The Delaware Supreme Court Overturns Court of Chancery, Allowing Corporations To Enact Federal Forum Provisions to Keep Securities Act Claims In Federal Court

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Securities Alert

- Securities & SEC
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Friday, March 20, 2020

On March 18, 2020, the Delaware Supreme Court (the “Court”) issued a groundbreaking decision reversing the Delaware Court of Chancery’s December 2019 ruling in Sciabacucchi v. Salzberg, 2018 Del. Ch. LEXIS 578 (Del. Ch. Dec. 19, 2018), and holding that charter provisions adopted by public companies that designate a federal forum for securities claims brought pursuant to the Securities Act of 1933 (“Federal Forum Provisions”) are valid and enforceable. The Court of Chancery previously had found three public companies’ Federal Forum Provisions ineffective and unenforceable on the grounds that companies cannot mandate the forum in
which “external” claims—claims that do not “involve the rights and relationships established by or under Delaware’s law”—are brought. The Delaware Supreme Court’s ruling has significant ramifications for Delaware corporations, as the decision allows corporations to mandate that plaintiffs asserting Securities Act claims bring those claims in federal court.

**Why This Issue Matters**

In 2018, the United States Supreme Court held that state courts shared concurrent jurisdiction to hear class actions asserting solely Securities Act claims – which create liability for false and misleading statements in offering materials – and that such claims were not removable to federal court. See *Cyan, Inc. v. Beaver Cty. Emps. Ret. Fund*, 138 S. Ct. 1061, 1066 (2018). Prior to *Cyan*, permitting removal of Securities Act claims was the minority position in the federal district courts. Since *Cyan*, it has been reported that Securities Act filings in state court increased 40% between 2018 and 2019, and 45% of those filings were accompanied by parallel actions in federal court. See Opinion at 12. One of the reasons plaintiffs generally prefer litigating Securities Act claims in state courts is that such actions are not encumbered by the Federal Rules of Civil Procedure or, arguably, all of the stringent requirements of the Private Securities Litigation Reform Act of 1995 (“PSLRA”). In holding that corporations may enact Federal Forum Provisions mandating Securities Act claims be litigated in federal court, the Delaware Supreme Court acknowledged that such provisions “can provide a corporation with certain efficiencies in managing the procedural aspects of securities litigation following . . . Cyan.” Opinion at 11. We expect that plaintiff will file a petition for *certiorari* to the United States Supreme Court.

**Ruling**

In a unanimous ruling penned by Justice Karen Valihura, the Court held that the challenged Federal Forum Provisions were facially valid under the Delaware General Corporation Law (“DGCL”) and also survived a facial challenge as matter of policy. To successfully prosecute a facial challenge, the plaintiff was required to establish that: (1) the Federal Forum Provisions “cannot operate lawfully or equitably *under any circumstances*” (emphasis in original); (2) the provisions “do not address proper subject matters as defined by statute;” or (3) the provisions “can never operate consistently with law.” The Court rejected the plaintiff’s contentions on all three grounds.

The Court first determined that Federal Forum Provisions fall squarely within the broad enabling statute governing a Delaware corporation’s certificate of incorporation, Section 102(b)(1). Under Section 102(b)(1), Delaware corporations may adopt provisions that provide for: (1) the management of business and conduct of the affairs of the corporation; or (2) provisions that create, define, limit, and regulate the powers of the corporation, directors, and stockholders so long as those provisions are not contrary to state law. According to the Court, the challenged Federal Forum Provisions “could easily fall” within *either* category, and were thus facially valid.

The Court also determined that the Federal Forum Provisions did not violate the
substantive law of Delaware. According to the Court, stockholder-approved charter amendments such as Federal Forum Provisions “are given great respect under [Delaware] law.” The Court noted that Delaware law allows “immense freedom” for corporations to adopt provisions for their organization and governance. The Court emphasized that the 2015 amendments to the DGCL did not alter Section 102(b)(1)’s broad scope. Applying these principles, the Court concluded that Federal Forum Provisions are not contrary to Delaware’s substantive law or public policy.

Importantly, the Court rejected the Court of Chancery’s finding that Section 102(b)(1) created a “binary world” between purely “internal” and “external” claims, with only the former being subject to lawful regulation by corporate charters. The Court specifically noted that Securities Act claims are “internal” to a company insofar as they arise from “internal corporate conduct” on behalf of the Board. Consequently, Federal Forum Provisions that seek to regulate the forum for Securities Act claims are not “external,” fall within the scope of Section 102(b)(1), and thus may be regulated by charters and amendments. The Court concluded that, unlike the Chancery Court’s “binary” view, issues regulated by Section 102 actually fall within a “continuum” between “internal affairs” (e.g., fiduciary duties) and purely “external” claims (e.g., tort claim for personal injury). Finding Section 102’s definition of “intra-corporate affairs” to be more expansive than the Chancery Court’s definition of “internal affairs,” the Court opined that there are at least some issues that fall outside the “internal affairs” boundary but within Section 102(b)(1)’s boundary, and therefore legally permissible to be included in corporate charters and amendments.

In a nod to the impact the Cyan decision has had on securities litigation since 2018, the Court recognized that Federal Forum Provisions allow corporations to adopt “certain efficiencies” in managing the procedural aspects of Securities Act litigation. Because Cyan allows for concurrent litigation of Securities Act claims in state and federal court, Federal Forum Provisions in effect provide a procedural mechanism for companies to consolidate these claims that is absent in state court. Without Federal Forum Provisions, the Court recognized that companies would lack the ability to consolidate these cases, thereby being exposed to the very real possibility of inconsistent judgments and other rulings of importance, such as discovery stays. With these provisions, companies can now funnel Securities Act claims to federal forums where coordination and consolidation are possible.

**Key Takeaways**

- Companies organized in Delaware that have not yet adopted Federal Forum Provisions should consider whether they should do so. Federal Forum Provisions allow companies to ensure that any securities fraud claims brought under federal law are filed in federal court, so that plaintiffs will be subject to the Federal Rules of Civil Procedure and the PSLRA.

- For companies considering adopting Federal Forum Provisions, the following risks are worth considering:
  - The Court’s decision is not applicable to corporations organized under the laws of states other than Delaware.
The Court's decision only focused on the facial challenge to the Federal Forum Provisions. The Court did not consider the Federal Forum Provisions on an “as applied” basis, meaning that any company that adopts a Federal Forum Provision potentially could face litigation as to its application to a particular plaintiff. To minimize risk, companies should ensure their Federal Forum Provisions are reasonable and do not contravene public policy in specific states in which they operate.

The Court’s decision was limited to an analysis of Federal Forum Provisions adopted in a company’s charter, not its bylaws. Although likely, it is not clear from the Court’s holding whether a corporation’s adoption of a Federal Forum Provision in its bylaws would be upheld.

Corporations adopting Federal Forum Provisions may consider steering Securities Act claims to a specific federal district. We believe that such efforts likely will be challenged by stockholder plaintiffs, and it is unclear whether such provisions would survive the same facial scrutiny that the Court applied in this case.

- In the coming years, we envision a decrease in the number of Securities Act claims brought in state court, along with a decrease in the bifurcation of federal securities actions.

- Left unresolved for now is whether Federal Forum Provisions will be enforced in state court proceedings in jurisdictions other than Delaware. The Court acknowledged this risk, and noted that it believed the provisions do “not offend principles of horizontal sovereignty.” Moreover, the Court observed that Federal Forum Provisions are aligned with due process insofar as they allow companies and directors to know what state laws apply to their corporate actions.

- Some commentators have watched the Sciabacucchi decision with great interest, speculating that the Court’s decision potentially could encourage corporations to adopt mandatory arbitration provisions in their corporate charters requiring plaintiffs to bring Securities Act claims in an arbitral forum, rather than in federal or state court. The Court swiftly rejected this contention in its decision, noting that “such provisions” explicitly would violate state law, which provides that charters and bylaws cannot “prohibit bringing such claims in the courts of this state.” (citing 8 Del. C. § 115).

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