Delaware Supreme Court Finds Exclusive Federal Forum Provisions for Securities Act Litigation Are Valid

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On March 18, 2020, a unanimous Delaware Supreme Court held in *Salzberg v. Sciabacucchi* that provisions in a Delaware corporation's certificate of incorporation requiring actions arising under the U.S. Securities Act of 1933 (the "Securities Act") to be filed in a federal court instead of a state court are valid under Delaware law. The decision reverses a 2018 decision in the Delaware Court of Chancery and will likely reinvigorate the adoption of Securities Act exclusive federal forum provisions ("FFPs"), in particular for companies contemplating an initial public offering. Similar to developments following then-Chancellor Strine's decision in *Boilermakers Local 154 Retirement Fund v. Chevron Corp.* with respect to exclusive forum provisions governing disputes concerning the internal affairs of Delaware corporations, the enforceability of FFPs will need to be tested in other state and federal courts.

Executive Summary

FFPs offer companies a potentially powerful tool to reduce the expense of litigating duplicative Securities Act lawsuits in multiple forums. Private companies with the ability to adopt exclusive federal forum provisions relatively easily should consider doing so, in particular before or in connection with an IPO. D&O insurance brokers may come to expect FFPs to be included for newly public companies and will be looking to see if FFPs are enforced by other courts.

Companies that are already public may prefer to evaluate further developments before taking action, as many did after the initial *Boilermakers* decision, while FFP-related litigation continues to play out. Public companies will need to be particularly mindful of investor and proxy advisory firm scrutiny in deciding whether to take action, and private companies should also consider possible negative reactions after they are public.

Any company adopting an FFP should be sure to include in its SEC filings robust disclosure of the impact of the provision, the benefits to stockholders and the risks and uncertainties related to their enforceability in courts of other states.

The Origins of FFPs

The origins of FFPs stem from the private rights of action under the Securities Act. Plaintiffs may bring such suits in either federal or state courts. Following the U.S. Supreme Court's decision in *Cyan v. Beaver County Employees Retirement Fund*, Securities Act claims filed in state court may not be removed to federal court, and there is no procedural mechanism to consolidate or coordinate simultaneous federal and state actions or multiple state court actions filed in different forums. As a result, companies face potentially significant expense from duplicative litigation.

While state and federal courts have concurrent jurisdiction over Securities Act claims, claims brought under the U.S. Securities Exchange Act of 1934 (the "Exchange Act"), such as Section 10(b) / Rule 10b-5 claims, are subject to exclusive federal court jurisdiction. Securities Act claims are primarily relevant to companies conducting IPOs or follow-on offerings pursuant to a Securities Act registration statement, and so the burden and expense of defending concurrent litigation fall disproportionately on companies in earlier stages of growth.

Although historically claims under the Securities Act were litigated predominantly in federal court, such litigation began to migrate to state court at least in part due to the 1995 passage of the Private Securities Litigation Reform Act ("PSLRA"). Among other things, the PSLRA codified certain procedural safeguards aimed at reducing abusive litigation. Plaintiffs' attorneys recognized they could evade PSLRA restrictions by filing claims in state court. In response, in 1998 Congress passed the Securities Litigation Uniform Standards Act ("SLUSA") with the intent of making federal courts the exclusive venue for most securities fraud class actions. However, courts were divided on whether SLUSA stripped state courts of jurisdiction over Securities Act class actions.

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In 2018, the U.S. Supreme Court resolved this question in *Cyan*, holding that Securities Act class actions may be brought in state court and are not removable to federal court.[1] *Cyan* accelerated the migration of Securities Act claims from federal court to state court. In the wake of *Cyan*, premiums and retentions for D&O insurance significantly increased with commentators attributing this in part to the concurrent increase in state court Securities Act litigation.

Against this backdrop, a growing number of companies, primarily in anticipation of an IPO, adopted FFPs that would require Securities Act litigation to be filed in a federal forum. FFPs aim to solve the problem of duplicative, parallel actions in federal and state courts and the challenges of multi-forum litigation.

FFPs Are Valid under Delaware Law

The lower court decision by the Delaware Court of Chancery in *Sciabacucchi* considered a facial validity challenge to FFPs in the charters of three companies that recently completed their IPOs. For example, Stitch Fix's FFP, which is representative of provisions for the other defendants and many other companies, reads as follows:

> 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].

The Court of Chancery held that FFPs were invalid primarily because Securities Act claims do not "involve rights or relationships that were established by or under Delaware's corporate law."

The Delaware Supreme Court's opinion begins by emphasizing that for FFPs to be facially invalid, it must be shown that they "cannot operate lawfully or equitably under any circumstances." Turning to Section 102(b)(1) of the Delaware General Corporation Law, the court noted that a corporation's certificate of incorporation may include any provision "for the management of the business and for the conduct of the affairs of the corporation" or any provision "regulating the powers of the corporation, the directors and the stockholders" if such provisions are not contrary to the laws of the state of Delaware.

The court reasoned that the preparation of a Securities Act registration statement and its review by a corporation's directors and officers are important parts of the management of that corporation's business and affairs and of its relationship with its stockholders. In reversing the lower court opinion, the Delaware Supreme Court explained that the Court of Chancery took an overly narrow view of Section 102(b)(1) by limiting its scope to matters of Delaware law. In addition, the Delaware Supreme Court found that the purpose of an FFP also does not conflict with either Delaware law or federal law. The court concluded that FFPs merely seek to regulate the forum of Securities Act litigation and are valid under Delaware law. While the Court's decision clears the way for companies to adopt FFPs, the question remains whether other state and federal courts outside of Delaware will respect and enforce FFPs.

Considerations for Adopting an FFP

For private companies considering IPOs, the advantages of adopting an FFP are significant. D&O insurance brokers will likely be looking to see FFPs included for companies seeking to go public, and the brokers will also be watching to see if the provisions are enforced, state cases are successfully removed to federal courts and the overall amount of state court Securities Act litigation decreases. To the extent an FFP can be adopted before or in connection with an IPO process, there seem to be few potential drawbacks to doing so, although companies should be mindful that their governance provisions will be reviewed by public company investors and proxy advisory firms both during and following the IPO process.

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[1] For additional background on the Cyan decision, please see Davis Polk's client memorandum, "**The Supreme Court's Cyan Decision and What Happens Next**."

Whether public companies should adopt FFP bylaws or charter provisions is more complex. Because FFPs only relate to claims under the Securities Act arising from offerings under registration statements and do not affect more common Section 10(b) litigation under the Exchange Act, there may be proportionately fewer benefits, especially for more mature public companies. Public company boards should also evaluate the risk of investor scrutiny in response to the proposed adoption of an FFP, particularly if adopted unilaterally by the board as a bylaw provision without stockholder approval. For example, Glass Lewis recommends stockholders vote against the reelection of the governance committee chair if the board of directors adopts a forum selection clause without stockholder approval, subject to a limited exception that such provision is "narrowly crafted" to suit the corporation's particular circumstances which usually provides little relief. Public companies that expect to conduct significant offerings under registration statements, especially follow-on offerings for common stock or equity-linked securities, and are therefore more exposed to the risks of Securities Act litigation, may be more incentivized to adopt an FFP. Similar to after the *Boilermakers* decision, public companies may want to take an initial wait-and-see approach to see if FFPs become more mainstream.

Companies deciding to adopt FFPs should include robust disclosure in their registration statements and periodic reports, including what the FFP means for stockholders as well as relevant risk factors. The SEC has generally issued comments regarding disclosure of FFPs, and we expect this practice will continue.

While there are many reasons for companies to consider adopting FFPs now, important uncertainties persist. Enforcement of FFPs for Delaware corporations will largely be in the hands of other courts outside of Delaware, so it remains to be seen if they will follow the *Sciabacucchi* decision. However, this decision is a clear holding that FFPs are valid under Delaware law and may be adopted by Delaware corporations. Companies organized outside of Delaware should also consider whether FFPs may be valid under relevant governing law using the same principles of the *Sciabacucchi* opinion, and, if so, should also consider adopting an FFP.

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