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After Salzberg: Impact of Delaware's Validation of Federal Forum Provisions

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In the last two years, plaintiffs' lawyers have increasingly been bringing lawsuits under the Securities Act of 1933 ("Securities Act"), such as claims relating to public offerings, in state rather than federal court. Resisting that trend, some corporations have adopted forum-selection clauses requiring that such cases be brought in federal court. In *Salzberg v Sciabacucchi*, the Delaware Supreme Court earlier this month upheld the validity of such clauses, known as federal-forum provisions ("FFPs"), in the certificates of incorporation of Delaware corporations.

The decision is a significant victory for corporations seeking to ensure that federal securities law claims under the Securities Act are litigated in federal courts rather than state courts.

While claims under section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") may only be brought in federal court, claims under the Securities Act may be brought either in federal or state court. The U.S. Supreme Court made that clear in *Cyan, Inc. v. Beaver County Employees Retirement Fund*. After *Cyan*, plaintiffs' lawyers began filing more of their Securities Act cases in state court.

That ruling created the prospect that corporations could be forced to litigate class actions under section 10(b) of the Exchange Act in federal court, while litigating related claims under the Securities Act in state court. FFPs were designed to avoid these and other consequences of having to litigate federal-law claims under the Securities Act in a state court.

The litigation generated by the Securities Act involves not only initial public offerings by companies going public, but also established companies that offer stock through registration statements filed with the U.S. Securities and Exchange Commission ("SEC") as in secondary or follow-on offerings.

The FFPs do not, of course, overrule the *Cyan* decision. Rather, because corporate certificates of incorporation (also known as charters) and bylaws are treated as contracts between companies and their stockholders, they are considered to represent an agreement by which the stockholders agree to exercise their rights under the Securities Act in a particular manner, that is, by agreeing to the limitation on the forum otherwise available for litigation.

Salzberg involved three Delaware corporations – Blue Apron Holdings, Inc., Roku, Inc., and Stitch Fix, Inc. – that launched initial public offerings in 2017. Before filing their registration statements with the SEC, each company adopted an FFP requiring actions arising under the Securities Act to be filed in a federal court. The plaintiff in *Salzberg* challenged all three.

The Delaware courts had previously considered forum-selection clauses in corporate certificates of incorporation or bylaws in a different context. During the 2000's, plaintiffs' lawyers were increasingly bringing claims such as deal litigation, breach of fiduciary claims and derivative actions

in a variety of different states, including the state of incorporation and state of principal operations. To combat that, companies adopted provisions requiring that such claims involving the "internal affairs" of the corporation be brought in the state of incorporation, most often Delaware.

In *Boilermakers Local 154 Retirement Fund v Chevron Corp.* ("Boilermakers"), the Chancery Court held that a forum selection clause adopted in a bylaw by a Delaware corporation is valid, binding and enforceable. In 2015, the Delaware Legislature amended the Delaware General Corporation Law ("DGCL") essentially to codify the *Boilermakers* ruling.

However, in the lower court decision in *Salzberg*, the Chancery Court held that a Delaware corporation's adopting a forum selection clause requiring stockholders to bring internal affairs cases in a particular state forum – the kind of clause approved of in *Boilermakers* – should be treated differently than an FFP requiring stockholders to bring federal law claims in a particular jurisdiction, *i.e.*, a federal court. Vice Chancellor Travis Laster ruled 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."

The Delaware Supreme Court, however, disagreed and reversed the Chancery Court decision.

The Delaware Supreme Court held that FFPs were permitted under both of the two broad categories of matters that DGCL section 102(b)(2) allows to be addressed in a corporation's certificate of incorporation: 1) provisions for the management of the business and for the conduct of the affairs of the corporation, and 2) provisions creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders, or any class of stockholders. Considering the drafting, reviewing and filing of registration statements by a corporation and its directors as an important aspect of a corporation's management of its affairs and of its relationship with its stockholders, the court found that regulation of such functions through FFPs would come within either category of permitted provision under DGCL section 102(b)(2).

The court also found that FFPs do not violate the public policies or law of Delaware. In addition to noting the broadly enabling language of DGCL section 102, the court recognized the wide latitude that DGCL allows businesses to adopt terms best suited to the particulars of that enterprise. Treating certificates of incorporation as contracts among a corporation's stockholders, Delaware law gives great respect to stockholder-approved amendments to such certificates.

While the Delaware Supreme Court agreed with the Chancery Court that claims under the Securities Act are not "internal corporate claims" within the meaning of DGCL, the court concluded that DGCL section 102(b)(2) is not limited to such "internal corporate claims."

The court also went to some length to better define the continuum of corporate matters which charters may address, ranging from core internal affairs where Delaware law is most permissive, to external affairs, where it affords corporations the least leeway to construct their own order. FFPs address intra-corporate matters, the court found, and fall within the "Outer Band" of the scope of DGCL section 102(b)(2).

Finally, the 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. In doing so, the court cited *Rodriguez de Quijas*

v. Shearson/American Express, Inc., 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." 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," 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."

Implications

After *Salzberg*, the boards of Delaware public companies, as well as those contemplating initial public offerings, should consider adopting FFPs. But while *Salzberg* resolves the question of whether FFPs are valid under DGCL, it leads to new questions to be considered. For example:

- **Will state courts outside of Delaware enforce FFPs for Delaware corporations?** The court expressed concern about this point, with respect to FFPs as well as other matters falling within the Outer Band of DGCL section 102(b)(2), but concluded that FFPs do not contravene notions of horizontal sovereignty and should be respected by other states.

- **What are the limits to the private ordering endorsed in *Salzberg*, particularly in the context of FFPs?** The court left open the possibility that a particular FFP, in its construction and operation, might violate DGCL. The court cautioned that particular FFPs may be struck down if found "inequitable," "unreasonable and unjust," to "overreach," or if otherwise found to contravene public policy. Still, it offered no particular basis for invalidating such a clause, and thus does not offer much support to a plaintiff hoping to invalidate one.

- **S*alzberg* involved an FFP in a certificate of incorporation. Would the same FFP in the bylaws also be valid?** *Boilermakers*, the case that approved a forum-selection clause choosing the state of incorporation as the exclusive jurisdiction for internal-affairs disputes, involved a bylaw, not a certificate. And nothing in the *Salzberg* decision suggests that adopting it by bylaw rather than in a certificate would make a decisive difference. In fact, the *Salzberg* court's extensive discussion of *Boilermakers* and *ATP Tour, Inc. v. Deutscher Tennis Bund* – neither of which involved a dispute concerning a certificate of incorporation – indicates that the court's holding is not limited to certificates of incorporation.

- **Will FFPs lead to a leveling off or decline in directors and officers insurance costs for corporations?** The rise in state court litigation under the Securities Act has been linked to an increase in premiums charged by directors and officers insurance carriers. There has been speculation that curbing such state court litigation could change that trend. Corporations will see in the months ahead whether that in fact happens.

- **Will purchasers of registered bonds be faced with FFPs?** Corporate debt may be registered with the SEC and subject to the Securities Act. Bondholders are not parties to corporate charters. But corporations may explore including provisions in bond indentures to seek to require bondholders to bring Securities Act claims in federal court.

- **Will proxy advisors take a position on FFPs that make it difficult for already public Delaware corporations from adopting FFPs?** Prior to *Salzberg*, the leading proxy advisers had mixed views regarding forum selection clauses. The ISS advisory firm, focusing on forum-selection clauses for internal affairs claims, said it evaluates exclusive forum provisions on a case-by-case basis, taking into account factors such as: (1) the company's stated rationale for adopting such a provision; (2) disclosure of past harm from stockholder lawsuits outside the jurisdiction of incorporation; (3) the breadth of application of the bylaw, including the types of lawsuits to which it would apply and the definition of key terms; and (4) governance features such as stockholders' ability to repeal the provision at a later date (including the vote standard applied when stockholders attempt to amend the bylaws) and their ability to hold directors accountable through annual director elections and a majority vote standard in uncontested elections. Glass Lewis holds a more negative view, stating that "[it] believes that charter or bylaw provisions limiting a stockholder's choice of legal venue are not in the best interests of stockholders" and recommending that stockholders vote against such a provision unless the issuer company can meet a heavy burden of showing the need for such a clause.

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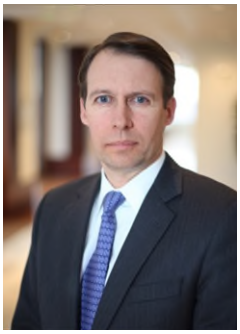

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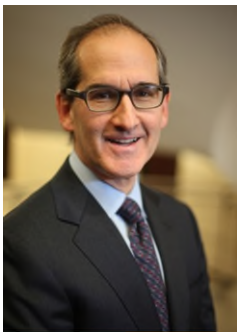

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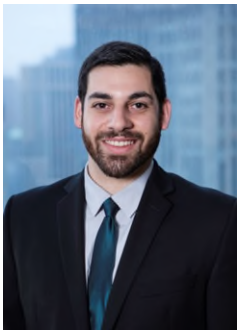
Eric Rieder helps clients solve some of their most difficult litigation problems. His national practice focuses on securities, mergers and acquisitions and other complex litigation. For many years the leader of Bryan Cave's Securities Litigation Group, he has tried and won important cases in courts and arbitrations around the country, and successfully litigated others to resolution through motions and settlements. He advises clients on the duties of both public and private company directors and officers, and has extensive experience handling SEC investigations and audit and special committee investigations. He writes and speaks regularly on securities law and M&A issues.



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