CUG.COMments

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Underwriters of D & O and Professional Liability Insurance

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….This issue of CUG.COMments looks at exclusive-forum provisions.

INTRODUCTION

Should corporations be able to dictate where intra-company lawsuits can be filed through enactment of "exclusive-forum provisions?" Before 2010, exclusive-forum provisions in corporate documents were effectively non-existent. According to a paper by Professor Joseph A. Grundfest of Stanford Law School, prior to March 2010 only sixteen publicly-traded companies had forum selection provisions in either their corporate charters or bylaws.

Two years later, the outcome of two lawsuits over exclusive-forum provisions is a closely watched development in corporate law, with implications for companies, their shareholders, plaintiff and defense attorneys and D&O insurers. How did exclusive- forum provisions move from anonymity to center stage?

BACKGROUND

What are exclusive-forum provisions?
These provisions, when contained in a corporation's bylaws or its certificate of incorporation (sometimes called the charter or articles of incorporation) mandate that disputes between constituents of the same company —intra-company disputes— must be brought in a predetermined legal forum, generally the state of the company's incorporation, which in practice is often Delaware.

Disputes falling within such provisions generally include derivative shareholder actions brought by shareholders on behalf of the corporation and actions alleging breach of fiduciary duty owed by directors and officers to the corporation or its shareholders.

It should be noted that exclusive-forum provisions generally do not apply to class actions alleging violations of federal securities laws because federal statutes require those class action lawsuits to be heard in the federal court system. Plaintiffs in those cases cannot choose between competing state court systems when filing their claims.

March 16, 2010: the Revlon Dicta
In his opinion issued *In re Revlon Inc. Shareholders Litigation*, Vice Chancellor Laster of the Delaware Chancery Court made this seemingly innocuous statement:

> *If boards of directors and stockholders believe that a particular forum would provide an efficient and value-promoting locus for dispute resolution, then corporations are free to respond with charter provisions selecting an exclusive forum for intra-entity disputes.*

This suggestion received further encouragement in a lecture delivered by Professor Grundfest to the Delaware Bar in October of 2010. Public corporations, said Professor Grundfest, should consider exclusive-forum provisions either through a shareholder-approved charter amendment or a bylaw amendment. "How can this hurt?" concluded Professor Grundfest.

Someone was paying attention: by the end of 2011, according to one commentator, nearly 200 Delaware corporations had adopted various forms of exclusive-forum provisions, many of them included in pre-IPO company documents and thus largely protected from shareholder challenges.

The appeal of exclusive-forum provisions

What makes exclusive-forum provisions attractive? Part of the answer lies in the surge in multi-jurisdictional state law shareholder lawsuits, such as derivative lawsuits for mismanagement or class actions triggered by merger and acquisition transactions. According to a report by Cornerstone Research, in 2011 ninety-six percent of all M&A deals valued at over $500 million were subject to litigation, up from fifty-six percent in 2007. The general premise behind these lawsuits, which typically target directors of the acquired company, is that the defendants did not do enough to maximize shareholder value from the sale.

While multi-jurisdictional state court lawsuits have been a feature of corporate litigation for decades, the frequency and settlement severity of these parallel lawsuits became more problematic only in the last few years as more plaintiff lawyers search for more ways to recover a fee in shareholder litigation. Unlike the federal court system, there is no mechanism to combine several comparable lawsuits filed in different states into one proceeding in one state court. As a result, one set of alleged wrongdoing can spawn multiple state court cases by multiple plaintiff attorneys, all of whom are seeking a fee for prosecuting essentially the same claim.

An exclusive-forum provision seeks to eliminate the risk of defending the same claims in multiple state courts. If successful, such a result would accomplish two things. First, the defendants would avoid the time and expense of defending multiple suits and the risk of inconsistent results in those suits. Second, assuming the provision selects Delaware as the exclusive forum, litigation could be prosecuted only in Delaware Chancery Court, which generally provides an experienced and thoughtful approach to business disputes. Both of these goals would be largely counter to the interests of the plaintiffs' bar.

2012: THE PLAINTIFFS' BAR STRIKES BACK

Faced with the growth in the number of exclusive forum provisions adopted by corporations, the plaintiffs' bar picked up the gauntlet. Early in 2012, shareholder lawsuits against sixteen companies that had or were planning to adopt exclusive-forum provisions were filed in Delaware. Twelve were against companies that had or proposed to add exclusive-forum provisions into their bylaws, while four were filed against companies that proposed to add the provision to their corporate charters through shareholder approval.

Prior case law regarding the validity of those provisions is scarce and not definitive. For example, in 2011 a federal court in California refused to enforce an exclusive-forum provision adopted by Oracle Corporation in its bylaws. This rejection of the provision was due partly to the absence of shareholder approval for the provision. It is not clear how the court would have ruled if shareholders had approved the provision:

> *Certainly, were a majority of shareholders to approve such a charter amendment, the arguments for treating the venue provision like those in commercial contracts would be much stronger, even in the case of a plaintiff shareholder who had personally voted against the amendment.*

The court's analysis may have been colored by the fact that the bylaws amendment had been quickly passed following allegations of wrongdoing against certain directors. This could be seen as trying to move the goal posts while the ball was in the air.

The Delaware lawsuits: defendant companies respond

Perhaps in response to the Oracle decision, most of the companies responded to the Delaware lawsuits by abandoning the exclusive-forum provision. Ten of the twelve companies adding the provision to their bylaws withdrew the amendments, and three of the four companies that had proposed charter amendments have scrapped their plans.

The two remaining suits involving a bylaw provision are against Chevron Corporation, which has already diluted its exclusive-forum provision by adding exceptions for certain circumstances, and FedEx Corporation. Both cases are in their initial phases and it is unclear whether they will be actively litigated in the Delaware Chancery Court.

The one remaining suit involving a charter provision is against Cameron International, which submitted the proposed provision for shareholder approval at its May 11, 2012 annual shareholders meeting. The proposal was defeated. As a result, the lawsuit now appears moot.

SUMMARY

Notwithstanding Professor Grundfest's suggestion to adopt exclusive-forum provisions by amending either bylaws or charters, it seems that the tide may be turning against a unilateral change to the bylaws that does not involve a say from shareholders.

If and when the Delaware Chancery Court addresses this issue either in the pending Chevron and FedEx cases or in some future case, the Court may support an exclusive-forum provision adopted by shareholders, but it seems doubtful the Court will support a unilateral bylaw provision adopted without shareholder approval. Courts in other states seem less likely to support even a shareholder-approved provision since the provision would probably prevent a suit in that other state. In any event, the recent vote at the Cameron International annual meeting shows that even if companies are permitted to put the matter to shareholders, approval is far from assured. At least one shareholder advocate body, the Council of Institutional Investors, has stated its formal opposition to exclusive-forum provisions in its corporate governance policy.

The exclusive-forum saga is the latest skirmish in the continuing battle between shareholder attorneys and corporations. The frequency of traditional federal securities class action lawsuits has remained relatively constant for several years: the Stanford Law School web site shows the number hovering around the 200 mark since 2005. In their pursuit of new revenue sources, the plaintiffs' bar has been filing more suits in state courts, where they can better select their preferred forum and even duplicate other suits already being prosecuted in another state. Managing those increasingly popular multi-jurisdictional suits will be a major challenge for defendants in the years to come.

By definition, these state court cases must assert state law claims. Therefore, the primary focus of these suits is alleged breaches of fiduciary duty by directors and officers. Typically, those claims are asserted on behalf of a company in shareholder derivative suits against the director and officer defendants. To further aggravate the exposures to the defendants in those derivative suits, any settlement or judgment in those derivative suits is not indemnifiable by the company under the laws of most states. Therefore, this trend toward increased state court claims further emphasizes the importance of companies maintaining high quality Side A-only D&O insurance policies. ❖

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