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Will 'Salzberg' Curtail Arbitration Provisions in Corporate Charters and Bylaws?

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The Delaware Court of Chancery's recent decision in *Sciabacucchi v. Salzberg*, C.A. No. 2017-0931-JTL, at *5 (Del. Ch. Dec. 19, 2018), makes clear that forum selection provisions adopted in corporate charters that purport to restrict where plaintiffs may file claims under the Securities Act of 1933 (the Federal Forum Provisions) are "ineffective and invalid." According to the court, existing Delaware law does not authorize the "constitutive documents of a Delaware corporation to bind a plaintiff to a particular forum" with respect to an "external claim," e.g., one that "does not involve rights or relationships that were established by or under Delaware's corporate law." Claims under the 1933 Act, the court holds, are such "external claims." In explaining its reasoning, the court detailed that Delaware corporate law lacks the authority to support such provisions because "Delaware's authority as the creator of the corporation does not extend to its creation's external relationships, particularly when the laws of other sovereigns govern those relationships."

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The Court of Chancery's holding in *Salzberg* offers what might seem to be a cautious interpretation of the reach of Delaware corporate law. Defining Delaware's reach narrowly, the court avoids a potential collision with federal securities law. Beyond these direct consequences, *Salzberg* has interesting potential ramifications for Delaware corporations seeking to benefit from arbitration provisions in corporate charters and bylaws. State and federal courts often accord arbitration provisions treatment akin to forum selection provisions, see *National Industries Group (Holding) v. Carlyle Investment Management*, 67 A.3d 373, 384 n.41 (Del. Ch. 2013) ("[A]n arbitration clause 'is, in effect, a specialized kind of forum-selection clause.'") (quoting *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 519 (1974)). For years, commentators have debated whether a corporation could adopt or enforce a charter or bylaw provision mandating arbitration of some or all claims addressed to the corporation's governance. The Court of Chancery appears to be adding another important precedent to that debate.

In *Salzberg*, the Court of Chancery relies heavily on the distinction between internal and external corporate claims drawn by the Court of Chancery, the Delaware Supreme Court and the General Assembly. In 2013, the Court of Chancery held in *Boilermakers Local 154 Retirement Fund v. Chevron*, 73 A.3d 934, 942, 952 (Del. Ch. 2013), that Delaware corporations may adopt bylaws restricting the forum in which stockholders may file claims "relating to internal corporate governance." There, Chief Justice Leo E. Strine Jr., then writing as chancellor, explained that, "because the forum selection bylaws address internal affairs claims, the subject matter of the actions the bylaws govern relates quintessentially to 'the corporation's business, the conduct of its affairs, and the rights of its stockholders [*qua*stockholders].'" The chief justice also provided two contrasting examples of "external claims" that a bylaw could not regulate: "a tort claim

against the company based on a personal injury … that occurred on the company's premises or a contract claim based on a commercial contract with the corporation."

In 2014, the Delaware Supreme Court affirmed the internal/external distinction when, in *ATP Tour v. Deutscher Tennis Bund*, 91 A.3d 554, 555 (Del. 2014), it upheld the validity of a fee-shifting bylaw adopted by a nonstock corporation. Holding in *ATP Tour* "that the bylaw was facially valid because it 'allocate[d] risk among parties in intra-corporate litigation,' … [t]he Delaware Supreme Court did not suggest that the corporate contract can be used to regulate other types of claims," see *Salzberg*, C.A. No. 2017-0931-JTL, at *28 (quoting *ATP Tour*, 91 A.3d at 558). Then, in 2015, the Delaware General Assembly limited *ATP Tour* to its facts by banning fee-shifting provisions from corporate charters and bylaws; but it also codified *Boilermakers*, extended it to charter provisions, and defined "internal corporate claims" to "encompass claims covered by the internal-affairs doctrine."

Applying this distinction between internal and external claims, the court in *Salzberg* found that a 1933 Act claim is an external claim because it "resembles a tort or contract claim brought by a third-party plaintiff who was not a stockholder at the time the claim arose" due to the "distinct nature of a claim based on a defective registration statement." In particular, the 1933 Act permits claims against defendants with no "internal role with the corporation"; "shares of a Delaware corporation are only one subset of … one type" of "as many as 369 different types of securities" within the 1933 Act's definition of "security"; and, when "the predicate act of purchasing [shares of stock] occurs, the purchaser is not yet a stockholder and does not yet have any relationship with the corporation that is governed by Delaware corporate law." Consistent with *Boilermakers*, *ATP Tour*, and Section 115 of the DGCL, *Salzberg* casts a narrow net for "internal claims."

The *Salzberg* court also contrasts the limits of Delaware's authority to regulate "external claims" with the extent of its broader authority to regulate "internal claims." "Because the state of incorporation creates the corporation," the court explains, "the state has the power through its corporation law to regulate the corporation's internal affairs." Thus, Delaware has the power to regulate a corporation's internal affairs by defining "the parameters of the property rights that [it] has chosen to establish," *id.* at *43, which it does through "a multi-party contract"—the certificate of incorporation—"that includes the State of Delaware" and "always incorporates by reference the limitations imposed by the DGCL."

According to the court, however, "the state of incorporation cannot use corporate law to regulate the corporation's external relationships" because neither Delaware's sovereignty nor the internal-affairs doctrine confers the power to regulate "actors and activities within [other states'] territorial jurisdiction" or "the behavior of parties in other capacities." Indeed, Delaware "cannot assert authority over other types of claims based on the corporate contract, because the claims do not arise out of internal corporate relationships." Because arbitration provisions widely are considered "a specialized kind of forum selection clause," *Salzberg* effectively holds that existing Delaware law does not authorize corporations to adopt charter or bylaw provisions mandating arbitration of "external claims."

Salzberg has implications both outside and inside of Delaware. First, if the court is correct that Delaware cannot regulate "external claims," then its sister states likely cannot do so either. Thus, arguably *all* arbitration bylaws and charter provisions are "ineffective and invalid" to the extent they purport to regulate federal securities claims or other external claims—regardless of the state of incorporation. Second, if the court is correct that only Delaware may regulate the internal affairs of the corporations it creates, then Section 115 of the DGCL validly prohibits corporations from adopting arbitration bylaws or charter provisions that "prohibit bringing [internal corporate] claims in the courts of [Delaware]."

As with any decision, the true impact of *Salzberg* will be determined by other courts and regulators that grapple with and expand upon its reasoning—a process that is already underway. See, e.g., Johnson & Johnson, SEC No-Action Letter (Feb. 11, 2019) (granting no action request based on New Jersey Attorney General's conclusion, among others, that a bylaw mandating stockholders arbitrate federal securities claims is prohibited by *Salzberg*, to which New Jersey courts would look for guidance). And since *Salzberg* is on appeal, see *Salzberg v. Sciabacucchi*, No. 25, 2019 (Del. Jan. 17, 2019), this includes the Delaware Supreme Court. As *Salzberg* develops, followers of Delaware jurisprudence should continue to focus on the limitations that appear to be developing regarding the ability of Delaware corporate entities to establish forum parameters beyond the narrow set of internal claims.

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