In the News: Exclusive Forum Charter and Bylaw Provisions

By William M. Kelly

The momentum behind exclusive forum provisions in corporate governance documents has been gathering, slowly but unmistakably. These provisions require that specified classes of litigation, including derivative claims, be brought exclusively in the state court of the company's state of incorporation.[1] Exclusive forum provisions have now been adopted in one form or another by over 80 US public companies. But no standard "best practices" approach has emerged, and a number of basic questions are still not answered definitively:

- Will these provisions be enforced by courts outside the state of incorporation?
- Are bylaw provisions as enforceable as charter provisions?
- Are the timing and other facts surrounding the adoption of the provisions relevant to their enforceability?
- Should these provisions become part of the standard IPO governance package?
- How will institutional shareholders and their advisors react to exclusive forum provisions?

For companies these issues boil down to a single question: is now the time to be considering adopting an exclusive forum provision? This article provides a snapshot of the state of play on these issues, taken as of the conclusion of the 2011 proxy season.

What Problem Are We Trying to Solve?

Companies that have lived though derivative or other shareholder litigation know that there can be a world of difference between litigating in the Delaware Court of Chancery and in other courts. The Court of Chancery's expertise, both in substantive corporate law and in the procedural aspects of shareholder litigation, combined with its relatively expedited procedures; make it an attractive forum in terms of predictability and, often, expense, even though the court may be far away from the company's principal place of business.

Exclusive forum provisions can in theory be particularly helpful in avoiding the phenomenon of parallel litigations brought in different courts by different plaintiffs. This practice has been particularly noticeable in recent years in the litigation that almost invariably arises from the announcement of public M&A transactions. The plaintiffs' lawyers filing in Delaware will argue that the case should be handled there because the issues often are matters of Delaware law. The other lawyers will say that they filed in the headquarters jurisdiction because the questioned acts occurred there, and the witnesses and documents are likely there as well. How are these parallel proceedings to be managed? Who takes precedence?

There is no standard answer to these questions. Often one court or another takes the initiative and the other acquiesces, thanks to judicial courtesy, inertia or other factors. But these "other factors" can include gamesmanship among counsel, with plaintiffs' firms often engaging in a scrum over who can claim first mover advantage: Who filed first? Who schedules the first hearing? Who brings on the first motion for expedited discovery? The prospect of settlement only compounds the problem, with two or more sets of plaintiffs' lawyers elbowing each other for a seat at the table and the right to claim credit for the settlement. The spectacle is wasteful at best. Exclusive forum provisions should in principle mitigate some of these problems.

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Testing Exclusive Forum Provisions in Court

The early adopters of exclusive forum provisions tended to act via bylaw amendment, which is typically the easiest approach as it can be affected by board action without shareholder approval. But the lack of shareholder approval can be a source of vulnerability. In the sole decided case on the issue, *Galaviz v. Berg*[2], a federal court in California declined to enforce Oracle's Delaware exclusive forum bylaw on the basis that it constituted a "unilateral amendment." The court disagreed with Oracle's argument that a director-adopted bylaw could be enforced in the manner of a contractual exclusive forum provision.

Galaviz can be read broadly for the proposition that board-adopted bylaws are ineffective as a tool to limit shareholder litigation, but a more narrow reading is perhaps equally plausible. The *Galaviz* court highlighted the fact that the Oracle directors, who were the defendants in the shareholder suit, adopted the exclusive forum bylaw *after* the occurrence of the acts that gave rise to the lawsuit, albeit prior to the filing of the case. *Galaviz* might therefore not govern a case where the bylaw was adopted on a "clear day"[3].

2011 Proxy Season Developments

Seeking to strengthen their exclusive forum provisions against *Galaviz*-like challenges, several companies this year proposed exclusive forum charter provisions for shareholder approval, including three large-cap companies: Allstate, Altera and DIRECTV[4] The results so far have been mixed. At Altera and DIRECTV, the proposed amendments were approved by healthy majorities of the votes cast but only narrowly received the majorities of the outstanding shares (50.3% and 53.2%, respectively) required to adopt a charter amendment. At Allstate, however, the exclusive forum amendment was rejected by a majority of the votes cast and received the support of only 41.9 percent of the outstanding shares.

With the issue beginning to appear in proxy statements this year, ISS has been required to take a view on the phenomenon. Rather than assessing the merits of exclusive forum provisions on their own, ISS has yoked the issue to a list of unrelated governance "best practices", including majority voting, annual election of directors, what ISS calls a "meaningful special meeting right" (under which 10 percent shareholders can call a special meeting), and the absence of a poison pill unless approved by shareholders. ISS's stated position is that it will not recommend in favor of an exclusive forum provision unless the company has adopted all of these practices. This year ISS recommended against all three of the large-cap company proposals mentioned above. As is true in other contexts, an ISS negative recommendation is not necessarily fatal, but it does mean you are in for a fight.[5]

Considering an Exclusive Forum Provision

At this moment the overall picture on exclusive forum provisions is a bit murky: while there are potential real benefits, there are lingering questions as to issues such as enforceability and shareholder acceptance. Here is an outline of a thought process for companies considering the issue.

Start with the most basic question: do you think that the company would benefit from an effective exclusive forum provision?[6] While the attractions of the Court of Chancery are real, some companies have concluded that they would rather not be locked into litigating there, as there are cases in which litigating in the home jurisdiction may be preferable.[7] Others may simply not have a strong view about the issue.

If an exclusive forum provision is desirable, how should the company adopt it? Irrespective of whether *Galaviz* is a precedent that other courts will follow, having the provision in the certificate of incorporation will put the company in the strongest position if the provision needs to be enforced. For most companies the

easiest time to obtain shareholder approval is before the IPO, and indeed our survey of companies that have filed for IPOs this year indicates that more than 80% of them have adopted exclusive forum provisions. Companies that are reincorporating or emerging from reorganizations present another opportunity, since in these cases the exclusive forum provision is usually bundled as part of the total governance picture. In fact, of the 80+ companies that have adopted exclusive forum provisions, more than half have done so pre-IPO or in a reincorporation or restructuring.

For companies that are already public and that would be considering an exclusive forum provision on a standalone basis, the optimal path is less clear. The results of the 2011 season demonstrate that shareholder approval of these provisions is far from a foregone conclusion, especially for companies that have not chosen to adopt the full slate of ISS-approved "best practices" for governance. Companies in this situation will need to assess their own context and shareholder base and consider, ultimately, whether this issue is important enough to justify the effort, the change in other governance practices, and the goodwill consumption that may be required to obtain shareholder approval. Many companies will conclude that the game is not worth the candle.

Companies considering submitting the issue to shareholders should be alert to their overall governance context and may wish to couple the exclusive forum provision with other governance changes that may be perceived to be shareholder friendly, such as declassifying the board or permitting shareholders to call special meetings. Altera, DIRECTV and Allstate all took this approach in the 2011 proxy season. It is possible that the halo impact of these other changes (all adopted by strong majorities) helped the Altera and DIRECTV exclusive forum provisions to squeak through. Another approach is to avoid *a la carte* consideration of the issue by having a single vote on an amended certificate of incorporation. Life Technologies took this tactic in 2011, bundling a declassified board with an exclusive forum provision, with the package receiving approval from 72.7 percent of the outstanding shares.

If you have concluded not to seek shareholder approval should you nonetheless consider a board-adopted bylaw amendment? *Galaviz* demonstrates the potential limitations of this path. Even so, the companies that have adopted exclusive forum bylaws appear to have concluded that there is little downside in doing so, since there is as yet no indication that these companies have suffered a backlash as a result. A bylaw has the further advantage of being easily reversible or amendable if circumstances warrant.

Notes

1. A typical exclusive forum provision reads as follows:"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, or other wrongdoing by, any director, officer, or other employee of the Corporation to the Corporation or the Corporation's stockholders, (iii) any action asserting a claim against the Corporation arising pursuant to any provision of the General Corporation Law of the State of Delaware, the Corporation's Certificate of Incorporation or its By-Laws, or (iv) any action to interpret, apply, enforce or determine the validity of the Corporation's Certificate of Incorporation or By-Laws, or (v) any action asserting a claim against the Corporation governed by the internal affairs doctrine. Any person or entity purchasing or otherwise acquiring any interest in shares of stock of the Corporation shall be deemed to have notice of and consented to the provisions of this Article."

2. N.D. CA, No. C 10-3392-RS (Jan. 3, 2011).

3. The shareholders in *Galaviz* held shares before the exclusive forum bylaw was adopted, and so the court did not address whether shareholders who acquired shares after the amendment would be deemed to have consented to the exclusive forum clause. An exclusive forum bylaw, such as the sample provided in note 1, should have language related to notice and deemed consent of the shareholders in order to address this issue and make enforcement more likely.

4. Two other large cap companies adopted exclusive forum provisions that were bundled with a broader set of amendments: Life Technologies, which eliminated its classified board, and Williams Sonoma, which reincorporated from California to Delaware.

5. One factor that makes obtaining shareholder approval a bit easier is that, at least for now, the New York Stock Exchange takes the view that these proposals are "routine" and therefore eligible for voting by brokers on behalf of customers who have not otherwise provided instructions.

6. For a thoughtful analysis of the issues, see Joseph Grundfest, Choice of Forum Provisions in Intra-Corporate Litigation: Mandatory and Elective Approaches (The 2010 Pileggi Lecture, October 8, 2010), Rock Center for Corporate Governance at Stanford University Working Paper No. 91 (2010).

7. Most of the recently adopted provisions, as in the example provided in note 1, are "elective", meaning that the company has the option to consent to litigation elsewhere. But an exclusive forum provision creates a default preference for Delaware, and the standard for review of a board decision to opt out of Delaware is not clear. In any case, of course, even a "mandatory" provision can in practice be elective if the company chooses not to enforce it.