Securities Litigation Alert

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Judge Rules California State Law Does Not Prohibit Federal Forum Provisions That Seek To Avoid Cyan's Bar on Removal of Securities

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Key Points

- California state court held that federal forum provisions for Securities Act claims are not illegal and may be used to sidestep the bar on removal of Securities Act claims following the United States Supreme Court's ruling in *Cyan*.
- The decision may result in increased adoption of federal forum provisions in governing documents.
- The Court emphasized that the federal forum provision at issue was "cautiously and narrowly drafted" to only address the choice of forum, but left intact all of the substantive rights and remedies (and the right to a jury trial) provided to investors under the Securities Act of 1933.

Summary

In *Wong v. Restoration Robotics Inc. et al.*, the Superior Court of the State of California held that federal forum provisions for the Securities Act of 1933 (the "1933 Act") claims are not illegal under California law and may be used to sidestep the bar on removal of Securities Act claims following *Cyan*.

This decision will likely result in increased use of federal forum provisions in governing documents.

Background

In 2018, the United States Supreme Court unanimously held that state courts have jurisdiction over claims for violation of the 1933 Act, and that the provisions of the 1933 Act prohibit removal of such claims from state court to federal court. *Cyan Inc. v. Beaver County Emp. Ret. Fund*, 138 S.Ct. 1061 (2018).

After *Cyan*, initial public offering (IPO)-related lawsuits filed in state court increased exponentially and directors and officers (D&O) insurance premiums skyrocketed as litigation became more costly and more uncertain. To address this risk, some Delaware corporations began including federal forum provisions in their corporate

governing documents to require all persons purchasing their corporate stock to give up their opportunity to pursue 1933 Act claims in *any* state court, thus avoiding the challenges presented by the Supreme Court's decision in *Cyan*.

The legality of this new procedural tactic was originally rejected by the Delaware Court of Chancery, which held that a corporate forum selection clause requiring all Securities Act of 1933 claims to be brought in Federal court did *not* involve the corporation's "internal affairs," and was unenforceable under Delaware law and violated Delaware public policy. See *Sciabacucchi v. Salzberg*, No. CV 2017-0931-JTL, 2018 WL 6719718, at *22 (Del. Ch. Dec. 19, 2018), *appeal dismissed*, 204 A.3d 841 (Del. 2019), *and judgment entered* (Del. Ch. 2019), *vacated* (Del. Ch. 2020), and *rev'd*, 227 A.3d 102 (Del. 2020). The court specified that such forum selection clauses can only apply to "internal affairs," not the external affairs of a corporation.

The Delaware Supreme Court reversed in *Salzberg v. Sciabacucchi*, 227 A.3d 102 (Del. March 2020), announcing that there was not a "binary world of only 'internal affairs' claims and 'external affairs' claims," but rather a "continuum" between the two, and holding that such federal forum provisions were not contrary to Delaware law. The Delaware Supreme Court held that federal forum provisions were a means for corporations to avoid duplication of securities actions in federal and state courts.

This set the stage for the securities class action lawsuit brought against Restoration Robotics, a Delaware corporation with a principal place of business in California, before Judge Weiner of the California Superior Court, County of San Mateo, alleging Restoration Robotics violated the 1933 Act by issuing a materially false and misleading registration statement. Restoration Robotics had a provision in its Amended and Restated Certificate of Incorporation that establishes U.S. federal district courts as an exclusive form for all lawsuits asserting a cause of action arising under the 1933 Act. Although the court originally rejected the defendants', motion to dismiss, it granted a motion to reconsider in light of the Delaware Supreme Court ruling.

Opinion

The Court held that a provision in a corporation's certificate of incorporation stating an exclusive forum selection of U.S. federal district courts for all lawsuits arising under the 1933 Act is not prohibited by California law.

In *Wong v. Restoration Robotics Inc. et al.*, No. 18CIV02609, pending in the Superior Court of the State of California in San Mateo County, Judge Weiner wrote that after *Cyan*, some Delaware corporations decided to "craft unilateral, specifically-targeted provision[s]" to be added to and "buried" in their corporate governing documents, to force all persons purchasing their corporate stock to give up their opportunity to pursue 1933 Act claims in *any* state court.

The decision followed the March 2020 holding of the Delaware Supreme Court in *Salzburg. v. Sciabacucchi*, which reversed a Chancery Court finding that the state corporation law prohibited companies from adopting federal forum provisions for Securities Act litigation, holding that the law provides "flexible and wide discretion" for businesses. In her September 1 decision, Judge Weiner noted that the Delaware

Supreme Court deemed *Cyan* irrelevant to its analysis in *Sciabacucchi*, and generally criticized its reasoning and the comparison of the federal forum provisions to arbitration provisions. The Court remarked that if federal forum provisions were analogous to an arbitration provision, they would be procedurally unconscionable—"[i]ndeed, glaringly so." Sept. 1, 2020 Order at 27, *Wong v. Restoration Robotics*, *Inc*., No. 18CIV02609 (Cal. Super. Ct., Sept. 1, 2020).

Instead, the most-closely analogous law is that pertaining to forum selection clauses. The Court also found it persuasive that the federal forum provision at issue was subject to a shareholder vote and approval, and was not applied retroactively. As a result, the burden of proof shifted to the plaintiffs to demonstrate that the federal forum provision was unenforceable, unconscionable, unjust, or unreasonable. The Court held that the plaintiffs failed to meet their burden of proof.

Although the Court noted that the federal forum provisions would be unenforceable if they sought to attempted to create jurisdiction or select jurisdiction where none would otherwise exist, the Court found that because there was "no disruption of the substantive rights of the shareholders to all protections provided by the Securities Act of 1933," only a change in the procedural aspect of state versus federal forum, the federal forum provision was not illegal under California law and did not violate any California statute or public policy:

> Indeed, unlike an arbitration clause, the FFP [Financial Fair Play] does not take away the rights of the parties to litigate in court, or to have a jury trial, or to appeal, etc. It removed the opportunity to use the different procedural advantages of a state court forum, but does 'not take away' the substantive protections provided by the Securities Act itself. It also does not particularly create any additional expense or inconvenience, as the FFP wisely permits the filing of a shareholders laws[uit] in any federal district court in the United States (presumably one that is the proper venue).

Id. at 29.

Instead, the Court reasoned that there is no procedural loss of due process, as shareholders can present their federal law claims to a federal court, in a state or province of a state close to their residence, have the opportunity for discovery and trial by jury with "even greater" authority in federal court to obtain personal jurisdiction over defendants, and to subpoena witnesses to trial. *Id*. at 43.

As a result, the Court declined jurisdiction over the claims. The real culprit, the Court continued, "is the broad scope of Section 102 of the Delaware General Corporation Law," but whether or not Section 102 is unconstitutional under federal law "is not subject to adjudication by this California state court." *Id*. at 44.

Impact

This decision may ultimately expand the use of federal forum provisions in governing documents, depending on whether the *Wong* decision is widely adopted by other courts throughout the state.[1] However, many companies are already adopting federal forum provisions and will likely continue to do so until definitive law is made. If adopted, corporations should ensure the federal forum provisions are "cautiously and

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narrowly drafted" to address only the choice of forum. Additionally, federal forum provisions should be implemented by shareholder vote and approval, should not apply retroactively and should leave intact all of the "substantive rights and remedies" provided to investors under the 1933 Act.

[1] *See*, *e.g.*, *In re Dropbox, Inc. Sec. Litig.* (Lead Case No. 19-CIV-05089) (Superior Ct., San Mateo Cty.) (Permitting supplemental briefing to address the Wong decision and setting hearing on motion to dismiss for October 15, 2020).

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