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# Pushing the Envelope: *Salzberg v. Sciabacucchi* and Delaware's Evolving View of the Internal Affairs Doctrine

By Professor Mark J. Loewenstein\*

In January of this year, the Delaware Supreme Court handed down its decision in *Salzberg v. Sciabacucchi*,<sup>1</sup> upholding a provision in a certificate of incorporation that designated the federal courts as the exclusive jurisdiction for the litigation of claims under the federal Securities Act of 1933 ("1933 Act").<sup>2</sup> The inclusion of these provisions in Delaware charters and bylaws—often referred to as "Federal Forum Provisions" or FFPs—raised important questions as to the reach of the internal affairs doctrine. This doctrine provides that the jurisdiction of incorporation regulates the internal affairs of its corporations: the relationship among and between the corporate officers, directors and shareholders. Although, strictly speaking, the Court left this definition of internal affairs untouched, the practical effect of the decision was, perhaps, to expand the reach of state corporate law by expanding the kinds of provisions that a corporation may include in its charter and bylaws. I will return to the implications of *Salzberg* after a summary of the opinion.

## A. The Supreme Court opinion.

The Court began its opinion quoting an example of the FFPs from the charters of two of the three corporate parties to this litigation (Stitch Fix, Inc. and Roku, Inc.):

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 Company] shall be deemed to have notice of and consented to [this provision].<sup>3</sup>

The corporate parties had amended their charters to include FFPs before filing for their initial public offerings, presumably to avoid having to litigate 1933 Act claims in state court. Unlike the Securities Act of 1934, the 1933 Act expressly provides that private rights of action may be filed in either federal or state

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courts. It is likely that the corporate parties preferred to litigate any such claims in federal court, where the Private Securities Litigation Reform Act of 1995 (PSLRA) would apply. The PSLRA includes various provisions generally perceived as less favorable to plaintiffs than state law.

The FFPs in this case were challenged on the basis of two arguments: first, that FFPs do not relate to the internal affairs of the corporation and, therefore, are beyond the jurisdiction of state law; and second, provisions added to the Delaware General Corporation Law (DGCL) in 2015 at least implicitly preclude such provisions. Focusing on the former argument, the Chancery Court granted plaintiffs' motion for summary judgment,<sup>4</sup> writing that "the constitutive documents of a Delaware corporation 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."<sup>5</sup> Because "the Federal Forum Provisions attempt to accomplish that feat," the court held that the provisions are "ineffective and invalid."<sup>6</sup>

The Delaware Supreme Court reversed.<sup>7</sup> The Court began its analysis with Section 102(b)(1) of the DGCL, which provides, generally, what may be set forth in a Delaware certificate of incorporation. It allows "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 . . ."<sup>8</sup> Deconstructing this provision, the Court noted that it authorizes "two broad types of provisions: *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."<sup>9</sup> The Court followed this with its conclusion: FFPs are facially valid and fall within either of these categories because they seek to regulate the forum in which "intra-corporate" litigation may take place.<sup>10</sup>

The impetus for FFPs was triggered by the U.S. Supreme Court decision in *Cyan, Inc. v. Beaver County Employees Retirement Fund*,<sup>11</sup> which held that federal and state courts have concurrent jurisdiction over claims under the 1933 Act, and that such claims if filed in state court are not removable to federal court. This holding led to a dramatic increase in 1933 Act claims in state court and in parallel class actions filed in both state and federal courts. The result was a chaotic and, in some cases, an unmanageable situation for corporate defendants. Thus, the Delaware Supreme Court concluded, FFPs were necessary to ensure "judicial economy and avoid duplicative efforts among courts in

resolving disputes.”<sup>12</sup>

The Court also rationalized its holding on the basis of private ordering, noting that since charter amendments require stockholder approval and are considered “contracts among a corporation’s stockholders”<sup>13</sup> they “should be respected as a matter of policy.”<sup>14</sup>

Finally, the Court dealt with two arguments that plaintiffs relied upon: certain amendments to the DGCL adopted in 2015 and the case of *ATP Tour, Inc v. Deutscher Tennis Bund*.<sup>15</sup> Among other things, the 2015 amendments added § 115, which authorized charter provisions that designated Delaware as the exclusive jurisdiction for “internal corporate claims” and defined that term as 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.”<sup>16</sup> The provision also invalidates charter provisions that prohibit Delaware courts from hearing such claims.

Plaintiffs’ argument with respect to the 2015 amendments thus rested on the implication that because § 115 did not explicitly allow provisions like FFPs, it implicitly forbade them. The Court rejected this argument, relying primarily on traditional rules of statutory interpretation and on what it called a “holistic reading” of § 115. That section was limited, by its terms, to “internal corporate claims” while FFPs address 1933 Act claims, which are quite different. Indeed, the Court noted that federal courts are “most experienced in adjudicating them.”

Plaintiffs’ argument based on *ATP*, though successful in the Chancery Court, did not persuade the Supreme Court. In *ATP* the Delaware Supreme Court had answered a certified question on referral from the United States Court of Appeals for the Third Circuit regarding a fee-shifting provision in the bylaws of a Delaware nonstock corporation. A member of the corporation challenged the fee-shifting provision following an unsuccessful claim against the corporation under the federal antitrust laws, Delaware fiduciary law principles, and other claims. The Delaware Court advised the federal court that the fee-shifting bylaw was facially valid. Plaintiffs in the *Salzberg* litigation argued that the Court in *ATP* upheld the fee-shifting provision because the underlying litigation involved claims under Delaware law (among other claims) and, therefore, the bylaw dealt with “internal affairs,” a permissible subject for bylaws. FFPs, however, relate to claims governed by federal law and, therefore, are beyond the scope of permissible bylaws. On this argument the Court made perhaps the most important pronouncement in the case: claims under Section 11 of the 1933 Act “are ‘internal’ in the sense that they arise from internal corporate conduct on the part of the

its impact on the internal affairs doctrine. It was on this basis that the Chancery Court held the FFPs were not enforceable: they went beyond the internal affairs of the corporation. The Supreme Court held that charter provisions are not limited to internal affairs; such provisions need only be within the limitations of DGCL § 102(b)(1). A robust view of this section would justify a charter provision that, say, mandates arbitration for claims brought by stockholders under the federal securities laws.<sup>24</sup>

Whether the charter (or bylaw) provision is a forum selection provision or an arbitration provision, the claim may be brought outside of Delaware in defiance of the provision. The court would have to decide whether the robust reading of the *Salzberg* court should be followed or the traditional internal affairs doctrine, as articulated by the Chancery Court in this litigation. Given how zealously courts tend to guard their jurisdiction,<sup>25</sup> the corporate defendant may not fare well.

Another possible challenge to the internal affairs doctrine comes from the opposite direction: state statutory law that does relate to the internal affairs of corporations chartered elsewhere but headquartered or at least doing business within the state enacting the law. A recent California law, for instance, mandates gender diversity on the boards of publicly held corporations headquartered in California.<sup>26</sup> The composition of a corporate board of directors is arguably the quintessential internal affair, but California courts are unlikely to deny enforcement of its law—which is grounded on public policy—even if the foreign corporation, headquartered in California, had a charter provision that conflicted with the California mandate. That development may prompt other states to attempt similar forays into regulations and laws that encroach on the internal affairs of foreign corporations subject to its jurisdiction with the resulting dilution of the internal affairs doctrine.

Delaware legislators should take note of these developments. As Professor Manesh has noted, if Delaware corporations are too aggressive in defining the rights of their shareholders, particularly in the area of federal law, they invite federal regulation.<sup>27</sup> If the California legislation is upheld, other states may decide to regulate foreign corporations within their jurisdiction even if that regulation falls within the traditional view of the internal affairs doctrine, as articulated by the Chancery Court in this case. Combined, these developments threaten the hegemony of Delaware as a place to incorporate.<sup>28</sup> That, in turn, also threatens and puts in jeopardy the fiscal benefits to incorporating in Delaware.<sup>29</sup>

### **C. Questions left open by the opinion.**

#### **1. What about claims against underwriters and other professionals?**

*Salzberg* only upheld the facial validity of FFPs that relate to 1933 Act claims against the corporation and its officers and directors. But 1933 Act claims typically include claims against underwriters and other professionals connected to the public offering, some of whom (particularly underwriters) may have agreements requiring the corporation to indemnify them. This raises the question of whether 1933 Act claims may proceed against those defendants in state court while a parallel action proceeds in federal court against the corporation and its officers and directors. The answer appears to be yes. This, in turn, suggests that underwriters may require their Initial Public Offering (IPO) clients to remove FFPs from their Delaware certificates of incorporation to avoid having to bring a separate action for indemnification.

#### **2. What about claims made by investors who were not shareholders of the corporation at the time that they made the investment that is the subject of the litigation?**

The *Salzberg* court rationalized its decision, in part, on private ordering. The shareholders had agreed to the provision and should be bound by it. But if the purchaser in an IPO was not a shareholder before the investment, can it be argued that there was a contractual agreement between the corporation and the investor?<sup>30</sup> The corporation could argue that a purchaser of its stock makes that investment “knowing” of and “accepting” the terms of the charter and bylaws so, yes, there is a contract. This scenario may be one in which a future court limits the reach of *Salzberg* and rules that it only applies if the claimant was a stockholder at the time of the stock acquisition in question.

#### **3. May FFPs be included in bylaws?**

The bylaws of a Delaware corporation may contain provisions that are similar to those permitted in the certificate of incorporation. Section 109(b) of the DGCL provides: “The bylaws may contain any provision, not inconsistent with law . . . , relating to the business of the corporation, the conduct of its affairs and the rights or powers of its stockholders, directors, officers or employees.”<sup>31</sup> By comparison, the language in § 102(b)(1) permits provisions “for the *management* of the business” and provisions “creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders . . .”<sup>32</sup> So, the relevant question is whether FFPs relate to the business of the corporation or the rights or powers of its stockholders. At least

arguably, they do. Further, if the certificate of incorporation allows directors to amend the bylaws, FFPs may be imposed by the directors acting without stockholder approval.

#### **4. Under what circumstances may a Delaware court deny enforcement of an FFP?**

The Supreme Court in *Salzberg* emphasized that the FFPs before it were facially valid and enforceable, implying that there may be circumstances in which such a provision would not be enforced. One example may be when the plaintiff is not a stockholder before becoming the subject of the 1933 Act complaint. Under those circumstances, the plaintiff might argue that a charter provision cannot limit the rights of a person whose cause of action arose simultaneously with becoming a stockholder. Note, as well, if the litigation is filed in a state court outside of Delaware, the court might rule that the FFP cannot limit its jurisdiction and are inconsistent with its law. Finally, the *Salzberg* court recognized three circumstances under which an FFP might not be enforced: "There are three bases on which forum-selection provisions might be invalidated on an 'as applied' basis: (i) they will not be enforced if doing so would be unreasonable and unjust; (ii) they would be invalid for reasons such as fraud or overreaching; or (iii) they could be not enforced if they contravened a strong public policy of the forum in which suit is brought, whether declared by statute or by judicial decision."<sup>33</sup>

As to first circumstance, the U.S. Supreme Court indicated that the relevant criterion is whether "trial in the contractual forum will be so gravely difficult and inconvenient that he will for all practical purposes be deprived of his day in court."<sup>34</sup> Otherwise, "there is no basis for concluding that it would be unfair, unjust, or unreasonable to hold that party to his bargain."<sup>35</sup> It seems unlikely that a plaintiff could prevail on this test: not only does the 1933 Act provide that actions may be filed in federal court, but federal courts are likely to be more experienced in resolving such actions than are state courts.

As to "fraud and overreaching," this too seems like a high hurdle for plaintiffs challenging FFPs. By definition, these provisions are set forth in the bylaws or charter, and most likely the latter. In turn, these documents are filed as part of the registration statement and the FFP may be specifically mentioned in the prospectus.

Finally, an FFP does not appear to contravene any state public policy, much less a strong one. A state would have to adopt a statute or a state court would have decide a case that articulates a state policy against litigating a federal cause of action in a federal court. This is hard to imagine.<sup>36</sup>

### 5. Does the 1933 Act preempt an FFP?

As the 1933 Act expressly provides actions may be brought in federal or state court, a preemption argument may be asserted that precluding state court actions is preempted. While this question has not been addressed, it is worth noting that in *Rodriguez de Quijas v. Shearson/Am. Express Inc.*, the U.S. Supreme Court upheld an arbitration provision that implicitly precluded state court litigation under the 1933 Act.<sup>37</sup>

### D. Some Concluding Thoughts.

The public policy ramifications of the *Salzberg* decision has at least two aspects. First, is the decision's impact on the concept of internal affairs. At its core, that doctrine limits the reach of state corporate law, and at the same time is protective of state corporate law. A state can legislate, for instance, that corporations chartered there must give shareholders at least 10 days' notice of a shareholders meeting, and other states may not extend that period for corporations doing business or holding shareholder meetings there, but chartered elsewhere. The doctrine thus clarifies which state's laws apply in a given controversy. In *Salzberg*, however, there arguably was such a conflict: federal law provided that 1933 Act claims may be filed in federal or state court, while the corporate charters in *Salzberg*, sanctioned by the Court's decision, provided that such claims against the corporation may be filed only in federal court. More importantly, the Court rejected the Chancery Court decision that invalidated the FFPs on the basis that they addressed a matter beyond the corporations' internal affairs holding, instead, that Delaware charters are not bound by the internal affairs doctrine. Rather, at least with respect to forum selection provisions, it is enough if the matter to be litigated relates to "intra-corporate" matters which, in turn, the Court defined broadly. Thus, while the Delaware corporate code did not, expressly, extend the internal affairs doctrine, the *Salzberg* Court authorized corporations to do so in their certificates of incorporation, a sort of backdoor extension of the internal affairs doctrine.

Second, it is important to recognize the context of the decision. The corporate defendants in *Salzberg* reacted to a very real problem in a creative way.<sup>38</sup> To limit the risk of costly and duplicative litigation that might follow a public offering of stock, they included FFPs in their charters. The underlying policy question is whether this is an appropriate role for private ordering. When Congress enacted the 1933 Act and provided that claims thereunder may be brought in either federal or state court, it did not preface the provision with "unless otherwise agreed." The very real threat of frivolous securities litigation has motivated all sorts of responses, including, of course, the enactment of the



PSLRA itself. FFPs are just another response in what seems to be an ongoing battle, suggesting that it may be time for Congress to re-visit the question of securities litigation. So, while *Salzberg* is nominally about private ordering and the internal affairs doctrine, it is also about corporations trying to limit litigation. If the *Salzberg* decision survives, if state courts outside of Delaware honor FFPs and dismiss 1933 Act litigation, and if Congress does not respond, then private ordering will have achieved an important victory. But, this scenario seems unlikely and the *Salzberg* victory may be short lived.

## NOTES:

<sup>1</sup>*Salzberg v. Sciabacucchi*, 227 A.3d 102, 111–12 (Del. 2020). The third corporation in this litigation, Blue Apron Holdings, Inc., FFP was slightly different. *Id.* at 112.

<sup>2</sup>15 U.S.C.A. § 77e.

<sup>3</sup>*Salzberg*, at 109.

<sup>4</sup>*Sciabacucchi v. Salzberg*, No. 2017-0931-JTL, 2018 WL 6719718 at \*25 (Del.Ch. Dec. 19, 2018).

<sup>5</sup>*Id.* at \*3.

<sup>6</sup>*Id.*

<sup>7</sup>*Salzberg*, at 138.

<sup>8</sup>8 Del. C. § 102(b)(1).

<sup>9</sup>*Salzberg*, at 113.

<sup>10</sup>*Id.* at 114.

<sup>11</sup>*Cyan, Inc. v. Beaver Cnty. Emps. Ret. Fund*, 138 S. Ct. 1061, 1080 (2018).

<sup>12</sup>*Salzberg*, at 137.

<sup>13</sup>*Id.* at 116.

<sup>14</sup>*Id.*

<sup>15</sup>*ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554 (Del. 2014).

<sup>16</sup>8 Del. Gen. Corp. L. § 115.

<sup>17</sup>*Salzberg*, at 123.

<sup>18</sup>*Id.* at 124–25.

<sup>19</sup>*Edgar v. MITE, Corp.*, 457 U.S. 625 (1971).

<sup>20</sup>*Sciabacucchi*, 2018 WL 6719718, at \*1.

<sup>21</sup>*Edgar*, at 645.

<sup>22</sup>*Sciabacucchi*, 2018 WL 6719718, at \*2.

<sup>23</sup>*Id.* at \*3.

<sup>24</sup>See, Mohsen Manesh, *The Contested Edges of Internal Affairs*, 87 Tennessee L. Rev. 6 (forthcoming 2020) (suggesting mandatory arbitration).

<sup>25</sup>See, e.g., *Olmos v. Residential Credit Solutions, Inc.*, 92 F.Supp.3d 954,

955 (C.D.Cal. 2015).

<sup>28</sup>2018 Cal. Legis. Serv. Ch. 954 (SB 826) (Jan. 1, 2019) (adding Cal. Corp. Code § 301.3 and 2115.5).

<sup>27</sup>Mohsen Manesh, *supra* note 23, at 7.

<sup>28</sup>*Id.* at 54.

<sup>29</sup>*Id.* at 61–62.

<sup>30</sup>The Chancery Court grounded its opinion, in part, on the notion that purchasers in an IPO are not stockholders. *Sciabacucchi*, 2018 WL 6719718, at \*2. This has been vigorously challenged in Joseph A. Grundfest, *The Limits of Delaware Corporate Law: Internal Affairs, Federal Forum Provisions, and Sciabacucchi*. Prof. Grundfest cites a Securities Exchange Commission (SEC) study that “existing holders purchase additional shares in IPOs and follow-on offerings.” He also notes that the “ubiquity” of “order splitting” also causes “the vast majority of aftermarket Securities Act plaintiffs to be preexisting shareholders.” Joseph A. Grundfest, *The Limits of Delaware Corporate Law: Internal Affairs, Federal Forum Provisions, and Sciabacucchi*, 75 Bus. Law. 1319, 1327 (2020).

<sup>31</sup>8 Del. C. § 109(b).

<sup>32</sup>8 Del. C. § 102(b)(1).

<sup>33</sup>Salzberg, at 135 (quoting, in part, *M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 15 (1972)).

<sup>34</sup>*Bremen*, 407 U.S. at 18.

<sup>35</sup>*Id.*

<sup>36</sup>See Grundfest, *supra* note 31 at 1345–46 (where this issue is discussed, reaching the same conclusion).

<sup>37</sup>*Rodriguez de Quijas v. Shearson/Am. Express Inc.*, 490 U.S. 477 (1989).

<sup>38</sup>The idea of FFPs has been attributed to Prof. Grundfest of Stanford Law School. Joseph A. Grundfest, *Federal Forum Provisions: Historical Development and Future Evolution* (Dec. 2, 2019) (unpublished manuscript available at <http://ssrn.com/abstract=3497126>); See also, Priya Cherian Huskins, *A Big Win for Corporate America: Ending Frivolous IPO Suits in State Courts*, CFO Network, Apr. 8, 2020; and Grundfest, *supra* note 31, at fn. a1.