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Federal Forum Provisions:  
Historical Development and Future Evolution

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Abstract: The Securities Act of 1933 provides for concurrent federal and state jurisdiction. In 2015, plaintiffs significantly increased the frequency with which they filed Securities Act claims in state court, where dismissal rates are lower and weaker claims have greater settlement value. The cost of directors and officers insurance for issuers conducting initial public offerings, the form of transaction most sensitive to Securities Act litigation risk, has increased dramatically. This increase is concurrent with plaintiffs' shift away from federal court.

Federal Forum Provisions (FFPs) appear in charters or bylaws. They require that Securities Act claims be litigated in their traditional forum, federal court. FFPs arose as a direct response to plaintiffs' shift from federal to state court Securities Act litigation. In *Sciabacucchi*, Delaware Chancery held that FFPs are invalid. That opinion is currently on appeal to Delaware's Supreme Court.

Part I of this note reviews data documenting the migration of Securities Act claims from federal to state court, and shows that approximately 75% of all issuers today facing Securities Act claims face at least one complaint filed in state court. Part II analyses plaintiffs' incentive to migrate, and focuses on the lower probability of state court dismissal, combined with an array of other procedural advantages that benefit plaintiffs in state court. Part III presents novel data documenting a rapid and significant increase in the cost of directors' and officers' insurance. Part IV documents the evolution and propagation of FFPs, and shows that they have been adopted primarily by Delaware-chartered issuers who face a significant risk of Securities Act IPO litigation. Part V summarizes other scholars' findings that the stock prices of issuers with FFPs declined in a statistically and financially significant manner in response to Chancery's decision in *Sciabacucchi*. Part VI concludes with observations regarding the future evolution of FFPs contingent on the pending decision by Delaware's Supreme Court.

If FFPs are upheld as valid, then Delaware will have a further advantage in the market for corporate charters. If FFPs are held invalid, issuers will face incentives to petition other states to adopt legislation affirming the validity of FFPs. If that occurs, insurers will have a rational incentive to impose a "Delaware penalty" on issuers who are likely subject to Securities Act liability and who charter in Delaware rather than in states that enforce FFPs. If this market response emerges, it will be the first instance in which there is an immediate, quantifiable reason not to charter in Delaware. This result cannot be positive for Delaware's ability to compete in the market for corporate charters.

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Introduction. The Securities Act of 1933 provides for concurrent federal and state jurisdiction. Securities Act plaintiffs historically filed most complaints in federal court. Beginning in 2015, however, plaintiffs began migrating to state court where motions to dismiss are less frequently granted. Claims that would likely have been dismissed in federal court survive and have greater settlement value in state court. The cost of directors' and officers' insurance ("D&O insurance") for issuers engaged in initial public offerings ("IPO"s), the category of insureds most likely to attract Securities Act claims, has since increased dramatically.

Issuers chartered in Delaware responded to the state court migration by amending their IPO charters or bylaws to include Federal Forum Provisions ("FFP"s) requiring that Securities Act claims be pursued either in federal court, or, if filed in Delaware state court, that they remain in Delaware.<sup>1</sup> In *Sciabacucchi*,<sup>2</sup> currently on appeal to Delaware's Supreme Court, Delaware's Court of Chancery held that Federal Forum Provisions are invalid under Delaware law.

If Delaware's Supreme Court rules that FFPs are valid under Delaware law, then those provisions will likely become ubiquitous in the organic documents of corporations conducting IPOs, much as intra-corporate forum selection provisions are today common fare. If Delaware's Supreme Court holds that FFPs are invalid under Delaware law, the economic pressure that provides the incentive for adopting FFPs will not abate. Corporations will respond by: (1) petitioning Congress to amend the Securities Act either to provide for exclusive federal jurisdiction, as is the case in the Exchange Act, or to override the Delaware decision and expressly to allow forum selection provisions that designate a federal forum for Securities Act claims; (2) working with states other than Delaware to amend their corporation codes expressly to permit FFPs, and then chartering in those states rather than in Delaware; and (3) working with the Delaware legislature to amend the DGCL expressly to permit FFPs in the organic documents of Delaware-chartered entities.

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<sup>1</sup> For a detailed analysis of the legal operation of Federal Forum Provisions see Joseph A. Grundfest, *The Limits of Delaware Corporate Law: Internal Affairs, Federal Forum Provisions, and Sciabacucchi* (September 12, 2019). Rock Center for Corporate Governance at Stanford University Working Paper No. 241. Available at SSRN: <https://ssrn.com/abstract=3448651> or <http://dx.doi.org/10.2139/ssrn.3448651> (forthcoming 75 *The Business Lawyer* 1 (2020)).

<sup>2</sup> *Sciabacucchi v. Salzberg*, No. 2017-0931-JTL, 2018 WL 6719718 (Del. Ch. Dec. 19, 2018).

Part I of this note presents data describing the migration of plaintiff Securities Act claims from federal to state court. Part II explains plaintiffs' incentives to migrate. Part III describes novel data documenting a dramatic recent increase in D&O insurance costs for IPOs, particularly among technology-based offerings. Part IV discusses the characteristics of the population of IPO offerings that has adopted FFPs to date. Part V summarizes findings by other researchers indicating that Chancery's decision to invalidate FFPs caused a statistically and financially significant decline in the market capitalization of publicly traded firms that have adopted FFPs. Part VI concludes by outlining potential future evolutionary paths for FFPs, contingent on the outcome of the appeal in *Sciabcucchi* currently pending before Delaware's Supreme Court.

## I. The Migration of Securities Act Claims.

Federal securities class action complaints most commonly allege violations of Section 10(b) of the Exchange Act of 1934,<sup>3</sup> and Rule 10b-5, thereunder.<sup>4</sup> In each year from 2014 through 2018, between 86% and 93% of corporate defendants named in newly-filed federal class action securities fraud complaints faced Rule 10b-5 claims.<sup>5</sup> Exchange Act claims are subject to exclusive federal jurisdiction and are therefore not implicated by the debate over migration from federal to state court.<sup>6</sup>

Securities Act claims are, in contrast, subject to concurrent federal and state jurisdiction.<sup>7</sup> Those claims are, however, less frequent. From 2012 to 2018, between 10% and 16% of federal class action securities complaints alleged violations of Section 11 of the Securities Act.<sup>8</sup> Between 4% and 12% alleged Section 12(a)(2) violations.<sup>9</sup> Sections 11 and 12(a)(2) claims are often jointly pled.<sup>10</sup> Approximately 11.82 percent of public offerings filed between 2010 and 2018 became subject to Section 11 litigation in federal or state court.<sup>11</sup>

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<sup>3</sup> 15 U.S.C. § 78j(b) (2012).

<sup>4</sup> 17 C.F.R. § 240.10b-5 (2018).

<sup>5</sup> *Securities Class Action Filings, 2018 Year in Review*, CORNERSTONE RESEARCH 10 fig. 9 ("Cornerstone 2018 YIR"), <http://securities.stanford.edu/research-reports/1996-2018/Cornerstone-Research-Securities-Class-Action-Filings-2018-YIR.pdf>.

<sup>6</sup> 15 U.S.C. § 78aa (2012).

<sup>7</sup> 15 U.S.C. § 77v(a) (2012).

<sup>8</sup> Cornerstone 2018 YIR, at 10, fig. 9.

<sup>9</sup> *Id.*

<sup>10</sup> *See, e.g.,* Daniel Hooper Smith, *Subjective Falsity Under Section 11 of the Securities Act: Protecting Statements of Opinions*, 6 U. P. R. Bus. L.J. 141, 160 (2015) ("Section 11 is often pled alongside section 12(a)(2) ..."); *Pension Tr. Fund for Operating Engineers v. Mortgage Asset Securitization Transactions, Inc.*, 730 F.3d 263, 277 (10th Cir. 2013) (plaintiffs alleging violations of sections 11 and 12(2)(a)); *Cozzarelli v. Inspire Pharm., Inc.*, 549 F.3d 618, 628 (4th Cir. 2008) (same); *Rombach v. Chang*, 355 F.3d 164, 178 (2d Cir. 2004) (same).

<sup>11</sup> Michael Klausner, Jason Hegland, Carin LeVine, Sarah Leonard, *IPO Litigation Risk* (unpublished data on file with author) (forthcoming, D&O Diary).

Historically, Section 11 claims were litigated predominantly in federal court. Table 1 documents that, in calendar year 2010, plaintiffs filed Section 11 claims against 24 issuers. The overwhelming majority, 22 of 24 (91.67 percent), were sued in federal court only. No issuer faced claims filed exclusively in state court. Only 2 issuers (8.33 percent) faced claims filed in both federal and state court. The Maximum Disclosure Loss (“MDL”)<sup>12</sup> exposure associated with the two actions filed in state and federal court was quite small in the context of overall class action securities fraud litigation: \$656 million, or only 14 one-hundredths of one percent of the total MDL alleged in all class action securities fraud complaints filed that year.<sup>13</sup> State court Section 11 litigation was, in 2010, a minor sideshow that warranted little if any attention.

By 2018, however, state courts came to dominate Section 11 litigation. Of the 41 issuers facing newly filed Section 11 claims, only 11 (26.83 percent) faced actions filed exclusively in federal court. In contrast, 30 (73.17 percent) faced claims filed either exclusively in state court, or in state and federal court. The MDL exposure associated with state court Section 11 actions surged to \$24.929 billion, a 38-fold increase over 2010 levels. Data for the first half of 2019 indicate that state court Section 11 litigation activity continues to dominate with 76.00 percent of new cases being brought exclusively in state court or in state and federal court. If first half trends continue, 50 issuers will be sued in Section 11 actions in 2019, a peak over this ten-year period, and again with roughly three quarters of the activity involving state court proceedings.

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<sup>12</sup> Cornerstone 2018 YIR, at 39 (“MDL is the dollar value change in the defendant firm’s market capitalization from the trading day with the highest market capitalization during the class period to the trading day immediately following the end of the class period. MDL should not be considered an indicator of liability or measure of potential damages. Instead, it estimates the impact of all information revealed during or at the end of the class period, including information unrelated to the litigation.”).

<sup>13</sup> Cornerstone Research, *Securities Class Action Filings, 2010 Year in Review*, 1, fig. 1 (showing that total MDL in 2010 was \$474 billion), <http://securities.stanford.edu/research-reports/1996-2010/Cornerstone-Research-Securities-Class-Action-Filings-2010-YIR.pdf>.

Table 1<sup>14</sup>  
Section 11 Class Action  
Activity by Venue (2010 – 2018)

Year	Federal Court Only	State Court Only	Parallel Filings	Total	Percentage of State or Parallel Filings	MDL of State Court Filings (\$Billions) *
2010	22	0	2	24	9.09%	\$0.656
2011	21	1	1	23	8.70%	\$2.679
2012	13	3	5	21	38.10%	\$5.897
2013	12	0	1	13	7.69%	\$0.187
2014	20	2	3	25	20.00%	\$7.944
2015	20	11	6	37	45.95%	\$37.097
2016	12	13	14	39	69.23%	\$33.799
2017	11	2	14	27	59.26%	\$23.102
2018	11	17	13	41	73.17%	\$24.929
2019 (1H)	6	12	7	25	76.00%	NA
2019 (est.) <sup>15</sup>	12	24	14	50	76.00%	NA

The increase in state court Section 11 litigation is occasionally attributed to the Supreme Court’s March 20, 2018, decision in *Cyan*.<sup>16</sup> However, Table 1 indicates that the trend began in 2015, about three years before *Cyan* was decided.

While *Cyan* might not have initiated the recent shift to state court, it did accelerate that shift and also significantly altered the geographic incidence of state court Section 11 claims. As Klausner, et al., observe, “[t]here has been a sharp increase in the number of cases filed in state court since *Cyan*....”<sup>17</sup> Prior to *Cyan*, state court Section 11 litigation concentrated in California. Since *Cyan*, Section 11 litigation has surged in New York. While no Section 11 claims were filed in New York State courts between 2010 and 2017, 13 claims were filed in 2018.<sup>18</sup> “These New York cases account for nearly the full difference between the number of state cases filed in 2017 and 2018.”<sup>19</sup> As Klausner, et al., observe, “unless Congress intervenes, the days of Section 11 cases being filed in federal court are over”<sup>20</sup> - - or, unless states permit the adoption of Federal

<sup>14</sup> Cornerstone 2018 YIR, 21-22, figs. 20, 21. Each entry denotes a single defendant against whom Section 11 claims have been filed in federal and/or state court. Data through June 30, 2019 are from Cornerstone Research, *Securities Class Action Filings, 2019 Midyear Assessment*. <http://securities.stanford.edu/research-reports/1996-2019/Cornerstone-Research-Securities-Class-Action-Filings-2019-MYA.pdf>.

<sup>15</sup> The estimate for the full year of 2019 is a simple linear extrapolation of first half data.

<sup>16</sup> See, e.g., Cornerstone 2018 YIR, at 21; *Cyan v. Beaver County Emp. Retirement Fund*, 138 S. Ct. 1061 (2018).

<sup>17</sup> Michael Klausner, Jason Hegland, Carin LeVine, Sarah Leonard, *State Section 11 Litigation in the Post-Cyan Environment*, at 7 (Dec. 2, 2019), available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3411861](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3411861).

<sup>18</sup> Cornerstone 2018 YIR, at 19, Fig. 18.

<sup>19</sup> Klausner, et al., *supra* note 18, at 7.

<sup>20</sup> *Id.*

Forum Provisions which would then constitute a non-legislative, private ordering solution that would redirect Securities Act litigation to federal court, its traditional forum.

## II. Plaintiffs' Incentives to Migrate.

Plaintiffs have powerful incentives to prefer state to federal court when litigating Section 11 claims. The literature highlights “three differences in procedural rules governing Section 11 class actions in state and federal court that could have a major impact on litigating and resolving these cases.”<sup>21</sup> First, pleading standards in many state courts are “more plaintiff-friendly than applied in federal court.”<sup>22</sup> Second, federal courts provide for automatic stays of discovery while motions to dismiss are pending, whereas state courts do not uniformly apply automatic stays.<sup>23</sup> Federal law also imposes restrictions on the identity of class representatives and class counsel that do not exist in state court proceedings.<sup>24</sup> These restrictions can also be viewed as less favorable to plaintiff counsel, particularly in weaker cases.<sup>25</sup> Third, “where cases based on the same alleged violations are filed in multiple states, or in state or federal court, the litigation can get complicated – and inefficient.”<sup>26</sup> Federal courts provide for “a relatively orderly process by which related cases are consolidated in one court,” but “there is no process for consolidation of a

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<sup>21</sup> *Id.* at 3.

<sup>22</sup> *Id.* at 3 – 6; see also Zachary D. Clopton, *Procedural Retrenchment and the States*, 106 CALIF. L. REV. 411, 424-27 (2018) (noting that *Iqbal / Twombly* pleading standards have been adopted by only five states and the District of Columbia. Most other states continue to apply their own, more lenient pleading standards.).

<sup>23</sup> Klausner, *et al.*, *supra* note 18, at 5. There is, however, a split as to whether the PSLRA’s discovery stay applies to state court proceedings. See Rachel Graf, *N.Y. Judges Split on Post-Cyan Discovery Stays*, Law360 (Aug. 7, 2019), <https://www.law360.com/articles/1185924/ny-judges-split-on-post-cyan-discovery-stays>. See also *Cyan*, 138 S. Ct. at 1066-67 (explaining that the PSLRA’s requirement that the lead plaintiff in any class action brought under the Federal Rules of Civil Procedure file a certification stating, among other things, that she had not purchased the relevant security at the direction of plaintiff’s counsel, is procedural, and thus applies only to suits brought in federal court). Some interpret *Cyan* to suggest that other procedural provisions of the PSLRA that are governed by the Federal Rules, for example, restrictions on payment of attorney fees and expenses, and the share of recovery to be awarded to the representative party, also do not apply in state court actions. See, e.g., Israel David & Samuel P. Groner, *State Court Securities Lawsuits and the PSLRA in a Post-Cyan Era*, Law.com (May 2, 2019), <https://www.law.com/newyorklawjournal/2018/05/02/state-court-securities-lawsuits-and-the-pslra-in-a-post-cyan-era/?slreturn=20190726093839>.

<sup>24</sup> For example, the PSLRA imposes a presumption that the lead plaintiff is the class member with the largest financial interest in the relief sought. 15 U.S.C. § 77z-1(a)(3)(B)(2018).

<sup>25</sup> “There is a possibility that [s]ection 11 actions in state court will be filed by opportunistic lawyers representing plaintiffs with minimal economic losses, just to extract nominal settlements from deep-pocket defendants who want the case to go away.” Dhruv Aggarwal et al., *Federal Forum Provisions and the Internal Affairs Doctrine*, 11 n.51(Aug. 18, 2019), <https://ssrn.com/abstract=3439078> (citing *In re BankAmerica Corp. Sec. Litig.*, 95 F. Supp. 2d 1044, 1049 (E.D. Mo. 2000), *aff’d*, 263 F.3d 795 (8th Cir. 2001), *as amended* (Oct. 3, 2001), as an example of a state court “authoriz[ing] a lead plaintiff that had previously been found woefully inadequate when bringing the same action in federal court.”).

<sup>26</sup> Klausner, *supra* note 18, at 5-6.

state case and a federal case.”<sup>27</sup> It follows that “defendants potentially face lawsuits not only in federal and state court, but possibly in multiple state courts, for the same alleged violation.”<sup>28</sup>

Support for the proposition that state courts are plaintiff-friendly in Section 11 cases is found in data indicating that only 22 percent of Section 11 complaints filed in state courts between 2011 and 2018 were dismissed,<sup>29</sup> whereas the comparable statistic in federal court is 40 percent.<sup>30</sup> Section 11 complaints are thus significantly more likely to survive a motion to dismiss and reach discovery in state court than in federal court. This difference in dismissal probabilities significantly increases the settlement value of Securities Act claims filed in state court.

Consider this simple example. Assume that a case has an expected settlement value of \$10 million in federal or state court, conditional on surviving a motion to dismiss. That lawsuit’s expected value in state court is \$7.8 million (a 78 percent survival probability (1.0-.22) multiplied by a \$10 million valuation). The same claim in federal court is worth \$6.0 million (a 60 percent survival probability (1.0-.40) multiplied by a \$10 million valuation). The \$1.8 million difference in this hypothetical constitutes a 30 percent premium to the expected settlement value in federal court. Put another way, all other factors equal, which is almost never the case in litigation, a Section 11 claim in state court is worth 30.0 percent more than in federal court simply because of the difference in dismissal probability. Higher expected verdicts and easier paths to discovery could easily and significantly increase this differential, thereby making state court even more attractive to plaintiffs.<sup>31</sup>

The literature further suggests that complaints that survive in state court, but that would have been dismissed in federal court, contribute to a proliferation of weak-merits Section 11 litigation. Commenters have expressed concerns that (a) state courts will fail to filter Section 11 cases at the motion to dismiss stage as vigorously as they do in federal courts, (b) cases of doubtful merit will be filed in state court in anticipation of a lenient bar at the motion to dismiss stage, and (c) defendants will face high litigation costs in simultaneously defending cases in state

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<sup>27</sup> *Id.* at 5.

<sup>28</sup> *Id.* at 5.

<sup>29</sup> *Id.* at 9.

<sup>30</sup> *Id.* This dismissal rate is based on cases in which there is a final ruling on a motion to dismiss. It excludes voluntarily dismissals and complaints dismissed without prejudice. Compare Cornerstone 2018 YIR, at 23 (Measuring the sample differently, and over a longer time period, indicating that between 2010 and 2017, the state court dismissal rate was 33% whereas the equivalent rate in federal court was 48%.).

<sup>31</sup> *Accord* Dhruv Aggarwal, Albert H. Choi & Ofer Eldar, Federal Federal Forum Provisions and the Internal Affairs Doctrine (August 18, 2019). U of Michigan Law & Econ Research Paper No. 19-009; U of Michigan Public Law Research Paper No. 646; Duke Law School Public Law & Legal Theory Series No. 2019-58. Available at SSRN: <https://ssrn.com/abstract=3439078> or <http://dx.doi.org/10.2139/ssrn.3439078>, at 13 (“[T]he lower rate of dismissal and higher probability of settlement suggest that the overall litigation expenses for corporate defendants are substantially higher in state courts as compared to federal courts.”).



and federal courts.<sup>32</sup> Obviously, the proliferation of weak-merit state court litigation also contributes to the growth of aggregate Securities Act litigation. The lower state court dismissal rate thus contributes both to the survival of weaker claims in state court and to the increase in the aggregate volume of Section 11 litigation, which gives defendants a basis upon which to claim that they are being subject to a larger volume of “non-meritorious” Securities Act litigation.

Data describing settlement values in state court and comparable Section 11 claims in federal court are sparse. Klausner’s data, summarized in Table 2, provide the best available information. Klausner cautions, however, that the relatively large values for mean federal settlements measured in either absolute dollar amounts or as a percentage of estimated statutory damages are driven by two very large settlements. If those settlements are excluded from the sample, “the mean settlement in federal court drops from \$18.3 million to \$9.8 million.” Excluding these outliers suggests, there appears to be no dramatic difference in settlement values between claims filed exclusively in federal court and those filed exclusively in state court.

These data should, however, be approached with caution because, in addition to the small sample size, a selection bias that can cause weaker claims systematically to be filed in state court can also cause the subsamples not to be comparable. Further, it may not be appropriate to truncate the samples by excluding the larger settlements obtained in federal court. Until sample sizes are sufficiently large to support quality-corrections more sophisticated than simple measures of the percentage of estimated maximum statutory damages, including metrics that reflect the underlying merits of each claim, it will be difficult to draw rigorous conclusions from the analysis of comparative settlement values. To be sure, the most obvious interpretation of these data suggests that weaker claims filed in state court can garner settlements comparable to those paid in respect of stronger claims filed in federal court, but that is not the only possible interpretation of the data.

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<sup>32</sup> See Doug Greene et al., *The Coming Securities Class Action Storm: Multijurisdictional Litigation After Cyan*, Practical Law 19 (2018), [https://www.wileyrein.com/media/publication/486\\_Q32018.pdf](https://www.wileyrein.com/media/publication/486_Q32018.pdf); David M. J. Rein et al., *Securities Litigation Involving the Private Securities Litigation Reform Act (PSLRA)*, THOMPSON REUTERS PRACTICAL LAW, <https://us.practicallaw.thomsonreuters.com/w-010-6738>; Michael S. Fylnn et al., *Client Memorandum: The Supreme Court’s Cyan Decision and What Happens Next*, DAVIS POLK & WARDWELL LLP (Apr. 13, 2018), <https://www.davispolk.com/files/2018-04-13-supreme-courts-cyan-decision-what-happens-next.pdf>.

Table 2

Settlement Values in  
Section 11 Cases Filed in  
Federal or State Courts  
(2014 - 2019)<sup>33</sup>

Settlements	Section 11 Cases Filed in	
	State Court Only	Federal Court Only
Dollar value		
Median	\$7,800,000	\$7,750,000
Mean	\$7,941,875	\$18,300,000
As a percentage of Estimated Statutory Damages <sup>34</sup>		
Median	11.0%	11.5%
Mean	12.4%	28.4%
No. of Observations	20	30

The ability to file Securities Act complaints in state court also causes an increase in the strategies available to plaintiff counsel seeking to capture a percentage of any ultimate fee award in connection with a settlement. Plaintiff counsel jockeying for positions that will allow them to participate in fee awards can now file in multiple federal courts and in multiple state courts. The pendency of complex litigation in multiple jurisdictions simultaneously increases the litigation burden on the defendant firm (and thereby increasing the incentive to settle) while increasing the pool of plaintiff firms with incentives to file claims in disparate jurisdictions.

Recent litigation in connection with the IPO of SmileDirectClub illustrates the problem. The issuer faces multiple Section 11 complaints filed in federal court in the Eastern District of Michigan, the Southern District of New York, and in the Middle District of Tennessee.<sup>35</sup> In state court, it faces claims filed in Tennessee Chancery Court, Tennessee Circuit Court, and Michigan Circuit Court.<sup>36</sup> “While there are mechanisms to consolidate cases within the federal court system, and even to consolidate cases within Tennessee, there are no mechanisms to consolidate cases between the federal court system and the Tennessee state court system. There are no mechanisms to consolidate cases between the federal court system and the Michigan state court

<sup>33</sup> Klausner et al., *supra* note 18, at 14, figs. 5, 6.

<sup>34</sup> Estimated Statutory Damages are defined in Klausner *et al.*, *supra* note 18, at 11, n. 24 (“Estimated statutory damages are calculated as the difference between the value of shares issued in a public offering and the market value of those shares at the time of a lawsuit, adjusted by the change in the overall market over the same time period.”).

<sup>35</sup> Kevin Lacroix, Multiplied and Parallel Litigation: The Mess that Cyan has Wrought (Nov. 18, 2019), at 2 – 3, available at <https://www.dandodiary.com/2019/11/articles/securities-litigation/multiplied-and-parallel-litigation-the-mess-that-cyan-has-wrought/>

<sup>36</sup> *Id.*

system. There are not mechanisms to consolidate cases between the Tennessee state court system and the Michigan state court system. As things stand, SmileDirect must now fight a multi-front war.... This is obviously a huge mess,”<sup>37</sup> and one that clearly advantages plaintiffs in the aggregate over the defendant.

The proliferation of state court litigation also imposes costs on the judicial system. “Complexity and expense aside, more state court class actions and parallel proceedings increases the risk of inconsistent rulings, whether by state court judges unfamiliar with the Securities Act’s terrain, or in cases involving unsettled or tricky issues.”<sup>38</sup> As a federal court recently observed, “remanding [a Section 11] case [to state court] creates the risk that parallel state and federal proceedings could produce inconsistent (and even contradictory) conclusions regarding key questions of fact and law.”<sup>39</sup> Increasing uncertainty increases a lawsuit’s settlement value and generates negative externalities for the judicial system and market as a whole.<sup>40</sup> The increases in settlement value attributable to increased uncertainty, and the negative systemic externalities caused by litigating Section 11 claims in state court, arise in addition to the costs imposed directly on issuers because of lower state court dismissal rates.

### III. The Cost of Directors and Officers Insurance.

The dramatic shift of Section 11 litigation to state court is concurrent with a steep increase in the price of D&O coverage for initial public offerings. Commenters attribute the price hikes to increased state court litigation following *Cyan*, combined with *Sciabacucchi*, which “effectively eliminates the possibility of using Federal Forum Provisions for most companies. The bottom line is that IPO companies ... now continue to face the possibility of having to fight Section 11 litigation in state court, possibly as part of a multi-front war.”<sup>41</sup> Consequently, “[m]any insurers will now only quote primary D&O insurance for an IPO company subject to a separate retention for state court securities lawsuits, and in some cases also subject to coinsurance. The retentions range as high as \$10 million or more.... In any event the cost of D&O insurance for the IPO companies is higher than in the past, in many cases significantly so.”<sup>42</sup>

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<sup>37</sup> *Id.* at 5.

<sup>38</sup> James Goldfarb & Guarav Talwar, *The Post-Cyan Spike in State Securities Act Filings*, Law360, (March 19, 2019, 1:54 PM EDT), [https://www.mmlawus.com/newsitem/pdf/The\\_Post-Cyan\\_Spike\\_In\\_State\\_Securities\\_Act\\_Filings\\_3015574751391253681.pdf](https://www.mmlawus.com/newsitem/pdf/The_Post-Cyan_Spike_In_State_Securities_Act_Filings_3015574751391253681.pdf).

<sup>39</sup> *Baker v. Dynamic Ledger Solutions, Inc.*, Case No. 17-cv-06850-RS, 2018 WL 4740197, at \*2 (N.D. Cal. Apr. 19, 2018).

<sup>40</sup> See generally Joseph A. Grundfest & Peter H. Huang, *The Unexpected Value of Litigation: A Real Options Perspective*, 58 STAN. L. REV. 1267 (2006).

<sup>41</sup> Kevin M. LaCroix, *The Top Ten D&O Stories of 2018*, DANDODIARY.COM (Jan 7, 2019), <https://www.dandodiary.com/2019/01/articles/director-and-officer-liability/top-ten-stories-2018/>.

<sup>42</sup> *Id.*

Press reports suggest that “rates are rising from 10% to 50% with some “extreme outliers” seeing even higher rates.”<sup>43</sup> Observers report that “firms including those with a recent initial public offering, financial troubles or a claims history are seeing very significant increases.”<sup>44</sup> “A \$5 million policy that cost \$200,000 in 2016 can now easily cost \$500,000 to \$600,000.”<sup>45</sup> Since Cyan, “the market has gotten absolutely more challenging.”<sup>46</sup>

Capacity for new business is also “dramatically thinner than historically” the case, and some policyholders with \$25 million in capacity “are seeing it reduced to \$15 million or \$10 million.”<sup>47</sup> These reductions in capacity diminish the aggregate effectiveness of insurance in a manner not reflected through increased retentions or rates. These significant increases in insurance premia, and reductions in coverage limits are costs borne by all IPO issuers and investors, regardless of whether issuers are named in Section 11 actions.

Data describing insurance market pricing reinforce these assessments. Table 3, based on data provided by Aon Commercial Risk solutions, a major D&O broker, shows that retentions, the deductibles paid out of pocket by insureds before coverage begins, have climbed dramatically since 2016 with median retentions for all IPO issuers rising from \$1 million to \$10 million in the first half of 2019. This is a tenfold increase in expense borne by the median insured before coverage is available. Median retentions for technology IPOs began at a higher base of \$1.25 million in 2016, and have also increased to \$10 million, an eightfold increase.

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<sup>43</sup> Judy Greenwald, *D&O Rates Skyrocket in Hardening Market*, BUSINESS INSURANCE (June 25, 2019), <https://www.businessinsurance.com/article/20190625/NEWS06/912329208?template=printart>.

<sup>44</sup> *Id.*

<sup>45</sup> Suzanne Barlyn, *D&O Insurance Costs Soar as Investors Run to Court Over IPOs*, INS. J. (June 18, 2019) (quoting Paul Schiavone, head of North American Financial Lines for Allianz Global Corporate & Specialty).

<sup>46</sup> *Id.* (quoting Jennifer Sharkey, President of the Northeast Management Liability Practice for insurance broker Arthur J. Gallagher & Co.).

<sup>47</sup> Greenwald, *supra* note 98.

Table 3

Median Retentions in  
Initial Public Offerings  
(2016 – 2019 (1H))<sup>48</sup>

Year	Median Retentions			
	All Offerings		Technology Offerings	
	Dollar Amount	Percentage of 2016 Level	Dollar Amount	Percentage of 2016 Level
2016	\$1,000,000	---	\$1,250,000	---
2017	\$1,000,000	100%	\$2,000,000	160%
2018	\$2,500,000	250%	\$5,000,000	400%
2019(1H)	\$10,000,000	1,000%	\$10,000,000	800%

The cost of insurance available once retentions are satisfied has also spiked. Table 4, also based on data provided by Aon, indicates that the median rate per million for the primary policy of coverage<sup>49</sup> for all IPO issuers increased from \$28,000 in 2016 (2.8 percent of the primary policy limit) to \$123,000 in the first half of 2019 (12.3 percent of the primary policy limit). The 2019 cost of coverage for the first million dollars of exposure beyond the retention was thus 439% of the comparable 2016 price. The increase for technology issuers was slightly more dramatic, with the median rate per million rising from \$28,150 in 2016 (2.815 percent of the primary policy limit) to \$134,000 in the first half of 2019 (13.4 percent of the primary policy limit), an increase of 476%.

<sup>48</sup> Aon Commercial Risk Solutions, data on file with author.

<sup>49</sup> The primary layer of coverage is often written for \$5 million or \$10 million. Thus, the median technology issuer represented by Aon in 2018 paid an annual premium of \$750,000 for \$10 million in primary layer coverage.

Table 4  
 Median Primary Rate Per  
 Million Dollars of Coverage  
 in Initial Public Offerings<sup>50</sup>  
 (2016-2019(1H))

Year and Quarter	Mean Retention	Percentage of 2015 Level	Mean Premium	Percentage of 2015 Level
2015	\$2.0 Million	100%	\$196,776	100.0%
2016	\$1.5 Million	75%	\$217,191	110.4%
2017	\$2.0 Million	100%	\$225,872	114.7%
2018: Q1	\$2.5 Million	125%	\$281,508	143.1%
Q2	\$2.5 Million	125%	\$314,847	160.0%
Q3	\$4.0 Million	200%	\$391,111	198.8%
Q4	\$5.0 Million	250%	\$540,334	274.6%
2019: Q1	\$7.5 Million	325%	\$660,144	335.5%
Q2	\$8.0 Million	400%	\$768,105	390.3%

A technology issuer at the market median in 2018 would thus pay an aggregate of \$1,340,000 for the first \$10 million in coverage that would become available only after the issuer had already absorbed \$10 million in litigation or settlement expenses.<sup>51</sup> The issuer could also learn that the maximum amount of coverage, even with higher retentions and premiums, was significantly lower than had previously been the case.

Further supporting data are presented in Table 5 which reports mean, not median, statistics regarding D&O insurance pricing provided by Woodruff-Sawyer, another leading D&O insurance broker. Table 5 indicates that, for the second quarter of 2019, mean retentions in IPOs were quadruple the levels observed in 2015. Premia almost quadrupled. These data are directionally consistent with Aon's median statistics and are of similar magnitude. The two data sets can be viewed as confirming a common underlying trend of dramatically increased cost for D&O insurance among IPO issuers.

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<sup>50</sup> *Id.*

<sup>51</sup> This calculation assumes that \$10 million of coverage is available at the same rate as the first \$1 million of insured exposure.

Table 5

Mean Retentions and  
Premia in IPOs  
(2015 – 2019 Q2)<sup>52</sup>

Year	All Offerings		Technology Offerings	
	Dollar Cost	Percentage of 2016 Level	Dollar Cost	Percentage of 2016 Level
2016	\$28,000	---	\$28,150	---
2017	\$22,847	81.6%	\$29,500	105%
2018	\$51,500	184%	\$75,000	266%
2019(1H)	\$123,000	439%	\$134,000	476%

While consistent with subjective reports regarding the effects of Section 11 claim migration to state court, these data are formally insufficient to establish causality. They do not control for a wide range of factors that influence insurance market pricing, nor do they test whether issuers more likely to be subject to problematic state court litigation incur higher premia. The data are, however, consistent with public reports that initial public offerings now face dramatically higher D&O insurance costs, and that issuers have powerful incentives to control the insurance costs associated with those offerings, as well as the litigation costs generated by Section 11 claims.

#### IV. The Evolution, Propagation, and Demographics of Federal Forum Provisions.

First proposed in May of 2016,<sup>53</sup> Federal Forum Provisions provide that federal Securities Act claims that were traditionally litigated in federal court will continue to be litigated in federal court where the judiciary has a comparative advantage in resolving those claims.<sup>54</sup> The first Federal Forum Provision appeared in the charter of an issuer whose registration statement was declared effective on March 1, 2017.<sup>55</sup> About two years later, as of March 27, 2019, at least 58 initial public offerings were of issuers with Federal Forum Provisions in their charters or bylaws.<sup>56</sup> Of these 58 issuers, 54 are chartered in Delaware. No other jurisdiction charters more than one issuer in the sample. These issuers are most frequently headquartered in California (28),

<sup>52</sup> Data provided by Woodruff Sawyer (on file with author).

<sup>53</sup> See Verified Class Action Compl. for Decl. J. at ¶ 46, *Sciabacucchi v. Salzberg*, No. 2017-0931-JTL (Del. Ch. Dec. 29, 2017).

<sup>54</sup> However, if a claim is filed in Delaware state court, the defendant corporation will rationally agree to litigate in Delaware lest the Federal Forum Provision as there applied violate DGCL 115. See *Infra*, Section VI.C.

<sup>55</sup> Snap, Inc., Form S-1 (March 1, 2017),

<https://www.sec.gov/Archives/edgar/data/1564408/000119312517068848/d270216d424b4.htm>.

<sup>56</sup> These issuers were identified by searching SEC filings on Forms S-1, 1-A, and 8-K through March 27, 2019, for documents containing the terms “exclusive forum” and “federal district courts.” Each document was then examined to assure that it referred to a charter or bylaws containing a Federal Forum Provision. The analysis excludes issuers still in registration as of March 27, 2019. Aggarwal, et al., *supra* note 32, however, report 107 instances of Federal Forum Provisions.

Massachusetts (12), New York (6), and Washington (3). In 27 of these 58 offerings (46.6%), the issuer is headquartered in California and chartered in Delaware. This is far and away the most common charter-headquarter duet.

Federal Forum Provisions appear primarily in the going-public charters of initial public offerings, and 93% of initial public offerings between 2013 and 2017 were chartered in Delaware.<sup>57</sup> Federal Forum Provisions are thus very much a Delaware phenomenon. Thirty-eight issuers included Federal Forum Provisions in their charters (65.5%), while twenty (34.5%) adopted them as bylaws. Nine (15.5%) designate a specific federal court in which Securities Act cases are to be filed. In each instance the designated court is in the judicial district of the corporation's headquarters, which is where the litigation would most likely proceed given federal venue rules and corporate defendants' historic preference for litigation in their home district.

The large majority of these issuers are in the biotech and technology sectors: 28 (48.3 percent) are categorized within four-digit SIC Codes that describe the biotech sector,<sup>58</sup> and the internet and computer tech sectors account for another 20 (34.5 percent).<sup>59</sup> The biotech and internet/tech sectors thus together account for 48 (82.8 percent) of the 58 companies. This is a rational pattern inasmuch as the expected benefits of Federal Forum Provisions are larger for issuers with higher probabilities of facing Section 11 claims.<sup>60</sup>

A separate analysis of a population of 107 issuers that adopted Federal Forum Provisions<sup>61</sup> reaches conclusions consistent with these demographics. That analysis also finds that "adopting firms are more likely to belong to industries that are known to be vulnerable to securities class action litigation."<sup>62</sup> The adopting firms tend to be larger than the norm in IPOs, and are more likely to engage in underpriced offerings: *i.e.*, the initial IPO price tends to be lower than the market price at the end of the first day of trading.<sup>63</sup> Firms adopting Federal Forum Provisions tend to have more negative earnings and higher levels of cash on hand.<sup>64</sup> Further, "the

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<sup>57</sup> See Wilmer, Cutler, Pickering, Hale and Dorr LLP, *2018 WilmerHale IPO Report 8*, at <https://www.wilmerhale.com/en/insights/publications/2018-ipo-report>.

<sup>58</sup> Issuer SIC codes are drawn from the cover pages of the corresponding issuer registration statements. SIC 2836 (biological products) had 13 issuers; SIC 2834 (pharmaceutical preparations) had 9 issuers; SIC 3841 (surgical and medical instruments) had 3 issuers; and there was one issuer in each of SIC 2833 (medicinal chemicals), 3845 (electromedical apparatus), and 4841 (cable and other pay television services).

<sup>59</sup> SIC 7372 (prepackaged software) had 8 issuers; SIC 7370 (computer programming, data processing) had 4 issuers; there were 3 issuers in SIC 5961 (retail catalogue and mail order); two issuers in SIC 7374 (computer processing and data preparation); and one issuer in each of SIC 3674 (semiconductor and related devices), 7371 (computer programming services), and 3651 (household audio and video).

<sup>60</sup> The three defendants in *Sciabacucchi* fit this pattern. Blue Apron, an online food service delivery platform, is categorized in SIC 5961; Roku, a cable device, in SIC 4841; and StitchFix, an online clothing and fashion service, in SIC 5961.

<sup>61</sup> Aggarwal et al., *supra* note 32, at 14.

<sup>62</sup> *Id.* at 15.

<sup>63</sup> *Id.*

<sup>64</sup> *Id.*



governance of firms that adopt [Federal Forum Provisions] tends to be more shareholder friendly than that of non-adopting firms,”<sup>65</sup> and are “less likely to have a dual class structure following the IPO.”<sup>66</sup> The “good governance” characteristics of firms adopting Federal Forum Provisions are potentially significant from a public policy perspective, and are consistent with and reinforces the hypothesis that Federal Forum Provisions are adopted to promote stockholder interests. This perspective is buttressed by findings that the *Sciabacucchi* decision was contemporaneous with a statistically and economically significant decline in the value of issuers that had adopted Federal Forum Provisions.

#### V. Stock Price Effects.

*Sciabacucchi*’s decision invalidating Federal Forum Provisions is correlated with a statistically and economically significant decline in the price of equity securities of issuers who have adopted Federal Forum Provisions.<sup>67</sup> Depending on model specification, window size, sample definition, and other variations in statistical technique, the magnitude of the effect appears to range from about -1.39% to -9.085%.<sup>68</sup> Using the two-day window, the most commonly employed metric, the analysis finds a stock price effect in excess of 7 percent over this period. “Taken at face value, this suggests that the decision [in *Sciabacucchi*] reduced the [average] total market capitalization of a firm with a [Federal Forum Provisions] by 7%.”<sup>69</sup>

This is a surprisingly large effect. While the study does not eliminate the possibility that confounding events may have inflated the estimate, “the size of the stock price effect strongly suggests that at the very least, it is safe to overrule the possibility that [*Sciabacucchi*] positively affected the stock price of firms that adopted [Federal Forum Provisions].”<sup>70</sup> Indeed, other studies provide support for a magnitude this large. “[G]iven the very high negative stock price effect of shareholder class action litigation valued by one study at almost 10 percent, and the impact that litigation in state courts as opposed to federal courts has on outcomes of litigation...it may be argued that the negative stock price effect does actually reflect the [magnitude of] the negative impact of [*Sciabacucchi*] on firm value.”<sup>71</sup>

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<sup>65</sup> *Id.*

<sup>66</sup> *Id.* at 16.

<sup>67</sup> *Id.* at 20-21.

<sup>68</sup> *Id.* at 20-21, tbls. 6-9.

<sup>69</sup> *Id.* at 22.

<sup>70</sup> *Id.*

<sup>71</sup> *Id.* (citing Amar Gande & Craig M. Lewis, *Shareholder-Initiated Class Action Lawsuits: Shareholder Wealth Effects and Industry Spillovers*, 44 J. FIN. & QUANTITATIVE ANALYSIS 823 (2009) (finding a lawsuit related stock price decline of 9.79 percent)).

## VI. Potential Future Evolution.

The future of Federal Forum Provisions hinges critically on the *Sciabcucchi* appeal currently pending before the Delaware Supreme Court. If Delaware's Supreme Court finds that Federal Forum Provisions are valid under Delaware law, then there is little reason for corporations not to adopt Federal Forum Provisions in their organic documents. The provisions would provide an easy mechanism to direct Securities Act litigation to federal court where the probability of dismissal is higher, and litigation costs are likely lower. Causing those claims to be presented in federal court would also eliminate the litigation costs associated with the jurisdictional jockeying that arises when plaintiffs file claims in federal and state court.

A decision validating Federal Forum Provisions would also strengthen Delaware's position in the market for corporate charters because it would provide another reason for corporations to prefer a Delaware charter over charters on offer from other states that lack clear precedent validating Federal Forum Provisions. Issuers concerned over Section 11 claims would then rationally value the certainty available through the Delaware charter. Indeed, insurers might also value the certainty that would then be available in Delaware, and could rationally offer favorable pricing for issuers chartered in Delaware rather than in other states that do not as clearly hold Federal Forum Provisions to be valid.

If, however, Delaware's Supreme Court rules that Federal Forum Provisions are invalid under Delaware law, then the economic pressure to cause Securities Act litigation to be brought in federal court will not abate. On the federal front, corporations could petition Congress to amend the Securities Act either to eliminate concurrent jurisdiction by providing that all Securities Act claims must be brought in federal court, just as all Exchange Act claims must be brought in federal court, or expressly to permit forum selection clauses that would direct Securities Act claims to federal court, thereby invoking the Supremacy Clause to override the effects of the Delaware opinion. From this perspective, these federal lobbying efforts would come about because the corporate community would perceive Delaware's courts as intruding on the federal right to designate the forum in which a Securities Act claim is to be resolved.<sup>72</sup> The outcome of that federal lobbying initiative is, of course, difficult to predict. The plaintiff bar will rationally fight any such initiative, and the influence of the plaintiff bar on Congress should not be underestimated.

Alternatively, corporate interests could proceed at the state level. Outside of Delaware, it would be relatively easy for corporate interests to approach legislatures of states such as Nevada and suggest that they amend their corporate codes expressly to permit Federal Forum Provisions. Corporations and insurers would likely pursue this strategy with some vigor because it may be

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<sup>72</sup> See Grundfest, *supra* note 1, and discussion of *Rodriguez de Quijas v. Shearson /Am. Express Inc.*, 490 U.S. 477 (1989) therein (Section II.A).

perceived as having a higher chance of success than the approach on the federal front, and would likely be implemented more rapidly than federal legislation. Nor should it be surprising to see this state-level strategy succeed because it offers a potentially valuable lever to states seeking to compete with Delaware in the market for corporate charters.

Indeed, this strategy offers competing states a form of competitive advantage that none of them have ever in the past possessed when competing with Delaware for new charters. In particular, insurers will have incentives to price D&O coverage favorably for issuers who charter in jurisdictions that expressly permit Federal Forum Provisions. This price incentive will be most powerful for larger issuers in riskier technology sectors with greater Section 11 exposure. If such a price differential emerges in the D&O insurance market, it will be the first instance in which there is an immediate, quantifiable, and potentially significant cost associated with the decision to charter in Delaware rather than in another state. Put another way, the insurance market will rationally develop a “Delaware penalty” that will be expressed in the form of more expensive coverage for Delaware chartered issuers with material Section 11 exposure, compared with the rates that would be charged for the same issuer had they chartered in a state that enforces FFPs. The effect of such economic incentives is at present difficult to project, but it cannot advance Delaware’s ability to compete in the market for corporate charters.

Another state-level response would have corporate interests approach Delaware’s legislature to propose that the DGCL be amended to permit Federal Forum Provisions. The success of these efforts is also difficult to predict, but is likely lower than the probability of persuading at least one state other than Delaware to validate Federal Forum Provisions in order to create a new form of competition in the market for corporate charters. If efforts to amend the DGCL succeed, then Federal Forum Provisions should subsequently be expected to become ubiquitous. If those efforts fail, then the most likely outcome is that at least one sister state will amend its corporation code to validate Federal Forum Provisions, and Delaware will then remain subject to an unprecedented form of competition in the market for corporate charters, and to the emergence of a “Delaware penalty” in the market for D&O insurance.