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Delaware Supreme Court Upholds Exclusive Federal Forum Charter Provisions

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On Wednesday, in *Salzberg v. Sciabacucchi*, the Delaware Supreme Court unanimously held that charter provisions designating the federal courts as the exclusive forum for '33 Act claims are "facially valid," thereby reversing the decision of the Chancery Court, which had invalidated the provisions in the charters of three Delaware companies. The Chancery Court had previously invalidated the exclusive federal forum provisions (FFPs) at issue in the case because, among other reasons, Delaware's enabling statute (Section 102(b)(1)) – which provides general authority for non-mandatory charter provisions – was, in the lower court's view, inherently limited to "internal affairs" and FFPs were "external" matters. On *de novo* review, the Delaware Supreme Court rejected this analysis. It characterized FFPs as intra-corporate matters, located in a new territory – the "outer band" between internal and external matters – which fell within the statutory scope of Section 102(b)(1) and are, therefore, valid on their face. Given the substantial benefits of an FFP in the event of '33 Act litigation (which includes Section 11 claims), companies that do not have an FFP in their charter or bylaws, whether as a result of uncertainty about the validity of FFPs or otherwise, may want to revisit the issue.

You might recall that this case took on a heightened significance when, in March 2018, SCOTUS held, in *Cyan Inc. v. Beaver County Employees Retirement Fund*, that state courts continue to have concurrent jurisdiction over class actions alleging only '33 Act violations and that defendants cannot remove these actions from state court to federal court. Both before and especially after *Cyan*, many companies adopted FFPs in their charters or bylaws to avoid state court litigation of '33 Act claims (and forum shopping by plaintiffs for the most favorable state court forum). Section 115 of the Delaware General Corporation Law (DGCL) expressly permits the adoption of a charter or bylaw provision designating Delaware as the exclusive forum for adjudicating "internal corporate claims." The statute defines "internal corporate claims" as those claims "(i) that are based upon a violation of a duty by a current or former director or officer or stockholder in such capacity, or (ii) as to which this title confers jurisdiction upon the Court of Chancery." Claims under the '33 Act, however, are not expressly included.

The Chancery Court decision

Shortly before *Cyan* was decided, the plaintiff in *Sciabacucchi* filed a class action challenging the enforceability of the FFPs included in the charters of three Delaware companies (Blue Apron, Stitch Fix, and Roku). Two of the challenged FFPs were identical, stating: "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 Corporation shall be deemed to have notice of and consented to [this provision]." In the other instance, the FFP was essentially the same but included a savings clause, specifying exclusive federal jurisdiction but only "*to the fullest extent permitted by law*." In December 2018, on cross-motions for summary judgment, Vice Chancellor Travis Laster held that all three of the FFPs at issue were facially invalid.

In invalidating the FFPs in *Sciabacucchi*, Laster viewed *Boilermakers Local 154 Ret. Fund v. Chevron Corp.* (opinion by former Chief Justice Leo Strine Jr. while still on the Chancery Court) to be determinative. That case, Laster wrote, held that a corporation could adopt a forum selection bylaw to regulate "internal affairs claims brought by stockholders *qua* stockholders," but not "to regulate external relationships." He went on to say that the "*Boilermakers* decision noted that a bylaw cannot dictate the forum for tort or contract claims against the company, even if the plaintiff happens to be a stockholder." Under *Boilermakers*, he wrote, a '33 Act claim is distinct from "internal affairs claims brought by stockholders *qua* stockholders." Rather, he contended, a '33 Act claim "resembles 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. A 1933 Act claim is an external claim that falls outside the scope of the corporate contract."

In his decision, Laster also distinguished the authority of Delaware and its courts to regulate the internal affairs of

corporations, which are entirely creations of Delaware law, under the "internal affairs doctrine," as compared with the corporation's external relationships. In Laster's view, Delaware does not have the authority to regulate external relationships, which may be governed by other states' laws (such as antitrust or labor law), even when the party asserting the claim happens to be a stockholder. "The constitutive documents of a Delaware corporation," wrote Laster, "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."

As a result, Laster viewed DGCL Section 102(b)(1) as inherently limited to internal affairs. In addition, he pointed to commentary by members of the Corporation Law Council that accompanied the 2015 amendments to the DGCL adding Section 115. Although Section 115 does not explicitly prohibit the charter or bylaws from including forum selection provisions addressing other types of claims, the Council commentary suggested, in Laster's view, that the corporate charter and bylaws could not be used to regulate external claims and that a securities law claim was not an "internal corporate claim."

Defendants appealed.

The Delaware Supreme Court decision

On *de novo* review, the Delaware Supreme Court reversed the Chancery Court's decision. The Court held that FFPs were permitted under the "broadly enabling" provisions of Section 102(b)(1) of the Delaware General Corporation Law. That view, according to the Court, is also consistent with the general approach of the DGCL, which is expansive in its reach, allowing "immense freedom for businesses to adopt the most appropriate terms for the organization, finance, and governance of their enterprise," and affording "latitude for substantial private ordering." Section 102(b)(1) permits a certificate of incorporation 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 corporation, the directors, and the stockholders, or any class of the stockholders, … if such provisions are not contrary to the laws of this State." Giving "the statutory words their commonly understood meanings," the Court determined that an "FFP could easily fall within either of these broad categories, and thus, is facially valid." The Court reasoned that, especially after *Cyan*, FFPs can facilitate the management of litigation, which can be brought in multiple jurisdictions, thereby allowing a company to consolidate actions and achieve efficiencies, "classically fit[ting] the definition of a provision 'for the management of the business and for the conduct of the affairs corporation.'" By circumscribing where '33 Act claims may be brought, FFPs may also be viewed as "defining, limiting and regulating the powers of the corporation, the directors and the stockholders." Nor were FFPs considered by the Court to be contrary to state policy.

Contrary to the argument of the trial court that Section 115 of the DGCL precluded the inclusion of FFPs in constituent documents, the Court observed that Section 115 was intended to prevent the exclusion of Delaware as a forum for internal corporate claims, not to foreclose litigation in federal court based on federal jurisdiction:

Read holistically, Section 115 indicates a concern for centering particular claims – 'internal corporate claims' – in Delaware. This makes sense given Delaware's interest and expertise in corporate law. As Section 11 claims are not 'internal corporate claims," Section 115 does not apply. In sum, FFPs, which direct Section 11 claims to federal courts (which are most experienced in adjudicating them), do not violate Section 115 and are facially valid.

The Court also took issue with the trial court's effort to narrow the "broad enabling scope of Section 102(b)(1)" only to matters of "internal affairs." Although there was no suggestion on the table that '33 Act claims, which are governed by federal, not Delaware law, were "internal affairs" claims, the Court contended that they can involve aspects of internal matters and are often brought together with state fiduciary duty and disclosure claims based on the same facts. Accordingly, "Section 11 claims are 'internal' in the sense that they arise from internal corporate conduct on the part of the Board and, therefore, fall within Section 102(b)(1)." At oral argument, appellants contended that '33 Act claims are "intra-corporate" claims – *i.e.,* they are just like fiduciary duty claims (which are clearly within the definition of internal affairs) because they arise out of the nexus of the internal relationships among stockholders, directors and the company; the only difference is that '33 Act claims are brought under federal law, not Delaware law. That nexus is what brings FFPs within Section 102(b)(1). This argument was apparently persuasive to the Court, which faulted the trial court for failing to recognize the concept of "intra-corporate" claims and adopting an inappropriately binary position: "everything other than an 'internal affairs' claim was 'external' and, therefore, not the proper subject of a bylaw or charter provision." But FFPs, the Court maintained, relate to neither "external" claims, such as personal injury or breach-of-contract claims, nor strictly internal affairs matters. Rather, there is "a category of matters that is situated on a continuum" – intra-corporate claims – that are "in what might be called Section 102(b)(1)'s 'Outer Band,'" an area outside of internal affairs, but still encompassed by Section 102(b)(1). FFPs, the Court held, fall into this category and, as a

result, are facially valid.

The Court also took issue with the trial court's departure from "the established definition" of "internal affairs" set forth in the US Supreme Court's *Edgar v. MITE Corp.* decision and the Court's parallel definition in *McDermott v. Lewis*. Those cases define the "internal affairs doctrine" to involve "those matters which are *peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders."* The trial court, however, did not adopt this definition but, instead, unduly narrowed the doctrine to apply only to claims involving "the rights, powers, or preferences of the shares, language in the corporation's charter or bylaws, a provision in the DGCL, or the equitable relationships that flow from the internal structure of the corporation." In *McDermott*, the Court reiterated that the "umbilical tie of the foreign corporation to the state of its charter is usually still religiously regarded as conclusive in determining the law to be applied in *intracorporate disputes,*" and that the doctrine has serious constitutional implications. By unduly narrowing the definition, the trial court was in effect severing that tie.

The Court also found no basis in state or federal policy to invalidate the FFPs, particularly as forum-selection clauses are presumptively valid and enforceable under Delaware law and do not narrow the forum alternatives available under the Securities Act.

Finally, the Court considered the question of enforceability. Given that the case involved a facial challenge, the Court viewed the question of enforceability as a "separate, subsequent analysis," that depended "on the manner in which it was adopted and the circumstances under which it [is] invoked." The Court noted that none of the typical bases for finding a facially valid charter or bylaw provision to be unenforceable – such as fraud or overreaching, contravening strong public policy or that enforcement would be unreasonable and unjust – were implicated in this challenge. With regard to the question of enforceability of FFPs if challenged in the courts of other states, the Court contended that there were "persuasive arguments," such as due process and the need for uniformity and predictability, that "could be made to our sister states that a provision in a Delaware corporation's certificate of incorporation requiring Section 11 claims to be brought in a federal court does not offend principles of horizontal sovereignty," and, therefore, that they should be enforced.

Observations and commentary

- As the Court noted, FFPs can provide substantial benefits, allowing consolidation of multi-jurisdiction litigation, avoiding state court forum shopping and otherwise providing efficiencies in managing the procedural aspects of securities litigation. Therefore, companies incorporated in Delaware that have not yet adopted FFPs may want to consider adding a provision to their charter or bylaws.
- Although *Sciabacucchi* involved an FFP in the charter, we believe that a similar bylaw provision would likewise be viewed as valid, provided the company's charter authorizes the board to unilaterally amend the bylaws. In any event, companies should take care to ensure that, in deciding whether to adopt an FFP, their boards are fully informed.
- After the Chancery Court issued its decision in December 2018 invalidating the FFPs in *Sciabacucchi*, a number of companies with similar FFPs publicly disclose (via Form 8-K or in periodic reports), that, in light of the Chancery Court's opinion, they did not intend to enforce the provision unless the Chancery Court's decision was reversed. Companies that made such a disclosure should consult with the members of their Cooley team about whether additional disclosure is required and if they should update or modify language in future filings in light of the Delaware Supreme Court's decision.

Full disclosure: Cooley represented a group of companies that filed an *amicus* brief in support of the appellants' position that, under Delaware law, FFPs may be included in Delaware organizational documents.

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