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Delaware Supreme Court Rules That Corporate Charters Can Require Litigation of Federal Securities Act Claims in Federal Court

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The Delaware Supreme Court ruled today that Delaware corporations can adopt charter provisions requiring that actions under the federal Securities Act of 1933 be filed in a federal court. The decision in *Salzberg v. Sciabacucchi* gives Delaware corporations a way to avoid state-court or multi-forum litigation of Securities Act claims by channeling all such cases into the federal system, where they can be managed more effectively – and where they are subject to the more structured and stringent procedural standards mandated by federal law.

Delaware corporations might want to consider adopting federal-forum charter provisions to address the treatment of potential Securities Act claims.

Statutory Background

In the wake of the 1929 stock-market crash, Congress enacted the Securities Act of 1933 and the Securities Exchange Act of 1934. The Securities Act applies to public offerings of securities, provides for concurrent federal- and state-court jurisdiction, and prohibits removal of Securities Act claims from state to federal court. The Exchange Act was designed for aftermarket transactions and provides for exclusive federal jurisdiction.

The growth of state-court suits asserting federal claims arising from public offerings of securities dates back to federal legislation enacted in 1995 to control abusive securities litigation. In 1995, Congress enacted the Private Securities Litigation Reform Act of 1995 (the "PSLRA"), which dramatically changed the federal securities laws. The PSLRA imposed heightened pleading requirements and protections for forward-looking statements, mandated a stay of discovery pending any motion to dismiss, established a process for appointment of lead plaintiff and lead counsel in securities class actions, prescribed rules governing class-action settlements, and placed limits on awards of attorneys' fees.

The PSLRA's pleading requirements and discovery stay should apply to *all* claims asserted under the Securities Act and the Exchange Act, regardless of forum (although some conflict has emerged concerning the discovery stay's applicability in state courts). But the procedural provisions – such as the lead-plaintiff selection process, the rules governing settlements, and the fee limitations – apply only to federal-court class actions.

When members of the plaintiffs' bar sought to avoid the PSLRA's class-action restrictions by filing state-law claims and federal Securities Act claims in state courts, Congress enacted the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"). Section 77p of SLUSA preempts state-law securities claims for listed securities and permits the removal of covered class actions (defined generally as any damages action on behalf of 50 or more persons) alleging such claims. In 2018, however, the U.S. Supreme Court unanimously held in *Cyan, Inc. v. Beaver County Employees Retirement Fund* that the SLUSA amendments did not strip state courts of jurisdiction over class actions alleging violations of only the Securities Act and do not empower defendants to remove those federal-law cases from state to federal court. *Cyan* thus appeared to sound the death knell for efforts to keep cases asserting only Securities Act claims out of state courts.

The *Salzberg* Litigation

Even before *Cyan* was decided, but especially in its aftermath, some companies have tried to use charter or bylaw provisions to force Securities Act claims into federal courts. Those exclusive federal-forum provisions require Securities Act claims to be filed only in federal court.

Section 102(b)(1) of the Delaware General Corporation Law (the "DGCL") allows corporate charters to contain "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 stockholders . . . ." In addition, DGCL § 115, enacted in 2015, allows Delaware corporations to adopt exclusive-forum provisions in their certificates of incorporation or bylaws for "internal corporate claims," which are defined as claims "based upon a violation of a duty by a current or former director or officer or stockholder in such capacity" or as to which the statute grants jurisdiction to the Delaware Court of Chancery. Section 115 does not address whether Securities Act claims are "internal corporate claims"; nor does it preclude exclusive-forum provisions for other types of claims.

In the *Salzberg* case, the plaintiff sought a declaratory judgment invalidating three corporations' exclusive federal-forum provisions for Securities Act claims. The Court of Chancery held that Delaware corporations can use forum-selection provisions to regulate only internal-affairs claims "brought by stockholders *qua* stockholders," but not "external relationships." The court viewed Securities Act claims not as "internal affairs claims brought by stockholders *qua* stockholders," but rather as "a tort or contract claim brought by a plaintiff who happens also to be a stockholder, but under circumstances where stockholder status is incidental to the claim." The court also rejected the companies' reliance on § 102(b)(1), because that provision applies only to internal corporate affairs.

The Delaware Supreme Court unanimously reversed.

Delaware Supreme Court's Decision

The Supreme Court began by framing the scope of review. The plaintiff had brought a facial challenge to the federal-forum provisions, so he needed to show that they "cannot operate lawfully or equitably *under any circumstances.*" The Court ruled that the plaintiff had failed to make such a showing.

The Court began its analysis with § 102(b), which authorizes provisions "for the management of the business and for the conduct of the affairs of the corporation" and well as provisions "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." The Court held that a federal-forum provision "could easily fall within either of these broad categories, and thus, is facially valid."

Federal-forum provisions govern Securities Act claims related to "the management of litigation arising out of the Board's disclosures to current and prospective stockholders in connection with an IPO or secondary offering," and the claims arise from "the drafting, reviewing, and filing of registration statements by a corporation and its directors." Thus, "a bylaw [the Court presumably meant a charter provision] that seeks to regulate the forum in which such 'intra-corporate' litigation can occur is a provision that addresses the 'management of the business' and the 'conduct of the affairs of the corporation,' and is, thus, facially valid under Section 102(b)(1)."

While the Court did not consider Securities Act claims to be traditional "internal affairs" claims, it viewed them as sufficiently "intra-corporate" so that Delaware law could regulate their assertion. The Court also held that § 102(b)(1) is not limited to "internal affairs" matters as long as they are sufficiently "intra-corporate."

In a potentially consequential footnote toward the end of the decision, the Court observed that much of the opposition to federal-forum provisions appears to have arisen from a concern that, if those provisions are upheld, "the 'next move' might be forum provisions that require arbitration of internal corporate claims." The Court responded that "such provisions, at least from our state law perspective, would violate Section 115 which provides that, 'no provision of the certificate of incorporation or the bylaws may prohibit bringing such claims in the court of this state.'" Thus, at least for now, the Delaware Supreme Court does not seem inclined to look favorably on mandatory-arbitration provisions for internal corporate claims.

Implications

The *Salzberg* decision has significant potential implications for Securities Act class actions: it gives Delaware corporations a way to avoid to a multiplicity of related cases challenging securities offerings.

First, a federal-forum provision increases the chances that a corporation will be able to centralize multiple Securities Act cases in a single court. Without such a provision, no general procedural mechanism exists to transfer or consolidate related cases filed in federal and state courts. The normal methods of channeling related federal cases into a single forum – consolidation, transfers, multidistrict-litigation proceedings – do not work as between the federal and state systems. Federal and state courts can agree to coordinate with each other, and one court might choose to stay or adjourn proceedings in deference to the other, but parties in a federal suit probably cannot shut down state-court proceedings if the state court is unwilling to agree. The federal Anti-Injunction Act's exceptions (in aid of jurisdiction, and to protect and effectuate judgments) might allow a federal court to enjoin state-court proceedings if the federal case has advanced to the settlement phase or has gone to judgment. But the Act could pose hurdles in the earlier stages of a federal suit.

Second, a federal-forum provision ensures that Securities Act class actions will be subject to the PSLRA's procedural provisions embodied in § 27(a) of the Securities Act. Those provisions – which do not apply in state courts – include the certification requirement (requiring plaintiffs to certify that they authorized the filing of the case and did not buy the relevant security at counsel's direction or in order to participate in the action), the restriction on attorneys' fees (requiring that any fees and expenses awarded to class counsel "not exceed a reasonable percentage of the amount of any damages and prejudgment interest actually paid to the class"), and the rules governing disclosure of settlement terms to class members.

Third, a federal forum ensures that the PSLRA's discovery stay will apply to Securities Act claims. Some dispute exists as to whether the stay applies in state courts. The discovery stay is included in § 27(b), which applies to "any private action arising under this title" – language that would seem to cover state-court as well as federal-court suits. The stay is not part of § 27(a), which expressly applies only to class actions "pursuant to the Federal Rules of Civil Procedure." Nevertheless, some state courts have held that the discovery stay does not apply in state courts, while others have ruled to the contrary.

Fourth, federal Securities Act class actions are subject to the PSLRA's lead-plaintiff appointment process, which requires the plaintiff to publish notice of the filing of the complaint and give all other class members 60 days to apply to be lead plaintiff. The court then appoints a lead plaintiff from among the applicants (presumptively choosing the one who sustained the largest loss) and also appoints lead counsel. The statutory lead-plaintiff process thus generally serves to prevent duplicative class actions in multiple forums. That process, however, does not govern state-court Securities Act class actions. Thus, if state-court suits could go forward without regard to this process, competing class actions with two (or more) sets of class representatives and class counsel might proceed in federal and state courts, and the cases probably could not be consolidated in or transferred to a single forum.

The Delaware Supreme Court did observe that the enforceability of a specific charter provision can depend "on the manner in which it was adopted and the circumstances under which it [is] invoked." Facially valid provisions will not be enforced "if adopted or used for an inequitable purpose." The Court cited three situations in which a provision might be invalidated on an "as applied" basis: if enforcement would be "unreasonable and unjust"; if the provision "would be invalid for reasons such as fraud or overreaching"; or if the provision "contravene[d] a strong public policy of the forum in which suit is brought, whether declared by statute or by judicial decision." But none of those "as applied" issues was involved in the facial challenge addressed here. Future cases might explore such issues.

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