Designating Courts for Shareholder Lawsuits Is on the Rise

Exclusive forum provisions, however, are under growing scrutiny.

BY DOUG RAYMOND

Requirements adopted to force suits against companies to be filed only in certain courts, while a growing trend, face legal scrutiny depending on whether the case involves internal or external issues.

Two recent examples should be on the board's radar.

Blue Apron Holdings, Inc., Roku, Inc., and Stitch Fix, Inc. — all recently going public — adopted provisions as part of their IPOs to require that claims brought under the Securities Act of 1933 be handled in federal court. But those provisions were deemed "ineffective and invalid" by the Delaware Court of Chancery in December.

On the other hand, similar provisions adopted by other companies and focused on "internal corporate" claims, including matters like board misconduct, have survived legal scrutiny.

For example, a suit by a shareholder against 1st Century Bancshares involved a challenge in the California Court of Appeals to the company's bylaw provision that designated Delaware as the exclusive forum in which to litigate the company's internal corporate affairs.

In keeping with the courts of other states that have considered similar provisions (including Oregon, New York, and Illinois), the California court in December affirmed that the bylaw would be enforced by California courts, and acknowledged that such provisions can have the beneficial effect of consolidating "litigation into a single forum, thereby reducing litigation expenses and avoiding duplication of effort (not to mention promoting efficient use of judicial resources), which is beneficial to corporations and their shareholders alike."

There has been a significant increase in shareholder class actions alleging misdoings by corporate boards in recent years. And many of these lawsuits have been filed in jurisdictions often regarded as less sympathetic to corporate defendants, including California.

In response, corporate lawyers began recommending that their clients adopt bylaw (or charter) provisions that would require such suits to be filed only in certain courts chosen by the corporation, thereby limiting the ability of plaintiffs' lawyers to seek out more hospitable courtrooms. This effort was equally aimed at reducing the need for corporations to defend similar lawsuits across multiple jurisdictions.

Such provisions, known as "exclusive forum provisions," have been validated by the Delaware Courts as well as by an amendment to the Delaware General Corporation Law, which confirmed that a corporation may adopt a provision

in either its certificate of incorporation or its bylaws requiring "internal corporate claims" to be brought solely and exclusively in Delaware.

The landscape continues to shift, however, as companies explore the limits of these exclusive forum provisions, and they have come under growing scrutiny.

The two recent court opinions above provide directors important guidance while simultaneously raising new questions about the scope of such provisions.

In the Blue Apron, Roku and Stitch Fix case, the court struck down the federal forum-selection provisions and held that, under Delaware law, exclusive forum provisions must be limited to claims involving the company's internal corporate affairs. The claims related to the sales and purchases of the company's stock from the company itself were not based in Delaware law, but on the federal securities laws.

In general, internal corporate issues include issues such as the voting rights of shareholders, distributions of dividends and other corporate property, claims that directors have breached fiduciary duties, and other claims arising from the relationship between the corporation's officers and directors on the one hand, and its stockholders on the other. In contrast, issues such as the federal securities laws, labor and employment issues, and tax liabilities are typically governed by the law of the state in which the corporation is doing business (or by federal law). The *Blue Apron, et al.*, decision drew a fairly restrictive line in limiting the scope of what could be considered an "internal issue."

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For example, the proxy advisory service, Glass Lewis, issued guidelines that exclusive forum provisions "are not in the best interests of shareholders." It recommends shareholders vote against any proposed amendment seeking to adopt such a provision, unless the company presents a compelling justification and satisfies certain other criteria. Institutional Shareholder Services (ISS) has taken a more nuanced approach, stating that, in general, it does not consider exclusive forum provisions to be materially adverse to shareholders' rights, but it will evaluate them on a case-by-case basis.

On the one hand, given the 1st Century Bancshares case, directors can have greater confidence that courts — including those in states such as New York and California, in which many public companies maintain their headquarters — will respect these provisions should a litigious shareholder attempt to circumvent them. As the court observed, the adoption of an exclusive forum provision may then have the beneficial effect of consolidating litigation and reducing expenses while simultaneously reducing uncertainty by targeting litigation to one forum.

On the other hand, directors should be careful not to overreach by mandating an exclusive forum for claims that are not tied to the corporation's internal affairs. And, in any event, boards should consider how the company's investors and the proxy advisors such as ISS and Glass Lewis would respond to their adoption of an exclusive forum provision.

Both recent cases are significant decisions, the impact of which can be expected to reverberate for some time. For corporate boards that have not yet done so, now would be a good time for the directors to reassess whether to adopt an exclusive forum provision in either the company's charter or its bylaws.

While the Blue Apron opinion may be appealed, its limitation on the scope of exclusive forum provisions should be included in the board's assessment of whether, and how broadly to impose an exclusive forum requirement on stockholder litigation. And boards must continue to look forward and be mindful of future developments as the law in this area will continue to be written. ■

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