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Under Fire: Continued Attacks on Exclusive Forum Provisions May Slow Adoption

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In February, 11 Delaware corporations and their directors were sued in the Delaware Court of Chancery for adopting bylaw provisions mandating that shareholder lawsuits be filed exclusively in the Court of Chancery. All 11 cases were brought by the same two plaintiffs' law firms, and all essentially assert the same arguments that (i) exclusive forum bylaw provisions were inappropriately adopted by the corporations' directors without shareholder approval; (ii) designating an exclusive jurisdiction for litigation is not an appropriate matter to be addressed in a corporation's bylaws; and (iii) such designation exceeds the jurisdiction of the Court of Chancery and conflicts with the jurisdiction of federal and other state courts.

The new Delaware lawsuits follow on the heels of last year's federal court decision in *Galaviz v. Berg*,[1] striking down a similar exclusive forum provision in Oracle Corp.'s bylaws, increasing hostility of institutional shareholder groups toward exclusive forum provisions, and recent shareholder proposals to cause corporations that already have exclusive forum provisions to remove them. These collective attacks raise the question of whether it is worth it for existing public corporations without such provisions to add them, at least until the enforceability and desirability of such provisions (and the method of their adoption) becomes certain. This article reviews the recent uptick in adoption of exclusive forum provisions, the recent attacks, and weighs the relative benefits and costs.

Background

Public corporations incorporated in Delaware showed renewed interest in adopting exclusive forum provisions in their charters and bylaws after Delaware Vice Chancellor J. Travis Laster suggested in dicta in his March 2010 decision in *In re Revlon Shareholders Litigation*[2] that directors and shareholders are free to select an exclusive forum for intra-entity disputes.[3] A handful of Delaware companies had adopted such provisions in their charters and bylaws prior to Vice Chancellor Laster's decision, but his words seemed to provide the catalyst for commentators and practitioners to start recommending that public corporations

adopt exclusive forum provisions. By the end of last year, 195 Delaware corporations had adopted or proposed exclusive forum selection clauses in their charters or bylaws.[4]

An exclusive forum provision can take many forms, but the following is representative for a Delaware corporation:

> **Unless the Corporation consents in writing to the selection of an alternative forum, the Court of Chancery of the State of Delaware shall be the sole and exclusive forum for (i) any derivative action or proceeding brought on behalf of the Corporation, (ii) any action asserting a claim of breach of a fiduciary duty owed by any director, officer or other employee of the Corporation to the Corporation or the Corporation's stockholders, (iii) any action asserting a claim arising pursuant to any provision of the Delaware General Corporation Law, or (iv) any action asserting a claim governed by the internal affairs doctrine. Any person or entity purchasing or otherwise acquiring any interest in shares of capital stock of the Corporation shall be deemed to have notice of and consented to this exclusive forum provision.**

Such a provision does not limit the ability of shareholders to sue for violations of federal law (such as federal securities law violations) or noncorporate law claims under state law.

Some corporations have chosen to include an exclusive forum provision in their bylaws, which typically can be accomplished with board approval alone, while other corporations have elected to include such a provision in their charter, which requires both board and shareholder approval. The vast majority of public companies adopting exclusive forum provisions in their charters, however, did so prior to becoming a public company, and of those public companies implementing such a provision after already being public, most adopted the provision by bylaw amendment without seeking shareholder approval.[5]

During the 2011 proxy season, only six public companies sought shareholder approval for a charter amendment, five of which were adopted. Life Technologies Corp.'s proposal was bundled with charter amendments declassifying the corporation's board and passed easily. The five other proposals were presented on a stand-alone basis. While the proposals passed without issue for InsWeb Corp. and Lighting Science Group, both companies had significant insider ownership that favored the proposals and the result may not be indicative of future shareholder votes on similar stand-alone proposals. Proposals by DIRECTV and Altera Corp. were narrowly approved, while the proposal by The Allstate Corp. failed. To date, only three companies have filed proxy statements seeking equity approval of an exclusive forum provision in the 2012 proxy season.[6]

The rise in adoption of exclusive forum provisions is directly related to the rise in multijurisdictional litigation being asserted against public companies to challenge corporate actions, which is viewed by most corporate officers, shareholders and lawyers as wasteful of corporate resources. Particularly in connection with significant merger transactions, plaintiffs' firms routinely sue companies in multiple jurisdictions, as they compete to serve as lead counsel for the companies' shareholders and extract larger settlements.[7] Chancellor William B. Chandler, noted and described this phenomenon in March 2011:

> **Judges, defense counsel, and the plaintiffs' bar are now routinely confronted with these sorts of disputes and have yet to come up with a workable solution. The potential problems, as one can imagine, are numerous. Defense counsel is forced to litigate the same case—often identical claims—in multiple courts. Judicial resources are wasted as judges in two or more jurisdictions review the same documents and at times are asked to decide the exact same motions. Worse still, if a case does not settle or consolidate in one forum, there is the possibility that two judges would apply the law differently or otherwise reach different outcomes, which would then leave the law in a confused state and pose full faith and credit problems for all involved. Efficiency and comity**

would be better served if these cases were litigated in one jurisdiction.[8]

There are many reasons cited by Delaware corporations for designating the Delaware Court of Chancery as the exclusive forum to resolve intra-company disputes. Fairchild Semiconductor International, Inc.'s March 7 proxy statement provides a useful overview of the reasons companies cite in support of these provisions. The Fairchild proxy statement first notes that "[m]any authorities on corporate governance believe that stockholders derive a significant benefit from the inclusion of a provision in a corporation's certificate of incorporation requiring that certain stockholder lawsuits be brought exclusively in the Court of Chancery," and then offers the following explanation:

> **The benefits of litigating intra-company disputes in the Court of Chancery are clear. Over the years, the State of Delaware has developed a well-established body of corporate law, and the Court of Chancery is the most experienced forum for deciding the outcome of such disputes. Litigating intra-company corporate disputes in Delaware results in greater certainty and predictability for all stockholders. Furthermore, there is a significant risk that allowing stockholders to bring such highly sophisticated matters in forums with little familiarity or experience in corporate governance leaves stockholders at risk that foreign jurisdictions may misapply Delaware law. Additionally, such a provision helps to eliminate duplicative litigation in multiple forums, which can be costly and inefficient. Finally, the ability of the Court of Chancery to resolve disputes on an accelerated schedule reduces the time and cost of uncertain, protracted litigation.**

Although not identified as a reason to adopt the forum selection clause in the proxy statements of the few companies who have put the matter to a shareholder vote, companies favor shareholder litigation in the Court of Chancery because it is a court of equity, which is one of the principal reasons plaintiffs' attorneys express for avoiding the court. As a court of equity, plaintiffs in Court of Chancery cannot recover punitive damages (unless expressly authorized by statute) or demand a jury trial. An exclusive forum selection clause that requires shareholder disputes to be brought in the Court of Chancery eliminates jury unpredictability, including the risk that a jury may award damages in a far greater amount than is warranted, based on juror sympathies.

Shots across the Bow

Despite the proliferation of exclusive forum provisions and many corporate lawyers' view that such provisions are beneficial to both the corporation and such corporation's shareholders, use of exclusive forum clauses is under attack. In January 2011, a federal district court in California refused to enforce an exclusive forum provision in Oracle's bylaws where the "provision was unilaterally adopted by the directors who [were] defendants in [the derivative] action, after the majority of the purported wrongdoing is alleged to have occurred, and without the consent of existing shareholders who acquired their shares when no such bylaw was in effect."[9] Because the decision was based on federal law, it left unresolved the question of whether directors may unilaterally adopt forum selection bylaws under Delaware law. However, the court suggested that the argument to enforce a forum selection clause would be much stronger if the clause were adopted as a charter amendment approved by a majority of shareholders.[10]

Surprisingly to some, institutional shareholder groups are challenging and resisting exclusive forum provisions. During the 2011 proxy season, Institutional Shareholder Services Inc. (ISS) announced that it would oppose forum selection proposals unless a corporation asserting such a proposal had in place the following best-practices governance features:

- an annually elected board;
- a majority vote standard in uncontested elections of directors;
- a meaningful special meeting right (generally 10% without onerous restrictions); and
- the absence of a poison pill, unless the pill was approved by the company's shareholders.[11]

In effect, this policy reflected a view of tolerance for an otherwise undesirable exclusive forum provision only if a corporation adopted four other governance provisions considered important to ISS. For the 2012 proxy season, ISS announced that it would consider exclusive forum proposals on a case-by-case basis, taking into account both the company's litigation history (whether it has been materially harmed by shareholder litigation in jurisdictions outside its state of incorporation) and overall governance practices (whether it has an annually elected board, has majority voting in uncontested director elections, and does not have a nonshareholder approved poison pill).

For 2012, Glass Lewis & Co. (Glass Lewis) announced that it will generally recommend that shareholders vote against any stand-alone bylaw or charter amendment seeking to adopt an exclusive forum provision.[12] Where a proposal to adopt an exclusive forum provision is bundled with other bylaw or charter amendments that would be beneficially to shareholders, Glass Lewis will consider such proposal on a case-by-case basis. However, if the board adopts an exclusive forum bylaw provision without shareholder approval, including prior to an IPO, or, if the board seeks shareholder approval of an exclusive forum provision pursuant to a bundled bylaw or charter amendment, Glass Lewis will recommend a vote against the chairman of the corporate governance committee, or, if there is no such committee, a vote against the chairman of the board who served when the provision was adopted. Glass Lewis explains its view that "any provision limiting a shareholder's choice of legal venue is not in the best interests of shareholders as such provisions may effectively discourage the use of shareholder derivative claims by increasing their associated costs and making them more difficult to pursue." Consequently, corporations can expect opposition from Glass Lewis to proposals to add exclusive forum provisions and support for shareholder proposals to repeal provisions previously adopted.[13]

Similarly, the Council of Institutional Investors (CII), an association of pension funds, employee benefit funds, foundations and endowments, has adopted a policy of discouraging companies from adopting charter or bylaw provisions that restrict venue for shareholder litigation.[14]

Opposition to exclusive forum provisions also is starting to show up in the form of nonbinding shareholder proposals seeking repeal of exclusive forum provisions adopted without shareholder approval. For the 2012 proxy season, at least four corporations received shareholder proposals advocating repeal of the exclusive forum bylaw provisions adopted by board action without shareholder approval.[15]

The opposition of institutional shareholder groups to exclusive forum provisions is surprising to many corporate law practitioners and corporate managers who tend to view multijurisdictional litigation as imposing unwarranted costs on the corporation that are shared by all shareholders. The positions taken by ISS, Glass Lewis, CII and shareholders advancing proposals to remove exclusive forum provisions clearly demonstrate there is vocal support for a contrary view that such provisions impinge on shareholder rights.

Direct Legal Attack in Delaware

Against the backdrop of the federal court decision invalidating Oracle's exclusive forum bylaw and opposition from institutional shareholder groups against exclusive forum provisions generally, two notable Delaware plaintiffs' firms, Pricket, Jones & Elliot, P.A. and Kessler Topaz Meltzer & Check, LLP, jointly filed substantially similar complaints on behalf of the shareholders of Delaware corporations Air Products & Chemicals, Autonation, Inc., Chevron Corp., Curtiss-Wright Corp., Danaher Corp., FEDEX Corp., Franklin Resources, Inc., Navistar International Corp., priceline.com Inc., SPX Corp. and Superior Energy Services, Inc.[16] In each case, plaintiffs challenged the validity of an exclusive forum bylaw provision that was adopted by the corporation's board without shareholder approval. The sample exclusive forum provision provided above is similar to the exclusive forum bylaw provision for each of the defendant corporations.

Plaintiffs in these cases offer similar arguments to attack each board's adoption of an exclusive forum bylaw. The following arguments in the complaint filed against Danaher[18] are representative of the arguments made against the other defendant corporations:

- An exclusive forum bylaw provision exceeds the scope of matters permitted to be covered in by-

laws under § 109(b) of the Delaware General Corporation Law (DGCL), which states that bylaws "may contain any provision not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its shareholders, directors, officers or employees." The plaintiffs allege that the exclusive forum bylaw exceeds such authority because it (i) purports to apply to persons not subject to bylaw regulation, including *former* shareholders, directors, officers and employees, as well as non-shareholders who have "any interest" in the companies' stock (*e.g.*, holders of options, warrants and convertible debentures), and (ii) does not relate to internal corporate governance. Two of the bylaws at issue also require shareholders to institute actions against agents of the corporation in the Court of Chancery, which is not specifically authorized by the statute.

- Mandating use of the Delaware Court of Chancery to resolve all intra-company disputes (which might include actions at law) violates Delaware statutes that limit the Court of Chancery's subject matter jurisdiction to equitable claims and matters specifically authorized by statute.

- An exclusive forum bylaw provision cannot confer the Court of Chancery with exclusive personal jurisdictions over shareholders and certain defendants who would not otherwise be subject to personal jurisdiction in Delaware. The Danaher complaint asserts that under § 3114 of the DGCL, personal jurisdiction is available only for directors and certain senior officers, leaving the Court of Chancery without personal jurisdiction over most other corporate officers and employees. This could result in aggrieved shareholders not being able to sue certain officers and employees in the sole court where the shareholders are authorized to bring suit. The exclusive forum bylaw for two of the defendant corporations specifically provides that the provision only applies when all indispensable defendants are subject to personal jurisdiction in Delaware.

- The specific bylaw provision at issue is invalid and unenforceable because it (i) was unilaterally adopted without shareholder consent and under contract law principals mutual consent is required, and (ii) lacks mutuality by restricting only a shareholder's choice of forum while leaving the corporation free to initiate litigation in any forum it chooses. Like the Danaher bylaw, eight of the other challenged bylaw provisions allow the corporation to consent to a forum other than the Court of Chancery, to which the plaintiffs argue that the time required to obtain the corporation's approval would effectively limit the availability of other courts, given the expedited nature of many corporates lawsuits.

- A bylaw provision designating Delaware as an exclusive forum for a broad range of litigation conflicts with federal law, including the Securities Litigation Uniform Standards Act of 1998, and impinges original federal jurisdiction, federal diversity and supplemental jurisdiction, and federal bankruptcy jurisdiction.

- The specific provision at issue is not reasonable and equitable because it was unilaterally adopted by directors "to give themselves control over where they may be sued" and is "mandatory, excessive and ill-defined."

- The specific provision at issue is the product of a breach of fiduciary duty by self-interested directors. The plaintiffs in the Danaher complaint argue that the directors were self-interested because the bylaws "(i) enable[] them to cause litigation against them to be confined to the forum where they believe they are least likely to be held liable; (ii) enable[] them to avoid a jury trial; and (iii) may make it difficult or impossible for certain claims to be brought against them." Because the directors were self-interested, the plaintiffs argue that the entire fairness standard was applicable and not met.

The 11 cases recently filed in Delaware squarely raise the issue of enforceability of exclusive forum bylaws adopted without shareholder approval, and may provide Delaware courts an opportunity to address the legality of such provisions generally (including, for

instance, where included as a charter provision adopted with shareholder approval). The 11 cases have been consolidated and will be heard by Chancellor Leo E. Strine, Jr.[19]

Most commentators writing about the 11 cases in the first few weeks after they were filed have predicted Delaware courts will uphold the right of boards to add such provisions to corporate bylaws as a general proposition. Nevertheless, the full frontal attack on such provisions by the plaintiffs in these cases, and the possibility of future litigation concerning various nuances of exclusive forum provisions, creates uncertainty regarding their utility to corporations considering adopting them.

Practical Considerations

While many Delaware corporations responded to Vice Chancellor Laster's 2010 invitation to adopt exclusive forum provisions binding on all shareholders, corporations did so with the expectation that adopting such provisions offered the benefit of giving a corporation an additional way to combat multijurisdictional litigation with little downside. The rise of substantial resistance from institutional shareholder groups, the possibility of having to deal with shareholder proposals to remove the provisions and the specter of attracting litigation concerning the exclusive forum provisions themselves (or their manner of adoption) undoubtedly changes the calculus for corporations deciding whether to adopt one.

For corporations that adopt exclusive forum provisions in their charters prior to going public, being spun off or emerging from bankruptcy, there is less concern about litigation challenging the act of inserting such a provision. These companies can get the benefits of including such provisions in their charters without having to worry about seeking shareholder approval in the face of institutional shareholder group opposition (which will be present after going public) or risking litigation concerning the manner in which such provisions are adopted. These companies ultimately will face the prospect of shareholder proposals to remove such provisions and litigation challenging specific aspects of the particular provisions adopted if and when intra-company litigation ensues, but these risks are more remote and speculative.

For existing public corporations considering whether to adopt exclusive forum provisions, the risk of litigation if a board acts unilaterally to adopt an exclusive form bylaw and likely shareholder opposition to such a provision if adopted by charter amendment, coupled with the later risks of shareholder proposals seeking to remove such provisions and litigation challenging aspects of such provisions, may warrant waiting to implement such provisions until Delaware (and possibly other) courts confirm the legality of such provisions and manner of adoption. Such companies may still face shareholder opposition when they ultimately seek to add an exclusive jurisdiction provision, but by waiting may avoid costly litigation while the issues are sorted out in Delaware and ultimately be in a position to adopt an exclusive forum provision that is better tailored to address the specific issues raised in the current lawsuits.

NOTES

1. *Galaviz v. Berg,* 763 F. Supp. 2d 1170 (N.D. Cal. 2011).
2. *In re Revlon, Inc. Shareholders Litigation,* 990 A.2d 940 (Del. Ch. 2010).
3. *Revlon* at 960. In footnote 8 of the opinion, Vice Chancellor Laster identifies numerous authorities for this proposition.
4. Claudia H. Allen, *Study of Delaware Forum Selection in Charters and Bylaws*, at 22 n.6 & 8 (Updated Jan. 25, 2012) (hereinafter, Study).
5. Study at 1.
6. The companies that included proposals for exclusive forum provisions in their proxy statements were Sally Beauty Holdings Corp., Fairchild Semiconductor International, Inc., and Suburban Propone Partners LP, which proposed adopting the provision in its existing partnership agreement.
7. Study at 3 (citing several authorities discussing this phenomenon); *see also* Edward Micheletti and Cliff Gardner, *M&A Shareholder Litigation: A Year in Review*, Law360 (Jan. 12, 2012) ("In nearly every deal litigation matter, the plaintiffs' counsel attempt to create leverage for themselves by filing deal litigation raising issues of Delaware law not only in Delaware, but also in a non-Delaware forum.").
8. *In re Allion Healthcare Inc. Shareholders Litigation,* 2011 WL 1135016 (Del. Ch. 2011).
9. *Galaviz*.
10. *Galaviz* at 1175.
11. ISS, *U.S. Corporate Governance Policy 2012 Updates*, at 13 (Nov. 17, 2011), available

at http://www.issgovernance.com/files/ISS_2012US_Updates20111117.pdf.

12. Glass Lewis & Co., *2012 North American Proxy Season Preview*, at 13-14 (Dec. 12, 2011).
13. Glass Lewis & Co., *Proxy Season Preview 2012*, at 5-6 (Jan. 1, 2012).
14. Council of Institutional Investors, *Corporate Governance Policies* (Dec. 21, 2011), *available at* http://www.cii.org/UserFiles/file/CII%20Corp%20Gov%20Policies%20Full%20and%20Current%2012-21-11%20FINAL%20(2).pdf.
15. Study at 1.
16. Both firms recently served as plaintiffs' counsel in *In re Southern Peru Corporation Shareholder Derivative Litigation*, C.A. No. 961-CS (Del. Ch. Oct. 14, 2011), in which Chancellor Strine awarded plaintiffs the largest damages award in the Court of Chancery's history ($1.3 billion plus interest for a total award of $2 billion) and awarded the two plaintiffs' firms a staggering $300 million in attorneys' fees. The law firm Klausner, Kaufman, Jensen & Levison also is serving as "Of Counsel" in a number of the actions.
17. *BOILERMAKERS LOCAL 154 RETIREMENT FUND and Key West Police & Fire Pension Fund, on Behalf of Themselves and All Others Similarly Situated, v. DANAHER CORPORATION, Mortimer M. Caplin, H. Lawrence Culp, Jr., Donald J. Ehrlich, Linda P. Hefner, Walter G. Lohr, Jr., Mitchell P. Rales, Steven M. Rales, John T. Schwieters, Alan G. Spoon, and Elias A. Zerhouni*, 2012 WL 381847 (Del. Ch. 2012).
18. Steven M. Haas, *Talking Points: The Significant of Exclusive Forum Bylaws*, www.boardmember.com (Feb. 29, 2012), *available at* http://www.hunton.com/files/News/9130bcff-5a2f-478e-a1c4-1ba30b21391e/Presentation/NewsAttachment/2a48a255-b6d5-4488-a170-1ffeaada088a/Corp_Board_Member_Talking_Points_Haas.pdf.