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Commercial division update: When forum selection clauses collide with the internal affairs doctrine

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Historically, New York courts have viewed the internal affairs doctrine as strict and mandatory; however, they have recently softened this approach and apply a more discretionary standard. This article examines the evolution of these judicial approaches and recent Commercial Division cases reflecting their application.

Contracts frequently contain forum selection clauses that determine the venue for litigating disputes arising in connection with that contract. The inclusion of a forum selection clause can make future litigation more predictable by enabling the parties to hire appropriate counsel and understand the selected jurisdiction's applicable rules. While such clauses are generally enforceable in New York, very narrow grounds exist for their non-enforcement.

One basis on which New York courts have refused to enforce a forum selection clause is where it conflicts with the internal affairs doctrine. The internal affairs doctrine directs that issues concerning the internal affairs of a corporate entity should be determined by the law of its place of incorporation and by the courts of that forum, regardless of any conflicting choice of law clause or venue selection clause in the contract at issue.

Historically, New York courts have viewed the internal affairs doctrine as strict and mandatory. In more recent years, however, they have softened this approach and apply a more discretionary standard. In fact, a number of decisions have adopted an approach that makes the internal affairs doctrine only one factor to consider in an overall forum non conveniens analysis.

We examine below the evolution of these judicial approaches and the recent Commercial Division cases reflecting their application.

Appellate precedent

Under New York law, "[a] contractual forum selection clause is prima facie valid and enforceable unless it is shown by the challenging party to be unreasonable, unjust, in contravention of public policy, invalid due to fraud or overreaching, or it is shown that a trial in the selected forum would be so gravely difficult that the challenging party would, for all practical purposes, be deprived of its day in court.'" *Molino v. Sagamore*, 105 A.D.3d 922, 923 (2d Dep't 2013).

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Demonstrating the narrowness of the grounds for unenforceability of a forum selection clause, in *Freeford v. Pendleton*, 53 A.D.3d 32 (1st Dep't 2008), the First Department enforced a New York forum selection clause in a shareholder agreement against certain defendants who were parties to that agreement, even though none of the parties resided in New York and none of the alleged conduct took place in New York.

Separately, New York courts have long recognized the internal affairs doctrine as a reason to decline New York jurisdiction over disputes involving the regulation and management of the internal affairs of a foreign corporation.

For example, in a case that did not involve a forum selection clause, the First Department denied jurisdiction based on the internal affairs doctrine, reasoning that "where the controversy relates solely to the management of the internal affairs of a foreign corporation, it [is] the settled policy of our courts to decline jurisdiction," and that "[s]uch questions should be litigated in the courts of the State where the corporate defendant was organized." *Nothiger v. Corroon & Reynolds*, 266 A.D. 299, 300 (1st Dep't 1943), *aff'd*, 293 N.Y. 682 (1944).

The Second Department has explained that the internal affairs doctrine is "a 'conflict of laws principle which recognizes that only one state should have the authority to regulate a corporation's internal affairs—matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders—because otherwise a corporation could be faced with conflicting demands.'" *Mason-Mahon v. Flint*, 166 A.D.3d 754, 756 (2d Dep't 2018).

Where applicable, New York courts historically viewed the internal affairs doctrine as mandating that New York courts decline jurisdiction. *See, e.g., Langfelder v. Universal Laboratories*, 293 N.Y. 200, 204 (1944). However, later cases characterized it as a discretionary factor to be considered. In *Broida v. Bancroft*, 103 A.D.2d 88 (2d Dep't 1984), the Second Department carefully analyzed the evolution of this doctrine:

> Older cases tended to view the doctrine as jurisdictional, justifying the refusal to entertain such litigation on the premises that it was inadvisable to interpret the law of another State, that the possibility of conflicting decisions should be avoided, and that the court's judgment might not be enforceable elsewhere (see Ann., 155 ALR 1231, 1233-1235; Comment, Forum Non Conveniens as a Substitute for the Internal Affairs Rule, 58 Col L Rev 234, 234-235).

The court noted that the validity of the internal affairs doctrine was questioned by the U.S. Supreme Court in *Williams v. Green Bay & Western Railroad*, 326 U.S. 549 (1946), and abrogated entirely in the federal courts one year later in *Koster v. Lumbermens Mutual*, 330 U.S. 518, 527 (1947), where the court held that the internal affairs rule "is not entitled to separate status and should be treated as one facet under general principles of forum non conveniens." Accordingly, the Second Department concluded:

> We therefore hold that a suit which concerns the internal affairs of a foreign corporation should be entertained unless the same factors that would lead to dismissal under *forum non conveniens* principles suggest that New York is an inconvenient forum and that litigation in another forum would better accord with the legitimate interests of the litigants and the public (citation omitted).

Notably, the internal affairs doctrine has also been found to require the application of the law of the place of incorporation despite the existence of a contrary choice of law provision. *See, e.g., BBS Norwalk One v. Raccolta*, 60 F. Supp. 2d 123, 129 (S.D.N.Y. 1999), *aff'd*, 205 F.3d 1321 (2d Cir. 2000); *Om Investments v. E.S.P. Das,* No. 650936/2011, 2012 WL 10008054 (N.Y. Co. May 16, 2012).

Commercial division application

Commercial Division decisions have built upon this judicial evolution.

In re Topps Co. Shareholder Litigation., No. 600715/2007, 2007 WL 5018882 (N.Y. Co. June 8, 2007) involved a merger agreement by which a private equity group agreed to purchase The Topps Company Inc., a publicly traded Delaware corporation. A day later, a shareholder class action was filed in New York state court seeking to enjoin the transaction, asserting breaches of fiduciary duty in Topps' acceptance of an alleged below value purchase price. Subsequent shareholder class actions were filed in Delaware.

The merger agreement contained a New York forum selection clause. The defendants moved to dismiss or stay the Delaware action. The Delaware court denied defendants' motion, finding that New York law required the New York court to decline jurisdiction over the claims as they involved the determination of rights concerning the internal affairs of the defendant, a Delaware corporation, citing *Langfelder v. Universal Laboratories*, 293 N.Y. 200 (1944), and *Rogers v. Guaranty Trust Co. of New York*, 288 U.S. 123 (1933).

In reliance on the Delaware court's opinion, the defendants moved to dismiss the New York action.

However, the Delaware court's belief was based on outdated principles of New York law, and the defendants' motion was denied. In denying the motion, Justice Herman Cohn of the New York County Commercial Division recognized the strictness of the application of the internal affairs doctrine in older cases, and then went on to say that later New York cases have held that the application of the internal affairs doctrine is discretionary, allowing courts to balance the convenience and the relative interests of the states involved. *See generally Hart v. General Motors*, 129 A.D.2d 179, 182 (1st Dep't 1987); *Broida v. Bancroft*, 103 A.D.2d 88, 90-92 (2d Dep't 1984).

The court further relied on U.S. Supreme Court precedent in the *Williams v. Green Bay* case, which, as discussed above, held that, under federal law, the internal affairs doctrine should be treated as one factor in the forum non conveniens analysis.

Using that approach, the court denied the motion, finding that the only connection the case had to Delaware was that it was Topps' state of incorporation. It held that, while there was no question that Delaware law applied to certain aspects of the claims, New York contract law may also come into play given the New York choice of law provision in the merger agreement.

Two months ago, the Commercial Division was called upon to address this situation again. *DBI Lease Buyback Servicing, et al. v. Mullen Automotive*, No. 651110/2023, 2023 WL 5575649 (N.Y. Co. Aug. 30, 2023) involved a claim that the defendant, a Delaware limited liability company, improperly refused to provide the plaintiff an option for the purchase of up to $25 million in defendant's convertible preferred stock and an attendant warrant, as allegedly required by a letter agreement.

The plaintiff alleged that the defendant had stymied compliance with that agreement through amendments to its Delaware Charter and changes to its capital structure. In asserting that New York was the proper forum, the plaintiff relied on the mandatory New York forum selection clause in the letter agreement at issue.

The defendant countered that the Delaware Chancery Court was the exclusive forum for plaintiff's claims based on the Delaware forum selection clause in the defendant's charter, as well as under New York's internal affairs doctrine. In holding that the internal affairs doctrine mandated dismissal, Justice Margaret Chan of the New York County Commercial Division quoted the Court of Appeals decision in *Langfelder v. Universal Laboratories*, 293 N.Y. 200, 204 (1944), as follows:

> [J]urisdiction in any case will be declined… where a determination of the rights of litigants involves regulation and management of the internal affairs of the corporation dependent upon the laws of the foreign State or where the court in which jurisdiction is sought is unable to enforce a decree if made or where the relief sought may be more appropriately adjudicated in the courts of the State or country to which the corporation owes its existence.

The court went on to explain:

> [R]ights of third parties, whether they happen to be stockholders or not, if the rights are such as they are recognized by our laws, may be enforced by our courts, unless they relate to such internal affairs of the corporation as ought to be regulated only by the courts of the state or country to which it owes its existence.

Significantly, the court found that the internal affairs doctrine required the case to be litigated in Delaware regardless of whether New York law considers the internal affairs doctrine to be mandatory, citing *Cohn v. Mishkoff-Costlow Co.*, 256 N.Y. 102, 105 (1931), or discretionary, citing *Broida v. Bancroft*, 103 A.D.2d 88, 91 (2d Dep't 1984).

In conducting this analysis, courts need to make a threshold determination as to whether the internal affairs doctrine is even implicated. In *DBI*, the plaintiffs argued that it was a "simple contract suit" involving a breach of the letter agreement, which was governed by New York law. The court disagreed, reasoning that:

> Courts have declined jurisdiction in cases involving foreign corporations in which plaintiffs have sought a declaration of rights with respect to their stock following a merger, to compel the redemption of stock or payment of dividends, [and] a declaration that would have the effect of altering the corporate structure or forcing dissolution.

Other cases have held that, while the internal affairs doctrine applies to relationships between a company and its directors and shareholders, it does not apply to determine the rights of third parties external to the corporation. *See 79 Madison v. Ebrahimzadeh*, 203 A.D.3d 589, 590 (1st Dep't 2022).

Courts have also held that, while the substantive law of the place of incorporation applies to the entity's internal affairs, the procedural law of the forum state applies. *See Mason-Mahon v. Flint*, 166 A.D.3d 754, 756 (2d Dep't 2018).

Conclusion

In drafting forum selection clauses, contracting parties need to be mindful of the potential impact of the internal affairs doctrine when the contemplated forum to be selected is not the place of incorporation. While these Commercial Division decisions reflect a more discretionary approach to applying the internal affairs doctrine than in the past, they nevertheless caution about the risk that a forum selection clause may fail. As noted above, the same can be true for a contractual choice of law provision if it specifies different law than the law of the place of incorporation.