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An Overview for Boards on the Future of Forum-Selection Clauses

Balancing Considerations and Guidance from the Delaware Supreme Court, the SEC, Proxy-Advisory Firms, and Investors

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On March 18, 2020, the Delaware Supreme Court decided *Salzberg v. Sciabacucchi*,[1] rejecting a challenge to the validity of federal-forum provisions (FFPs) adopted in the corporate charters of three Delaware companies prior to their initial public offerings (IPOs). The FFPs at issue designated the federal courts as the exclusive venue for shareholder suits under the federal Securities Act of 1933. While concluding that FFPs can survive a facial challenge, the decision raises several new questions, such as how the opinion will apply to forum selection clauses adopted in contexts different from those at issue in the litigation, including whether companies may require that shareholder securities suits be brought in private arbitration. After briefly summarizing the *Salzberg* decision, we assess its impact on these and other questions.

The Delaware Supreme Court's Decision

FFPs are designed to address the 1933 Securities Act's venue provision. That provision allows private litigants alleging Securities Act violations—most often misstatements or omissions in registration statements (§ 11[2]) or prospectuses (§ 12(a)(2)[3]) and control-person liability (§ 15[4])—to sue in state or federal court.[5] And as the U.S. Supreme Court recently clarified in *Cyan v. Beaver County Employees' Retirement Fund*, Securities Act class actions brought in state court cannot be removed to federal court.[6] Corporations thus face a risk of simultaneous securities litigation on two fronts, since companies sued by parallel classes in state and federal court cannot remove the state-court suits and consolidate them. FFPs mitigate that risk by requiring shareholders to bring all Securities Act suits against the company and its directors and officers in federal court.

The three defendant-corporations in *Salzberg*—Roku, Stitch Fix, and Blue Apron—are Delaware corporations that, before their 2017 IPOs, adopted FFPs in their corporate charters. The plaintiff bought shares in each and then filed a putative class action against the directors of these three companies, seeking a declaratory judgment that FFPs are facially invalid under Delaware Law. While the Court of Chancery agreed with the plaintiff, the Delaware Supreme Court reversed, holding that the FFPs could withstand a facial challenge. The Court reasoned that FFPs fall within the broad ambit of Delaware General Corporation Law (DGCL) § 102(b)(1), which allows corporations to adopt (1) "provision[s] for the management of the business and for the conduct of the affairs of the corporation," and (2) "provision[s] creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders."[7] The Court determined that FFPs could fall into either one of these categories of so-called "intra-corporate affairs" under § 102(b)(1).[8]

In so holding, the Court rejected the argument that FFPs violate DGCL § 115. Section 115 bars forum-selection provisions that prevent "internal corporate claims" from being brought in "the courts of [Delaware]."[9] According to *Salzberg*, "internal corporate claims" are those concerning "matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders," such as claims for breach of fiduciary duty.[10] That is in contrast to "intra-corporate affairs"—i.e., claims that a shareholder brings against another shareholder, claims that a shareholder brings against the corporation, and claims that the corporation brings against a shareholder—at issue in FFPs. Therefore, according to *Salzberg*, FFPs are facially valid under § 102(b)(1) because they relate to intra-corporate affairs, while being outside of the "internal corporate claims" governed by § 115.

Key Takeaways and Open Questions

Should Private Companies Adopt their Own FFP Before Going Public?

Salzberg's immediate lesson is that FFPs are facially valid in Delaware. However, while FFPs as a *general matter* do not violate Delaware law, some still might. Whether a particular FFP will be valid depends on the "manner in which it was adopted and the circumstances under which it [is] invoked."[11] Under *Salzberg*, a corporation may enact a charter provision (governed by § 102(b)(1)) specifying a forum for the litigation of "intra-corporate affairs" so long as the forum-selection clause does not otherwise violate Delaware law.[12] And *Salzberg* explained two ways in which the provision might violate Delaware law:

1. if it requires that shareholders litigate "internal corporate claims"—those "based upon a violation of a duty by a current or former director or officer or stockholder" or for which the DGCL "confers jurisdiction upon the Court of Chancery"[13]—in a forum other than the courts of Delaware; or

2. if their enforcement would be unreasonable or unjust, they are the product of "fraud or overreaching," or they violate public policy.[14]

While the FFPs in *Salzberg* were adopted in the defendant-companies' charters, the Court's language suggests that similar provisions adopted in bylaws (under § 109, which incorporates § 102(b)(1)'s standard) would likely pass muster. The Court observed that "a bylaw that seeks to regulate the forum in which . . . 'intra-corporate' litigation can occur" would be facially valid.[15]

Therefore, although *Salzberg* concludes that FFPs may be valid under Delaware law, the circumstances surrounding their adoption and the specific language of the provision will ultimately be relevant in determining a specific provision's validity. See *Drafting Considerations* below.

What About Mandatory Arbitration Provisions?

The clarification of the interplay between DGCL §§ 102(b)(1) and 115 provides needed insight for Delaware corporations pondering forum-selection clauses even beyond the FFPs that *Salzberg* addresses. The lower-court in *Salzberg* held that § 102(b)(1) barred corporations from adopting *any* charter provision governing the forum for securities claims because, in the lower court's view, securities claims are not "intra-corporate affairs." That lower-court decision thus also barred corporations from implementing forum-selection provisions requiring, for example, shareholders to *arbitrate* claims for violations of the federal securities laws.

By reversing that decision, the Delaware Supreme Court suggested that all manner of forum-selection clauses—including mandatory-arbitration provisions—for securities claims would be valid under § 102(b)(1) and would also be valid under § 115, so long such clauses do not cover "internal corporate claims." Indeed, the Court made clear that § 115 forbids corporations from requiring shareholders to arbitrate *internal corporate claims*—such as fiduciary-duty claims—since such a requirement would deprive shareholders of the ability to litigate such internal claims in the "courts of [Delaware]."[16]

Despite the Delaware Supreme Court's suggestion that Delaware law might allow mandatory-arbitration provisions, companies considering such provisions—both inside and outside of Delaware—should proceed with caution.

In 1990, the SEC declined to accelerate the registration statement of an unnamed Philadelphia-based company that would have required arbitration, claiming that such a provision "violates the anti-waiver provisions of the federal securities laws." The SEC similarly expressed concerns regarding Carlyle's proposed mandatory arbitration provision prior to its 2012 IPO, leading to Carlyle's removal of the mandatory-arbitration clause from its governing documents. In a no-action letter issued to Gannett Company, the SEC Staff stated that "there appears to be some basis" for the "view that implementation of the [proposed mandatory arbitration provision] would violate the federal securities laws."

More recently, the SEC has again been faced with the same issue. This time, however, in a 2019 letter recommending no action on Johnson & Johnson's decision to omit from its proxy materials a shareholder proposal to include a mandatory-arbitration provision in its governing documents, the SEC Staff declined to take a position on whether such a provision would violate federal law.[17] The Staff nonetheless granted no-action relief for the exclusion of the proposal because the New Jersey Attorney General had expressed his view that the provision would violate New Jersey law. He based that view in part on the lower-court decision in *Salzberg*, explaining that because New Jersey's corporate law was based on Delaware's, the lower-court decision in *Salzberg* was persuasive.[18] Since then, the shareholder who had proposed the mandatory-arbitration provision filed suit in New Jersey federal court, challenging Johnson & Johnson's decision not to include the proposal. Because Johnson & Johnson defended its decision by citing the lower-court *Salzberg* decision, the court stayed the case pending the Delaware Supreme Court's ruling on the *Salzberg* appeal.

What About FFPs Adopted Once a Company Is Already Public?

The FFPs in *Salzberg* were implemented in corporate charters before each of the corporate-defendants' IPOs, and the Court did not say whether its analysis would be the same if such provisions appeared in a post-IPO amendment to a corporate charter. Even so, *Salzberg*'s language strongly suggests that such FFPs would likely withstand at least a facial challenge, noting that FFPs govern litigation arising out of a company's "IPO or secondary offering" (implying that an FFP might be adopted between an IPO and secondary offering).[19]

Although the *Salzberg* decision suggests that FFPs may be met with judicial approval even if adopted once a company is already public, at least in Delaware, corporations adopting FFPs via amendment to a corporate charter or bylaws after their IPO may face other challenges.

For instance, some large institutional investors and proxy advisory firms are concerned that FFPs are unfair. The proxy-advisory firm Glass Lewis has warned that "charter or bylaw provisions limiting a shareholder's choice of legal venue are not in the best interests of shareholders," and generally recommends voting against proposals seeking to implement such provisions unless certain conditions are met.[20] However, it also notes that it has recently updated its voting guidelines to provide that, while its general policy is to recommend voting against a company's governance committee chair when a board adopts a forum-selection clause without shareholder approval, "where it can be reasonably determined that a forum selection clause is narrowly crafted to suit the particular circumstances facing the company and/or a reasonable sunset provision is included," it will consider making an exception to this policy.[21] Also important for recently public companies is that the inclusion of forum selection clauses in organizational documents adopted prior to a company's IPO will also be a relevant consideration in whether to recommend voting against directors who were on the board at the time of adoption of such clauses.[22]

Although Institutional Shareholder Services (ISS), another key proxy-advisory firm, and Vanguard, one of the largest mutual fund and ETF providers, seemingly take more nuanced views of forum-

selection provisions—recommending shareholders to assess such provisions "case-by-case"[23]—those recommendation will still engender shareholder scrutiny of FFPs. Indeed, the Glass Lewis, ISS, and Vanguard guidelines all note that the rationale for the forum-selection clause matters.[24]

In short, while companies may adopt FFPs with little resistance before an IPO, large, sophisticated shareholders may create headwinds that are relevant for a post-IPO adoption. And if a corporation proposes a post-IPO forum-selection provision, it will increase the chances of obtaining shareholder approval or avoiding votes against the chair of the governance committee by offering a well-reasoned rationale.

Additional Drafting Considerations

Salzberg also leaves open how courts will deal with FFPs and mandatory-arbitration provisions when faced with a complaint alleging both securities claims and "internal corporate claims," such as fiduciary-duty claims. The FFPs in *Salzberg*, which designated the federal courts "the exclusive forum for the resolution of *any complaint* asserting a cause of action under the Securities Act," would presumably require that a complaint alleging Securities Act violations be brought in federal court, regardless of what other claims it contains. That provision likely complies with § 115 so long as § 115's requirement that shareholders be allowed to bring internal corporate claims in "the courts of [Delaware]" includes federal courts—a reading that *Salzberg* "presum[ed]" but did not decide.[25] If that reading is the correct one, in other words, a provision requiring shareholders to bring all complaints containing Securities Act claims in federal courts would comply with § 115 because it would still allow shareholders to sue in the Delaware federal court. By contrast, requiring shareholders to bring such a complaint in arbitration would seem to flout § 115, which as *Salzberg* notes, prevents corporations from forcing internal corporate claims into arbitration.[26] Thus, one way to prevent shareholders from defeating forum-selection clauses by joining Securities Act and internal corporate claims might be to specify that Securities Act *claims* (rather than *complaints* including such claims) must be brought in federal court.

Recap

While *Salzberg* determined that FFPs are facially valid, it leaves unanswered questions about how far companies may go in selecting the forum of their choice for "intra-corporate" affairs such as securities class actions, as the Court indicated that FFPs could be invalidated in as-applied challenges and that other, similar forum-selection provisions could be found invalid.[27]

As a result, companies considering such provisions should work with outside counsel to reduce the risk that shareholders will vote down such provisions or that courts will invalidate them, keeping in mind a few key points:

- Consider the SEC's current position before adopting any mandatory-arbitration clause.
- Adopt FFPs before an IPO, if possible.
- If adopting FFPs post-IPO, ensure there is a clear rationale, thorough disclosure, and shareholder engagement.
- Ensure FFPs are appropriately tailored to the needs of the company.
- Draft FFPs to apply to claims, not complaints.

For more information about FFPs, mandatory arbitration provisions, or the *Salzberg* case, please contact any of the authors listed above or your usual Freshfields contact.

[1] __ A.3d __, 2020 WL 1280785 (Del. Mar. 18, 2020).

[2] 15 U.S.C. § 77k(a).

[3] *Id.* § 77*l*(a)(2).

[4] *Id.* § 77o(a).

[5] We note that this issue does not arise in the context of claims brought pursuant to Rule 10b-5 under the Exchange Act, because those claims are required to be brought in federal court.

[6] 138 S. Ct. 1061, 1066 (2018).

[7] 8 Del. C. § 102(b)(1).

[8] *Salzberg*, 2020 WL 1280785, at *4.

[9] 8 Del. C. § 115.

[10] *Salzberg*, 2020 WL 1280785, at *14

[11] *Id.* at *21.

[12] *Id.* at *10 (citing *ATP Tour Inc. v. Deutscher Tennis Bund*, 91 A.3d 554, 557 (Del. 2014)).

[13] 8 Del. C. § 115.

[14] *Salzberg*, 2020 WL 1280785, at *21.

[15] *Id.* at *4.

[16] *Id.* at *23, n.169.

[17] *See* M. Hughes Bates, SEC No-Action Letter to Johnson & Johnson dated February 11, 2019, at 2-3, available at https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2019/dorisbehrjohnson021119-14a8.pdf.

[18] *See* Letter from Gurbir S. Grewal, Attorney General of New Jersey, regarding Johnson & Johnson – 2019 Annual Meeting – Omission of Shareholder Proposal of The Doris Behr 2012 Irrevocable Trust, January 29, 2019, at 3 available at https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2019/dorisbehrjohnson021119-14a8.pdf.

[19] *Salzberg*, 2020 WL 1280785, at *4.

[20] Glass Lewis, *2020 Proxy Paper Guidelines: An Overview of the Glass Lewis Approach to Proxy Advice United States* 47 (2016) (*Glass Lewis Guidelines*), https://www.glasslewis.com/wp-content/uploads/2016/11/Guidelines_US.pdf.

[21] *Id.* at 15.

[22] *Id.* at 20.

[23] ISS, *United States Proxy Voting Guidelines, Benchmark Policy Recommendations* 24 (*ISS Guidelines*), available at https://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf; Vanguard Funds, *Summary of the Proxy Voting Policy for U.S. Portfolio Companies* 19 (Apr. 2020) (*Vanguard Guidelines*), https://about.vanguard.com/investment-stewardship/portfolio-company-resources/2020_proxy_voting_summary.pdf.

[24] *See Glass Lewis Guidelines* 47 (recommending "that shareholders vote against any bylaw or charter amendment seeking to adopt an exclusive forum provision unless the company: (i) provides a compelling argument on why the provision would directly benefit shareholders; (ii) provides evidence of abuse of legal process in other, nonfavored jurisdictions; (iii) narrowly tailors such provision to the risks involved; and (iv) maintains a strong record of good corporate governance practices"); *ISS Guidelines* 24 (recommending that shareholders take into account factors including the Company's rationale for the bylaw); *Vanguard Guidelines* 19 ("A fund will vote case-by-case on management proposals to adopt an exclusive forum provision. Considerations include the reasons for the proposal, regulations, governance and shareholder rights available in the applicable jurisdiction, and the breadth of the application of the bylaw.").

[25] Such a reading accords with the legislative history of § 115, which notes that the Delaware General Assembly sought to bar only forum-selection provisions requiring shareholders to litigate internal corporate claims in "the courts in *a different State, or an arbitral forum*." Del. S.B. 75 syn. § 5 (emphasis added).

[26] *Salzberg*, 2020 WL 1280785, at *23 n. 169.

[27] *See id.* at *21 ("Given that we are addressing a facial challenge, we are not considering hypothetical, contextual situations regarding the adoption or application of FFPs. Such "as applied" challenges are an important safety valve in the enforcement context. As emphasized in ATP, whether the specific charter provision is enforceable 'depends on the manner in which it was adopted and the circumstances under which it [is] invoked.'" (quoting *ATP*, 91 A.3d at 558)).