

Circuits split on whether derivative Section 14 claims are subject to Delaware Court of Chancery forum bylaws

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On May 13, 2022, the 9th U.S. Circuit Court of Appeals held that a corporate bylaw requiring stockholders to bring derivative claims in the Delaware Court of Chancery could be applied to claims brought derivatively under Section 14(a) of the Securities Exchange Act of 1934 (Exchange Act). (*See Lee v. Fisher*, No. 21-15923, 2022 WL 1511322 (9th Cir. May 13, 2022)). The 9th Circuit's decision creates a split with the 7th U.S. Circuit Court of Appeals on the issue. (*Compare id.*, with *Seafarers Pension Plan ex rel. Boeing Corp. v. Bradway*, 23 F.4th 714 (7th Cir. 2022)).

While the 9th Circuit's approach to this question is persuasive, until the split is resolved, litigants will continue to dispute whether Delaware Court of Chancery bylaws can be applied in lawsuits asserting derivative Section 14(a) claims, and derivative plaintiffs may shop for jurisdictions taking the 7th Circuit's side in the split.

Like many Delaware corporations, The Gap, Inc.'s bylaws contain a forum selection clause requiring stockholders to file "any derivative action or proceeding brought on behalf of the Corporation" in the Delaware Court of Chancery. In *Lee v. Fisher*, notwithstanding this forum bylaw, Gap stockholder Noelle Lee brought a putative derivative action against the company's directors in the U.S. District Court for Northern District of California, alleging that the board had permitted the company to violate Section 14(a) of the Exchange Act by making false statements in proxy statements filed with the SEC about the level of diversity the company had achieved.

Lee argued that the forum bylaw requiring adjudication in Delaware state court could not be enforced against her because federal courts have exclusive jurisdiction over Section 14(a) claims under the Exchange Act. Therefore, enforcing the bylaw would prevent her from bringing a derivative Section 14(a) claim in any court. The district court rejected this argument and dismissed Lee's suit.

The 9th Circuit affirmed. The court held that no provision in the Exchange Act — including its provisions prohibiting contracts that waive compliance with the Exchange Act, and giving federal district courts exclusive jurisdiction over Exchange Act claims — articulates a federal policy against enforcing forum selection clauses because such enforcement might leave stockholder plaintiffs with no forum to bring derivative Section 14(a) claims.

The court reasoned that Lee failed to demonstrate that "she could not get any relief in the Delaware Court of Chancery" if she could not bring a derivative Section 14(a) claim. Therefore, enforcing the forum bylaw would not leave her without a forum to bring a derivative claim and redress alleged injury to the company.

Until the split is resolved, litigants will continue to dispute whether Delaware Court of Chancery bylaws can be applied in lawsuits asserting derivative Section 14(a) claims, and derivative plaintiffs may shop for jurisdictions taking the 7th Circuit's side in the split.

As the 9th Circuit acknowledged, the decision in *Lee* is contrary to the 7th Circuit's recent decision in *Seafarers Pension Plan ex rel. Boeing Corp. v. Bradway*.

In *Seafarers*, Boeing moved to dismiss a derivative Section 14(a) claim based on a Delaware Court of Chancery forum selection bylaw that was nearly identical to The Gap's. The district court granted the motion, but the 7th Circuit reversed. The 2-1 panel majority held that Delaware Court of Chancery forum selection bylaws cannot be enforced when a plaintiff brings derivative Section 14(a) claims for two principal reasons.

First, the majority held that Delaware law does not permit forum selection bylaws to apply to claims subject to exclusive federal jurisdiction. The court cited legislative history for Delaware General Corporation Law Section 115 — the statute authorizing forum selection bylaws — stating that Section 115 was "not intended to authorize a provision that purports to foreclose suit in a federal court based on federal jurisdiction."

Second, the majority held that allowing Boeing's bylaw effectively to foreclose derivative Section 14(a) claims would be contrary to

federal policy, which disfavors contractual provisions that purport to prospectively waive liability for federal statutory violations. In reaching this conclusion, the court rejected Boeing's argument (later accepted by the 9th Circuit) that enforcing the bylaw would not impair stockholder rights because the stockholder could bring state law fiduciary duty claims asserting the same theory as the stockholder would pursue in bringing a derivative Section 14(a) claim.

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The court distinguished prior cases holding that forum selection clauses can require securities plaintiffs to bring their claims in foreign countries as long as adequate remedies would be available under foreign law. The court concluded that those cases only apply when the forum selection clause specifies a foreign forum, and that the adequacy of state law remedies is not a sufficient reason to enforce a forum selection bylaw that limits the availability of federal claims.

Although the 7th and 9th Circuits' dueling opinions raise issues on which reasonable minds could disagree, the 9th Circuit appears to have the better of the argument. To start with, the 9th Circuit is likely correct that Delaware Court of Chancery bylaws do not meaningfully diminish stockholder rights just because they may preclude a stockholder from bringing a derivative Section 14(a) claim.

A derivative Section 14(a) claim asserts that the corporation's directors and officers harmed the corporation by making misleading disclosures in a proxy statement filed with the SEC that led stockholders to approve a decision that damaged the corporation. Such a suit seeks to force the directors and officers to pay the corporation damages for the value it supposedly lost when stockholders approved the harmful decision.

Stockholders frequently litigate this same basic type of claim in the Delaware Court of Chancery under the law of fiduciary duties, and that court is fully capable of ordering relief sufficient to compensate the corporation for any harm it may have suffered.

Therefore, because the stockholder has the option to raise the same theory seeking the same recovery through a derivative

claim for breach of fiduciary duty that he or she would bring in a derivative Section 14(a) claim, it is hard to see how the stockholder loses anything substantial by being required to bring all derivative claims in the Delaware Court of Chancery. Indeed, to the contrary, enforcing forum selection bylaws benefits all stockholders by concentrating derivative litigation in a single forum, which eliminates the waste associated with duplicative multi-forum litigation.

The 7th Circuit considered the availability of adequate alternative state law remedies irrelevant, because the Exchange Act prohibits any contract "binding any person to waive compliance with any provision" of the Exchange Act, 15 U.S.C. § 78cc(a), and the court considered Boeing's bylaw to function effectively as a waiver of derivative Section 14(a) claims. But it may be going too far to treat Delaware Court of Chancery bylaws as de facto waivers, given that the corporation could likely obtain the same recovery for the same injury in the Court of Chancery as it could obtain by suing in federal court under Section 14(a).

Moreover, it is not clear that the 7th Circuit was correct in concluding that Delaware law prohibits forum bylaws that apply to derivative Section 14(a) claims. As the 7th Circuit accurately noted, DGCL Section 115 was "not intended to authorize a provision that purports to foreclose suit in a federal court based on federal jurisdiction."

But, as Judge Frank H. Easterbrook argued in his dissent in *Seafarers*, a Delaware Court of Chancery bylaw does not prevent a stockholder from bringing a direct Section 14(a) claim in federal court to remedy his own injury from a misleading proxy statement. Nor does the bylaw prevent the corporation from bringing a direct Section 14(a) claim in federal court to remedy any injury it may have suffered.

While a Delaware Court of Chancery bylaw might prevent a stockholder from bringing a *derivative* Section 14(a) claim in the corporation's name without its consent, the right to bring derivative claims is a function of state, not federal, law. (See *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90 (1991)). Therefore, it is difficult to see how enforcing a Delaware Court of Chancery bylaw "foreclose[s] suit in a federal court based on federal jurisdiction." (DGCL Section 115)

In light of the split between the 7th and 9th Circuits, litigants will certainly continue to dispute whether Delaware Court of Chancery bylaws may be applied in cases where the plaintiff brings a derivative Section 14(a) claim, and other appellate courts may be called upon to weigh in on the issue. It will be interesting to study whether this split leads to overt forum shopping by stockholders seeking jurisdictions that follow the 7th Circuit's approach.

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