8] the United States Supreme Court resolved the uncertainty about SLUSA's effect and concluded that state courts continue to have concurrent jurisdiction over Securities Act claims. That decision foreclosed any possibility of keeping Securities Act class actions out of state court as a statutory matter. However, for those companies that had adopted exclusive federal forum provisions, there remained some hope that they would be effective to cut off actions brought in state court.

At the time *Cyan* was decided, there was pending a declaratory judgment case in Delaware challenging the validity of the federal exclusive forum provisions of three companies that had gone public in 2017. The hope that these provisions might provide a private ordering solution received a substantial setback when in late 2018 the Delaware Court of Chancery ruled in *Sciabacucchi v. Salzberg*[9] that federal exclusive forum provisions were ineffective and invalid because they purported to govern external claims when under the Delaware General Corporation Law they could only govern internal claims. An appeal of this decision has been dismissed until the trial court's ruling on the plaintiff's application for attorneys' fees. Once that issue is resolved, the defendant companies will be able to appeal Court of Chancery's decision. At present, their validity is very much in doubt.

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[5] 8 Del. C. § 115, adopted in 80. Del. Laws, c. 40, §5 (2015).
[6] *See, e.g., Genoud v. Edgen Grp., Inc.*, Case No. 625,244, 19th Judicial Dist. Court, Louisiana, Jan. 16, 2014); *Roberts v. TriQuint Semiconductor, Inc.*, 358 Ore. 413, 439-40 (Ore. 2015); *Hemg Inc. v. Aspen Univ.*, 2013 N.Y. Misc. LEXIS 5199, at *7 (N.Y. Sup. Ct., N.Y. Cnty., Nov. 4, 2013).
[7] *Compare, e.g., Luther v. Countrywide Financial Corp.*, 195 Cal.App.4th 789, 797-798, 125 Cal.Rptr.3d 716, 721 (2011) (holding that state courts have jurisdiction over covered class actions alleging only 1933 Act claims), with, *e.g., Knox v. Agria Corp.*, 613 F.Supp.2d 419, 425 (S.D.N.Y.2009) (holding that state courts lack jurisdiction over such actions)(cited in *Cyan, infra note* 8, at note 1).
[8] 138 S. Ct. 1061 (2018).
[9] 2018 Del. Ch. LEXIS, at *49 (Del. Ch. Dec. 19, 2018).

SEC Staff Review and Comment on Bylaw Provisions

Many companies preparing for their initial public offerings elect to include state exclusive forum provisions in their governing documents. At least until late 2018, some also included federal exclusive forum provisions. The SEC staff almost universally conducts full disclosure reviews of initial public offerings, and these exclusive forum provisions have been a frequent source of staff comment. In its review, the staff generally wants to make sure that the provisions are accurately described and that the implications and related risks are appropriately disclosed. To the extent that the bylaw provisions raise enforceability concerns under state or federal law, the staff expects a discussion of those concerns.

Before the Delaware Court of Chancery upheld the validity of state exclusive forum bylaws in *Chevron*, and the Delaware Legislature confirmed their validity in the 2015 amendments to the DGCl, the following was a fairly typical SEC staff comment:

> We note your disclosure in this section regarding an exclusive forum provision in your amended and restated certificate of incorporation. It appears that there are pending lawsuits challenging the validity of choice of forum provisions in charter documents. Please disclose that although you have included a choice of forum clause in your amended and restated certification of incorporation, it is possible that a court could rule that such a provision is unenforceable.

There were variations on this theme. Sometimes the company was requested to disclose the risk to investors of such having such a provision in its governing documents. Sometimes companies were asked to explain the risks to investors if the provision were found to be unenforceable. On still other occasions, companies were asked to state whether the provision applied to claims brought under the federal securities laws.

Once the validity question was fairly settled (at least in Delaware), the focus on enforceability diminished and the staff comments were frequently framed in terms of risks to investors of having such a provision in the governing documents. A typical comment was as follows:

> We note your disclosure regarding provisions of your amended and restated certificate of incorporation and amended and restated bylaws . . . stating that the Delaware Court of Chancery shall be the sole and exclusive forum for any stockholder bringing specified actions. Please add a risk factor describing the specific types of actions subject to the exclusive forum provision and the attendant risks to investors. For example, please highlight that such a provision may limit a stockholder's ability to bring a claim in a judicial forum that it finds favorable for disputes with directors, officers or other employees, and may discourage lawsuits with respect to such claims.

Occasionally the staff would ask companies to disclose whether the provision applied to claims under the federal securities laws. In addition, in jurisdictions other than Delaware where the validity of such a provision may not have been established, the staff might ask the registrant to discuss the validity. The focus of the comments, however, generally remained on the effect the provision may have on stockholder rights.

Each of the three defendant companies in the *Sciabacucchi* lawsuit challenging the validity of federal exclusive forum provisions included risk factor disclosure about its exclusive forum (both state and federal) provisions. None of them received staff comment on the disclosure.

Exclusive Forum Provisions after *Cyan* and *Sciabacucchi*

The *Cyan* and *Sciabacucchi* cases changed the landscape for federal exclusive forum provisions. Assuming that the Delaware Supreme Court upholds the *Sciabacucchi* decision, charter or bylaw provisions requiring an exclusive federal forum for Securities Act claims will not be valid, at least in Delaware, and it appears unlikely at this time that other states

would take a different view. Accordingly, most new registrants in 2019 are not including a federal exclusive forum provision in their governing documents.[10]

The same is not true for the state exclusive forum provisions, the validity of which seems to be settled at least under the Delaware General Corporation Law. Most if not all new registrants that are incorporated in Delaware, and many registrants incorporated in other states, include a forum selection provision in their governing documents before going public. These provisions remain an area of frequent staff comment although following the *Cyan* and *Sciabacucchi* cases the focus has evolved. The primary focus now appears to be whether the bylaw purports to cover claims brought under the federal securities laws. A typical comment might read as follows:

> We note that the forum selection provision in your bylaws identifies the Court of Chancery of the State of Delaware as the exclusive forum for certain litigation, including any "derivative action." Please disclose whether this provision applies to actions arising under the Securities Act or Exchange Act. In that regard, we note that Section 27 of the Exchange Act creates exclusive federal jurisdiction over all suits brought to enforce any duty or liability created by the Exchange Act or the rules and regulations thereunder, and Section 22 of the Securities Act creates concurrent jurisdiction for federal and state courts over all suits brought to enforce any duty or liability created by the Securities Act or the rules and regulations thereunder. If the provision applies to Securities Act claims, please revise your prospectus to disclose this information and to state that there is uncertainty as to whether a court would enforce such provision, and to state that stockholders will not be deemed to have waived the company's compliance with the federal securities laws and the rules and regulations thereunder. If this provision does not apply to actions arising under the Securities Act or Exchange Act, please also ensure that the exclusive forum provision in the governing documents states this clearly.

Some lawyers whose clients receive this comment may be surprised that the scope of the state exclusive forum provision would have extended to claims brought under federal law. After all, these provisions were developed in large part to address vexatious litigation brought as state breach of fiduciary duty claims challenging change-of-control transactions. These provisions typically address specifically claims brought under the DGCL or the corporation's governing documents and claims governed by the internal affairs doctrine. However, they expressly cover "derivative claims," and that seems to be the term upon which the SEC staff is focusing to raise the question of the applicability of the federal securities laws.

Application of Forum Selection Provisions to Federal Derivative Claims

Most corporate lawyers instinctively think of a derivative claim as necessarily relating to a state law breach of fiduciary duty that is being pursued against the directors or officers in the right of the corporation by one or more of its stockholders. However, federal courts recognize derivative claims brought against corporate directors and officers alleging violations of federal law. One easy example is a suit brought against a Section 16 insider to recover short-swing profits under Section 16(b) of the Exchange Act.[11] Less obvious are claims alleging that a breach of fiduciary duty by the directors caused the corporation to violate Section 14(a) of the Exchange Act and Rule 14a-9 promulgated thereunder when the corporation is alleged to have issued a misleading proxy statement.[12] Still another species of derivative action

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[10] One prominent registrant has included such a provision in its certificate of incorporation "subject to and contingent upon a final adjudication in the State of Delaware of the enforceability of such exclusive forum provision." *See* Uber Technologies (333-230812)(https://www.sec.gov/Archives/edgar/data/1543151/000119312519103850/d647752dex32.htm).

[11] Although engaging in a transaction that results in short-swing profit is not technically a violation of federal law, Section 16(b) provides a cause of action for recovery on behalf of the corporation. A Section 16(b) claim is, however, not, at least as a federal statutory matter, subject to the business judgment rule or a derivative action demand requirement, making Section 16(b) claims a peculiar statutory claim that lies somewhere between a direct claim and a classic derivative claim.

[12] *See, e.g., In re The Home Depot, Inc. S'holder Deriv. Litig.*, No. 1:2015cv02999 (N.D. Ga. 2016) (Dkt. No. 62); *In re PayPal Holdings, Inc. S'holder Deriv. Litig.*, 5:17-cv-00162 (N.D. Cal. 2017). These so-called "stockholder derivative litigations" read, at

is brought under Rule 10b-5 under the Exchange Act, where a controlling stockholder may be alleged to have violated the rule by causing the corporation to repurchase stock at a time at which the price was inflated because of a failure to disclose material adverse information.[13]

Derivative claims under the Securities Act appear to be a rarer breed, if they exist at all. Numerous efforts on the authors' parts to find a case that purported to be brought derivatively under the Securities Act have yielded no results. It might be theoretically possible for a stockholder to sue to force the corporation to bring claims it has under the Securities Act as a purchaser of shares in a registered offering. There do not appear to be any cases in which that claim has been made, and it is difficult to conceive of a plausible fact pattern where such a claim might arise.

The term "derivative claims" undoubtedly is broad enough to cover such claims brought under the federal securities laws. The SEC staff's comments have brought that into focus. In several responses to the staff comments, registrants have sought to preserve the applicability of the provisions to claims brought under the federal securities laws to the maximum extent permissible under the federal securities laws. Even assuming such a provision were enforceable post-*Sciabacucchi*, the question registrants should be asking is whether that is what they intended their exclusive forum provisions to cover. With the *Cyan* decision affirming the continued viability of concurrent state and federal jurisdiction, a provision purporting to require a Securities Act derivative suit (to the extent such a species exists) be brought in state court is clearly problematic. For Exchange Act derivative claims, federal courts have exclusive jurisdiction. Because these provisions will typically default ultimately to federal district court if the state courts do not have subject matter jurisdiction, one could at least make an argument that they could apply to Exchange Act derivative claims. Because the decision on whether to preserve the application of exclusive forum provisions to federal claims usually takes place as the registrant is attempting to clear comments so it can begin the road show for its initial public offering, it is fair to ask whether they are always the result of careful thinking about the consequences.

Delaware corporations will likely always want state law derivative claims challenging directors in the sale of the company to be brought in the Delaware Court of Chancery. That is what they were invented for. Beyond that type of claim, however, deciding the best place to litigate a particular claim is not necessarily straightforward. Although as discussed above it is difficult to envisage a Securities Act derivative claim, if such a claim were brought the corporation might not want that claim to be litigated in the Delaware Court of Chancery (if it even had jurisdiction) or another Delaware state court. In the more likely situation in which an action is brought derivatively under Rule 10b-5 or Rule 14a-9 under the Exchange Act, where there is exclusive jurisdiction in the federal courts, the default provisions of the bylaw – in which the federal district court in Delaware would have jurisdiction because the state courts do not have subject matter jurisdiction – would presumably apply. Setting aside whether that court would accept jurisdiction, not to mention questions of proper venue, *forum non conveniens* and the like, it is not at all clear that a Delaware corporation based in another jurisdiction, for example, would rather litigate a federal stockholder derivative claim in Delaware federal courts than in the federal courts in other jurisdictions.

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least to a corporate lawyer, as direct disclosure claims against the company for bad proxy disclosure along with state law derivative claims alleging breach of fiduciary duty by the directors.

[13] *See, e.g., Pappas v. Moss*, 393 F.2d 865 (3d Cir. 1968)(stockholder plaintiffs filed derivative action against the directors on behalf of the corporation, alleging that the directors had unanimously voted to issue themselves stock at far below its true value). Derivative claims were brought against directors and officers of several companies in connection with stock option backdating that occurred during the 2000s. *See, e.g., In re Comput. Sci. Corp. Derivative Litig.*, No. CV 06-05288 MRP (Ex.), 2007 WL 1321715 (C.D. Cal. Mar. 26, 2007) (asserting derivative claims under Sections 10(b) and 14(a) of the Exchange Act); *In re Asyst Tech., Inc. Derivative Litig.*, No. C-06-04669 EDL, 2008 WL 2169021 (N.D. Cal. May 23, 2008) (dismissing derivative claims asserted under Sections 10(b), 14(a), and 20(a) of the Exchange Act); and *In re Brocade Commc'n Sys., Inc. Derivative Litig.*, 615 F. Supp.2d 1018 (N.D. Cal. 2009) (dismissing Special litigation Committee's Derivative claims under Sections 10(b) and 13(b) of the Exchange Act). Derivative claims under Section 10(b) were also brought against Wells Fargo, alleging that certain officers and directors had sold stock back to the company at a time when the fake account scandal had not been disclosed. *See In re Wells Fargo & Co. S'holder Derivative Litig.*, 282 F. Supp.3d 1074 (N.D. Cal. 2017) (asserting claims under Sections 10(b), 14(a), 20A, and 29(b) of the Exchange Act).

The questions that the SEC staff has been posing in its review of the forum selection provisions should cause corporations that wish to have the Delaware Court of Chancery serve as the exclusive forum for deal litigation to think hard about whether the same is true (assuming it is even possible) for federal securities law claims. For Exchange Act claims, where the federal courts have exclusive jurisdiction, one might consider that Delaware is in the Third Circuit and presumably might want to compare the federal securities law jurisprudence in the Third Circuit to that in the circuit in which the corporation is headquartered (a likely alternative venue). For Securities Act derivative claims, it may not make the most sense for a Delaware corporation not headquartered in Delaware to require that those claims be brought in the Delaware Court of Chancery (if possible), particularly if incorporation is the only connection that company has to Delaware. Companies that are not incorporated in Delaware will need to go through similar analyses.

Delaware may not even uphold the applicability of an otherwise valid state exclusive forum bylaw to federal securities law claims, even those brought as derivative claims. There is certainly some argument that because the claims must be derivative they may fit within the definition of "internal corporate claims" in DGCL § 115 – "claims in the right of the corporation . . . that are based upon a violation of a duty by a current or former director or officer or stockholder in such capacity . . . ." A company asserting the applicability can expect to have to litigate that question. There should be a solid reason for wanting the exclusive forum provision to apply to federal securities law claims before taking a position likely to result in a challenge to it.

Companies incorporated in states other than Delaware that have adopted state exclusive forum provisions patterned after those in Delaware, but with reference to the courts in their home jurisdiction, might take a different view. They must consider the threshold question of enforceability and whether purporting to apply the provision to federal derivative claims might lead to the possibility of a negative result in any litigation over the provision's validity. As with Delaware corporations, to the extent there were derivative claims under the Securities Act, it may not make sense to try to force those into state court even if such a provision were enforceable. For Exchange Act derivative actions, although most companies would probably want those brought in the federal courts in their home state, that may not always be the case. In the end, the easier course – and indeed the more sensible one - may be to make it clear that the exclusive forum provision applies only to state derivative claims, unless there is some clear and certain benefit in doing otherwise.