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Delaware Supreme Court Upholds Forum Selection for Securities Act Claims

Charter Mandating That Federal Securities Act Claims Be Filed in Federal Courts Held to Be Permissible Under Section 102(b)(1) of the Delaware General Corporation Law and Thus Facially Valid

SUMMARY

In a widely anticipated decision issued March 18, 2020, in *Salzberg* v. *Sciabacucchi*, the Delaware Supreme Court reversed the Delaware Court of Chancery and held that Delaware law permits corporations to include in their certificates of incorporation federal forum provisions ("FFPs") that require shareholder actions asserting claims under the federal Securities Act of 1933 (the "Securities Act") to be filed exclusively in a federal court.[1] In rejecting a facial challenge to the validity of three similarly worded FFPs, Delaware's highest court ruled that the FFPs were permissible topics for regulating internal or intra-corporate affairs in Delaware corporate charters and that the FFPs did not violate any positive Delaware law or public policy. Although recognizing that FFPs remained potentially subject to challenge on an as-applied basis or under federal law, and that whether FFPs would be enforced in other state courts is uncertain, the Delaware Supreme Court in a carefully worded, 53-page decision provided some of the reasons why FFPs comport with federal law and should be honored by courts in other states just like any other forum-selection contract. The *Salzberg* decision provides much-needed guidance regarding the ability of Delaware corporations to utilize FFPs to avoid concurrent state and federal actions asserting the same Securities Act claims, which corporations have faced increasingly since the United States Supreme Court's 2018 decision in *Cyan* barring removal of Securities Act claims filed in state courts.[2]

BACKGROUND

Prior to filing registration statements with the United States Securities and Exchange Commission ("SEC") in connection with their initial public offerings, three Delaware companies—Blue Apron Holdings, Inc., Stitch

Fix, Inc., and Roku, Inc.—each adopted a provision in its corporate charter requiring actions asserting claims under the Securities Act to be filed in a federal court. The Securities Act creates a private right of action for purchasers of securities against, among others, issuers for any material misstatements or omissions contained in a registration statement or prospectus.[3] The Securities Act expressly provides that shareholders may bring suit in either federal or state court.[4] Following the enactment of the Securities Litigation Uniform Standards Act in 1998, federal courts were split regarding whether Securities Act claims filed in state court could be removed to federal court. In 2018, the United States Supreme Court resolved that split in *Cyan, Inc.* v. *Beaver County Employees Retirement Fund*, and ruled that Securities Act claims filed in state court cannot be removed to federal court.[5]

Since that decision, there has been a significant increase in the number of Securities Act cases filed in state court where significant procedural protections that apply in federal courts, including a mandatory stay of discovery, may not be available. Relatedly, issuers have faced a substantial increase in duplicative state and federal Securities Act cases. As the Delaware Supreme Court explained, "[w]hen parallel state and federal actions are filed, no procedural mechanism is available to consolidate or coordinate multiple suits in state and federal court."[6] The *Salzberg* decision emphasized these developments, noting that one report states that "[a]bout 45 percent of all state [Securities] Act filings in 2019 had a parallel action in federal court."[7]

In response to the duplication of Securities Act cases in state courts, several Delaware companies—including the three at issue in *Salzberg*—adopted provisions in their charters specifying that Securities Act claims could be brought only in a federal forum. For example, the FFP adopted by Roku states:

> Unless the Company consents in writing to the selection of an alternative forum, the federal district courts of the United States of America shall be the exclusive forum for the resolution of any complaint asserting a cause of action arising under the Securities Act of 1933. Any person or entity purchasing or otherwise acquiring any interest in any security of [the Company] shall be deemed to have notice of and consented to [this provision].[8]

These FFPs, initially conceived by Stanford Law School Professor and former SEC Commissioner Joseph Grundfest (and at times dubbed the "Grundfest Solution"),[9] provide a mechanism for Delaware corporations to avoid the uncertainty and inefficiency of having to defend against parallel Securities Act actions in multiple jurisdictions potentially subject to differing procedural rules and substantive law.

The plaintiff in *Salzberg* bought shares of common stock of each of the three companies, either in the initial public offering or shortly thereafter, and then filed a putative class-action complaint in the Delaware Court of Chancery seeking a declaratory judgment that the FFPs in the companies' charters are invalid under Delaware law.[10]

The Court of Chancery granted summary judgment in favor of the plaintiff, concluding that the "constitutive documents of a Delaware corporation cannot bind a plaintiff to a particular forum when the claim does not

involve rights or relationships that were established by or under Delaware's corporate law."[11] The Court of Chancery held that because the FFPs "attempt to accomplish that feat," they are "ineffective and invalid."[12]

THE DELAWARE SUPREME COURT'S DECISION

In a unanimous *en banc* decision issued on March 18, 2020, the Delaware Supreme Court reversed the Court of Chancery and upheld the facial validity of FFPs.

The Court first looked to the text of Section 102 of the DGCL, which "govern[s] the matters contained in a corporation's certificate of incorporation."[13] The Court explained that Section 102(b)(1) "authorizes two broad types of provisions: *any* provision for the management of the business and for the conduct of the affairs of the corporation," and "*any* provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders . . . if such provisions are not contrary to the laws of this State."[14]

After noting the "obvious" costs, inefficiencies and potential for inconsistent judgments incident to multi-fora litigation, the Court found that the FFPs served important corporate purposes by reducing costs, inefficiencies and inconsistencies, while affording litigants a convenient federal forum with greater securities law experience.[15] In light of the uptick in state court and parallel federal proceedings in Securities Act cases since *Cyan*, the Court explained that "[b]y directing [Securities] Act claims to federal courts whe[re] coordination and consolidation are possible, FFPs classically fit the definition of a provision 'for the management of the business and for the conduct of the affairs of the corporation.'"[16] The Court further explained that "[a]n FFP would also be a provision 'defining, limiting and regulating the powers of the corporation, the directors and the stockholders,' since FFPs prescribe where current and former stockholders can bring [Securities Act] claims against the corporation and its directors and officers."[17] Because the FFPs easily fell within the broad scope of Section 102(b)(1), the Court concluded that such provisions are "facially valid."[18]

The Court further held that the FFPs were not in facial conflict with other Delaware laws. The Court rejected the plaintiff's primary argument that the FFPs conflicted with Section 115 of the DGCL, which "preclude[s] a charter or bylaw provision from excluding Delaware as a forum for internal corporate claims," because Securities Act claims are not "internal corporate claims," but are (or may be) "intra-corporate claims" as to which "Section 115 does not apply."[19] The Court reasoned that Delaware cases had made clear distinctions between internal corporate claims, intra-corporate claims, and wholly external claims. The former two categories of claims may properly be the subject of regulation in the charter; only the latter category of "external claims" are on their face entirely outside the purview of corporate charters. The Court did not elaborate on the contours of "external claims," but noted that a prior decision had provided as examples "a tort claim for personal injury suffered by the plaintiff on the premises of the company or a contract claim involving a commercial contract."[20]

Finally, while it did not need to go further in order to reject the plaintiff's facial challenge to the FFPs, the Delaware Supreme Court included an extensive discussion of why FFPs do not on their face violate federal law and should be enforced by courts in other states. The Court pointed to *Rodriguez de Quijas* v. *Shearson/American Express, Inc.*, 490 U.S. 477 (1989), which "upheld an arbitration provision in a brokerage firm's standard customer agreement that precluded state court litigation of Securities Act claims," as "forceful support for the notion that FFPs do not violate federal policy by narrowing the forum alternatives available under the Securities Act."[21] Although the Court recognized that "[p]erhaps the most difficult aspect of this dispute" is "the 'down the road' question of whether [FFPs] will be respected and enforced by our sister states,"[22] the Court reasoned that FFPs should be treated like any contract between the company and its stockholders with a forum-selection provision. The Court thus concluded that "there are persuasive arguments . . . that a provision in a Delaware corporation's certificate of incorporation requiring [Securities Act] claims to be brought in a federal court does not offend principles of horizontal sovereignty—just as it does not offend federal policy."[23] Of course, like any charter provision or forum-selection provision, there are "important safety valve[s]" that might justify holding a specific FFP invalid or unenforceable, such as where (i) a provision is "adopted or used for an inequitable purpose"; (ii) enforcement in a particular instance would be "unreasonable and unjust"; (iii) the provision is "invalid for reasons such as fraud or overreaching"; or (iv) enforcement of the provision would "contravene a strong public policy of the forum in which suit is brought, whether declared by statute or by judicial decision."[24] Those as-applied arguments, however, were not grounds for finding the FFPs facially invalid.

IMPLICATIONS

Although the *Salzberg* decision does not answer all questions, it is significant in that it validates the ability of a Delaware corporation, as a matter of Delaware law, to adopt a charter provision directing that all Securities Act claims brought by shareholders be filed in federal court. This clarity would, if upheld in other jurisdictions, give companies, and their boards, a potentially powerful tool to counter the growing trend of shareholders represented by different lawyers filing the exact same Securities Act claims in both state and federal court. The existence of such parallel lawsuits is highly burdensome for companies because different substantive laws and procedural rules may apply in state and federal courts and there is no mechanism to coordinate or consolidate the actions. Indeed, the *Salzberg* decision acknowledges that "FFPs are a relatively recent phenomenon designed to address the post-*Cyan* difficulties presented by multi-forum litigation of Securities Act claims."[25] In finding that such provisions are not inconsistent with Delaware law, the Delaware Supreme Court reaffirms that the "DGCL was intended to provide directors and stockholders with flexibility and wide discretion for private ordering and adaptation to new situations."[26] And although the FFPs at issue in *Salzberg* had been adopted in each company's certificate of incorporation prior to the company's IPO, there is nothing in the Court's decision that would suggest a different result with respect to the facial validity of an FFP adopted by amendment to a company's charter.[27]

The decision, however, resolves only a facial challenge to the validity of FFPs in the charters of Delaware corporations. The decision leaves open for future cases important questions regarding the scope and enforceability of particular FFPs in particular situations, as well as their validity as a matter of federal law. Among these questions:

1. Although the Court explained its view as to why FFPs comport with federal policy, *Salzberg* does not resolve the validity of FFPs under federal law. The SEC has frequently required companies to disclose the uncertain enforceability of FFPs to Securities Act claims.[28]

2. In rejecting the plaintiff's facial challenge to the FFPs, the Delaware Supreme Court needed to find only that the FFPs could validly apply to some claim. The Court concluded that standard was easily met because the FFPs could validly apply to a claim by "existing stockholders" against directors "relating to shares of stock the directors were selling in a registered offering."[29] While the reasoning of the *Salzberg* decision supports a broad application of FFPs, it is not certain that Delaware courts would uphold FFPs for all Securities Act claims, including, for example, claims against underwriters or selling shareholders, or suits not involving common stock.

3. As the decision recognizes, there is no guarantee that other state courts will defer to the Delaware Supreme Court's decision or adopt its reasoning.[30] The Court observed, however, that the virtual universal acceptance among state courts of forum-selection bylaws mandating that all internal corporate claims be brought in what could be a distant and inconvenient Delaware forum gives reason for optimism that courts in other states likewise will accept and enforce FFPs.

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ENDNOTES

1 *Salzberg* v. *Sciabacucchi*, No. 346, 2019 (Del. Mar. 18, 2020).

2 *Cyan, Inc*. v. *Beaver Cty. Emps. Ret. Fund*, 138 S. Ct. 1061 (2018).

3 15 U.S.C. § 77k; *see Omnicare, Inc.* v. *Laborers Dist. Council Constr. Indus. Pension Fund*, 575 U.S. 175, 178-79 (2015).

4 *See* 15 U.S.C. § 77v(a).

5 *Cyan,* 138 S. Ct. at 1078 ("[The Securities Litigation Uniform Standards Act of 1998 ('SLUSA')] did nothing to strip state courts of their longstanding jurisdiction to adjudicate class actions alleging only 1933 Act violations. Neither did SLUSA authorize removing such suits from state to federal court.").

6 *Salzberg*, No. 346, 2019, slip op. at 13.

7 *Id.* at 12 (citing Stanford Law Sch. Secs. Class Action Clearinghouse & Cornerstone Research, *Securities Class Action Filings 2019 Year in Review* 4 (2020)).

8 *Id*. at 7 n.24 (citing App. to Opening Br. at A84, A100).

9 *See* Verified Class Action Complaint for Declaratory Judgment ¶¶ 45-46, *Sciabacucchi* v. *Salzberg*, No. 2017-0931-JTL (Del. Ch. Dec. 29, 2017).

10 *Salzberg*, No. 346, 2019, slip op. at 8.

11 *Sciabacucchi* v. *Salzberg*, 2018 WL 6719718, at *3 (Del. Ch. Dec. 19, 2018).

12 *Id*.

13 *Salzberg*, No. 346, 2019, slip op. at 10.

14 *Id*. at 10-11.

15 *Id*. at 13-14.

16 *Id*.

17 *Id*. at 14.

18 *Id*. at 11.

19 *Id*. at 17, 23.

20 *Id*. at 30.

21 *Id*. at 43.

22 *Id*. at 46.

23 *Id*. at 47.

24 *Id*. at 49.

25 *Id*. at 52.

26 *Id*. at 53.

27 *See id*. at 15 (citing earlier Delaware Supreme Court case as "support[ing] the view that FFPs in stockholder-approved charter amendments should be respected as a matter of policy").

28 *See, e.g.*, Letter from United States Securities and Exchange Commission, Division of Corporate Finance to Ping H. Rawson (Feb. 7, 2019), https://www.sec.gov/Archives/edgar/data/1213809/000000000019001693/filename1.pdf.

29 *Salzberg*, No. 346, 2019, slip op. at 31.

30 *Id*. at 46-48.

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