MUNGER TOLLES & OLSON LLP

SECURITIES LITIGATION CLIENT ALERT

Companies May Now Adopt Mandatory Federal Forum Provisions

IN BRIEF

Historically, plaintiffs filing claims under the Securities Act of 1933 may sue in either federal or state court. In a recent ruling, the Delaware Supreme Court held companies may adopt mandatory federal forum provisions as a means to avoid the filing of multiple securities actions in state and federal courts. The effect of this ruling will be to help companies avoid costly duplicative litigation.

COMPANIES MOST IMPACTED

- Privately held companies considering an IPO
- Public companies that may issue securities in the future
- Private equity or venture capital firms optimizing the governing documents of portfolio companies

WHY THIS IS IMPORTANT NOW

Today's market conditions will set the stage for many future transactions subject to the Securities Act. Companies may need to issues securities to raise capital to cope with the consequences of the COVID-19 lockdown. Companies with financial strength might acquire other companies using stock or debt securities as consideration. It's often easier (and does no harm) to adopt a mandatory federal forum provision before any securities transaction.

IN DETAIL

The Historical Challenge: The Costs of Duplicative Litigation

The two principal statutes under which plaintiffs bring securities claims prescribe different jurisdictional schemes. Plaintiffs filing Rule 10b-5 or other claims under the Securities Exchange Act of 1934 ("Exchange Act") must bring their claims in federal court. By contrast, Plaintiffs filing claims under the Securities Act of 1933 ("Securities Act") may sue in either federal or state court. And if such claims are brought in state court, they cannot be removed to federal court.[1]

Most plaintiffs prefer state court because motion practice aimed at scrutinizing the merit of claims early tends to be disfavored. Recent filing data demonstrates a dramatic shift in filings from federal to state venues.[2] In the past five years, the number of Securities Act cases filed in state court has increased by over 800%.

The concurrent jurisdiction of the Securities Act has been highly problematic from an economic standpoint. Insurance premiums and deductibles for policies providing coverage for such claims also have rapidly escalated, reflecting that it is more expensive to defend duplicative Securities Act claims in multiple forums and generally more expensive to defend such cases in state court.

Channeling Securities Act claims into federal court may reduce legal fees incurred by corporations facing such claims because federal courts typically evaluate the legal sufficiency of federal securities claims at the pleading stage with great attention in order to determine at the outset -- before expensive discovery has occurred --

[1] Until recently, there had been some debate as to whether a defendant could remove a case filed in state court to federal court, but the United States Supreme Court held that defendants may not remove. *Cyan, Inc. v. Beaver County Employees Retirement Fund*, 138 S. Ct. 1061 (2018). Following the *Cyan* decision, corporations have faced an increasing number of claims brought under the Securities Act in state court.

[2] See "Securities Class Action Filings—2019 Year in Review," Cornerstone Research (available here).

whether plaintiffs have alleged a potentially viable claim. In contrast to the approach of federal courts, pleading challenges in state courts are often disfavored, and plaintiffs may argue that they should be allowed to conduct burdensome discovery during the pendency of a pleading challenge.

As a result of these and other considerations, it is generally far more expensive to defend actions brought under the Securities Act in state court than it is to defend against the same claims brought in federal court.

Recent Development: The *Sciabacucchi* Ruling

In a decision last month (*Salzberg v. Sciabacucchi*), the Delaware Supreme Court ruled that Delaware corporations may adopt a provision mandating that lawsuits brought under the Securities Act must be brought federal court, and that such a provision is enforceable.

Although the decision applies to Delaware corporations, corporations from other jurisdictions may also wish to consider adopting a mandatory federal forum provision for Securities Act claims.

Actions to Consider

Adopting a mandatory federal forum provision for stockholders filing claims under the Securities Act is an approach we would encourage companies to consider. It is relatively straightforward to implement, and if companies intend to undertake any transactions in the future that could create the risk of future Securities Act claims (such as an offering of securities or an M&A transaction using stock), it would be advantageous to have a forum provision in place prior to any such transactions.

Other Considerations

- The interaction with any provision (adopted by many companies since 2018) requiring that stockholder derivative suits be brought in the state of incorporation. If the client doesn't already have a forum selection provision for derivative suits, it might want to adopt it at the same time as the provision for Securities Act claims.
- Whether to adopt the provision as a bylaw or as an amendment to the certificate, and (for companies already publicly traded) the response it might evoke from the proxy advisors.
- For a company not incorporated in Delaware, a risk assessment of whether its jurisdiction will follow the Delaware Supreme Court's lead.

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