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California court upholds exclusive Federal Forum Provision in post-*Cyan* securities class action

By Pamela S. Palmer, Esq., Howard M. Privette, Esq., Peter N. Villar, Esq., and Samantha K. Burdick, Esq., *Troutman Pepper*

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OVERVIEW

California recently set national precedent by enforcing a corporate charter provision requiring that all stockholder claims arising under the federal Securities Act of 1933 ("Securities Act") be filed *exclusively* in federal court — a provision commonly referred to as a Federal Forum Provision ("FFP").

The September 1, 2020 Superior Court decision in *Wong v. Restoration Robotics, Inc.*[1] builds on the Delaware Supreme Court's March 2020 decision in *Salzberg v. Sciabacucchi*,[2] which held that FFPs are facially valid under Delaware corporate law.

The *Wong* decision provides additional guidance under California law for corporations using or considering adoption of an FFP to restrict Securities Act claims to federal courts.

Both cases support the proposition that companies contemplating an initial public offering ("IPO") can make effective use of FFPs to mitigate the potential cost and burden of concurrent state and federal court jurisdiction over Securities Act claims by requiring stockholders to file those claims exclusively in federal court.

Companies began to adopt FFPs in response to the United States Supreme Court's 2018 decision in *Cyan, Inc. v. Beaver County Employees Retirement Fund*.[3] *Cyan* resolved a national split of authority over whether the federal Securities Litigation Uniform Standards Act of 1998 ("SLUSA") eliminated state jurisdiction over Securities Act class actions — holding that it did not.

Predictably after *Cyan*, plaintiffs' class action firms began filing post-IPO disclosure challenge claims under Section 11 of the Securities Act in state courts across the country, hoping to gain traction in state forums where judges are less familiar with federal securities law claims.

Now, with two distinct but complementary decisions upholding FFPs on different grounds in Delaware and California, FFPs are firming up as a barrier against state Securities Act litigation.

WHY FFPS MATTER

Cyan held that, even after SLUSA, federal and state courts continue to have concurrent jurisdiction over claims brought under the Securities Act, as set forth in the 1933 legislation. This means that stockholders have a statutory option to file federal Section 11 (and Section 12) challenges to the veracity of disclosures in a company's stock registration statement and prospectus in either state or federal court.

By electing to file in state court, plaintiffs may be able to avoid some of the procedural protections against meritless securities claims established by the federal Private Securities Litigation Reform Act of 1995 (the "PSLRA").

With two distinct but complementary decisions upholding FFPs in Delaware and California, FFPs are firming up as a barrier against state Securities Act litigation.

For example, in state court, a plaintiff may be able to avoid certain requirements that apply under the Federal Rules of Civil Procedure when a Securities Act case is filed as a class action, including: the appointment by the court of a "lead plaintiff" and "lead counsel" based on a formal motion-and-contest process;[4] restrictions on so-called "professional plaintiffs;"[5] limitations on the monetary recovery available to class representatives;[6] and restrictions on the amount of attorneys' fees that may be awarded.[7]

Other protections established by the PSLRA should still apply in both state and federal court, such as a mandatory discovery stay at the beginning of a case, and a "safe harbor" governing forward-looking statements — though one of the exceptions to the protection of the safe harbor encompasses forward-looking statements made in connection with an IPO.[8]

On balance, however, it is not surprising that the number of putative Securities Act class actions filed in state court rose dramatically following *Cyan*.[9]

The phenomenon of duplicative case filings is a costly and burdensome fallout of this trend. Whereas federal courts have built-in mechanisms for channeling duplicative case filings into a single federal forum via venue rules and the Multidistrict Litigation statute, there is no equivalent mechanism among state courts.

Therefore, plaintiffs' class action firms competing for control of Securities Act claims often file serial suits in different federal and

state forums, which forces defendants to scramble for judicial intervention by issuing discretionary stays in multiple forums.

WONG BACKGROUND

Restoration Robotics Inc., a medical technology company headquartered in California and incorporated in Delaware, launched its IPO in October 2017.

Not long after, investors filed a securities class action against the company under Section 11 of the Securities Act, alleging that its registration statement contained materially false and misleading statements.

They also sued the company's directors and certain of its officers, as well as the IPO underwriters and a venture capital financing company involved in the IPO. The plaintiffs filed the case in the California Superior Court for San Mateo County.

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Before the IPO, Restoration had adopted an Amended and Restated Certificate of Incorporation that included an FFP, restricting stockholders to filing any Securities Act claims in a federal district court (unless the company otherwise agreed).[10]

Restoration and its officers and directors moved to dismiss the case on the basis of *forum non conveniens*, seeking to enforce the FFP. The underwriter defendants and the venture capital defendants joined in the motion.

When the defendants filed the motion, however, the *Sciabacucchi* case in Delaware had recently come before the Delaware Court of Chancery, which struck down a similar FFP as beyond the authority granted to corporations under Delaware corporate law.

Based on that decision, the California court denied the defendants' motion to dismiss.

In a much-anticipated decision issued in March of this year, however, the Delaware Supreme Court reversed the Chancery decision and upheld the legality of FFPs under Delaware law.

On the basis of that groundbreaking decision, the California court in *Wong* agreed to reconsider the defendants' motion.

WONG ANALYSIS

The California court noted that the Delaware Supreme Court's decision in *Sciabacucchi* does not purport to mandate that other states enforce FFPs in every case.

The court emphasized that, in its view, the Delaware Supreme Court holding was limited to the narrow issue of whether inclusion of an FFP in a certificate of incorporation is authorized under Delaware corporate law.

Beyond that "facial validity inquiry," the Delaware Supreme Court itself acknowledged that the "question of enforceability is a separate, subsequent analysis" and, thus, its holding that FFPs are *valid* under Delaware corporate law is not necessarily determinative of whether an FFP is *enforceable* under other states' laws.

The Delaware Supreme Court also concluded that FFPs should not offend federal law and policy — and suggested that other state courts should find them enforceable under the laws of their own states — but the California court dismissed these discussions as *dicta*.

Indeed, the California court was critical of *Sciabacucchi*'s conclusion that FFPs ought not offend federal law and policy, remarking that it "provided no case law and legal analysis that an FFP is or is not contrary to federal law."

The court viewed the determinative issue before it as whether the FFP was enforceable under California law based on the circumstances of the case.

To evaluate that issue in *Wong*, the court reasoned that the FFP is "most akin to a contractual forum selection clause," where, under California law, the burden falls on the party contesting enforcement to demonstrate that the enforcement would be unconscionable or unreasonable.

> The California court found that the plaintiffs failed to show that the FFP would be unconstitutional or illegal under federal law.

Given that the Securities Act allows for federal *or* state jurisdiction, the court reasoned that there is nothing "inherently unlawful" about the FFP on its face and concluded, after extensive discussion, that the "FFP is not illegal under California law and does not violate any California statute or public policy — *unless it was shown to be unconstitutional or illegal under federal law*" (emphasis added).

On this point, the court found that the plaintiffs failed to show that the FFP would be unconstitutional or illegal under federal law.

Therefore, the court decided to enforce the FFP and, on that basis, declined to exercise jurisdiction over the Securities Act claims against Restoration and its officers and directors.

However, the court denied without prejudice the underwriters' and venture capital defendants' joinders in Restoration's motion, finding that they were not parties to the FFP and failed to provide the court with any authority showing that they should have "the right or authority to enforce that provision."

WONG AND *SCIABACUCCHI* TAKEAWAYS

Wong and *Sciabacucchi* illuminate a path for companies to seek to avoid the pitfalls of concurrent state and federal jurisdiction over Securities Act claims, such as the costs and inefficiencies of duplicative multi-forum federal and state litigation, risks of inconsistent rulings, increased cost of D&O insurance, and reduced opportunities to mitigate or eliminate meritless securities claims.

But neither *Wong* nor *Sciabacucchi* provides a true safe harbor. Unless and until FFPs are addressed by federal courts, these decisions do not conclusively answer the question of whether FFPs may be deemed to violate federal law or policy.

> Neither *Wong* nor *Sciabacucchi* provides a true safe harbor.

The court in *Wong* expressly suggested that plaintiffs may consider presenting the question to a federal court. Nor does *Wong* or *Sciabacucchi* bind other state courts.

Notably, these decisions also fail to provide immediate relief to third party defendants, such as the underwriter and venture capital defendants in *Wong*, which may still need to show that they are properly within the scope of a corporate FFP.

Indeed, if Securities Act claims against such third parties remain in state court, corporate defendants may still find themselves entangled in multi-forum litigation despite the presence of FFPs in their certificates of incorporation.

In light of *Wong* and *Sciabacucchi*, boards of directors should consult with counsel regarding whether, if and how to adopt an FFP to provide corporate flexibility in relation to shareholders' choice of forum for Securities Act claims.

Notes

[1] Wong v. Restoration Robotics, 18-CIV-02609 (Cal. Super. Ct., San Mateo Cty., Sept. 1, 2020).

[2] Salzberg v. Sciabacucchi, No. 346, 2019, 2020 WL 1280785 (Del. Mar. 18, 2020).

[3] Cyan, Inc. v. Beaver County Empls. Ret. Fund, 138 S. Ct. 1061 (2018).

[4] 15 U.S.C.A § 77z-1(a)(3)(B).

[5] 15 U.S.C. § 77z-1(a)(3)(B)(vi).

[6] 15 U.S.C. § 77z-1(a)(4).

[7] 15 U.S.C. § 77z-1(a)(6).

[8] The safe harbor is codified at 15 U.S.C. § 77z-2, and the IPO exception may be found at subsection 77z-2(b)(2)(D). The discovery stay is codified at 15 U.S.C. § 77z-1(b). Although plaintiffs often contest the applicability of the discovery stay in state court cases, state courts are increasingly likely to uphold the need for and propriety of the discovery stay in such cases.

[9] "Between 2011 and 2018, 84 parallel cases were filed (51 post-Cyan), and 28 pairs have been resolved in federal and state court. Of the 28, only five were dismissed or dropped in both state and federal court. The remaining 23 settled in one or both courts. That is, '82 percent of parallel pairs settled, compared to 67 percent of cases filed solely in state court and 65 percent of cases filed solely in federal court.'" Kevin LaCroix, The Post-Cyan Section 11 Litigation Environment, The D&O Diary (June 25, 2020), https://bit.ly/3c3sDXL.

[10] Restoration's FFP states: "Unless the Corporation 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, as amended. 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 Article VIII."

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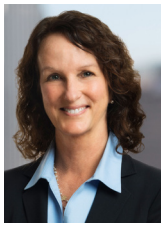
ABOUT THE AUTHORS



Pamela S. Palmer (L) is a partner at **Troutman Pepper** in Los Angeles. She represents companies in complex business disputes, investor and shareholder claims, securities and disclosure litigation, class actions, derivative suits, and merger and corporate control disputes, as well as consumer and competition claims. She can be reached at Pamela.Palmer@Troutman.com. **Howard M. Privette** (C) is a partner at Troutman Pepper in Orange County, California. He handles securities and class action litigation and represents companies in internal investigations and government enforcement actions. He can be reached at Howard.Privette@Troutman.com. **Peter N. Villar** (R) is a partner at Troutman Pepper's Orange County office, representing companies in complex business, intellectual property and securities litigation. He has tried and defended dozens of commercial disputes across the country, including several of the largest cases in the Central District of California. He can be reached at Peter.Villar@Troutman.com. **Samantha K. Burdick** (not pictured) is an associate in the firm's Los Angeles office. She can be reached at Samantha.Burdick@Troutman.com.