



CORPORATE BYLAWS MANDATING ARBITRATION AND BARRING CLASS ACTIONS THREATEN SHAREHOLDERS' RIGHTS

We write to bring to your attention a recent disturbing trend in corporate governance that not only significantly impairs shareholders' rights, but also compromises the integrity of corporate governance generally. Recent years have seen a disturbing rise in the number of companies that have adopted in their bylaws or governing instruments various provisions that purport to limit shareholders' ability to protect and enforce their rights in courtrooms across the country. Such provisions often require plaintiffs to submit to arbitration any claims they may have involving their investment in the corporation, or impose outright bans on shareholders participating in class actions.

A pair of recent decisions by the U.S. Supreme Court—*AT&T Mobility v. Concepcion*¹ and *American Express v. Italian Colors Restaurant*²—have enabled corporations to avoid liability in any class action simply by including a forced arbitration clause in a service agreement, employment agreement, or other contract. By upholding class waivers, these decisions override state laws of accountability and make no exception for federal statutory rights.

Corporations now have begun to seize on arbitration provisions as a way to limit shareholder rights. Because bylaws are considered to establish the “contractual” terms that govern a company's operations,³ these provisions fit neatly within the framework for forced arbitration created by recent Supreme Court precedent. Because these provisions have been adopted unilaterally by corporate boards without shareholder approval, however, they represent a real and present threat to principles of sound corporate governance that balance the rights of shareowners against the responsibility of corporate managers to run the business.

The seriousness of this threat cannot be understated. In *Corvex Management LP, et al. v. CommonWealth REIT, et al.*,⁴ shareholders brought an action on behalf of a real estate investment trust (“REIT”) arguing that the company's board breached their fiduciary duties by taking unlawful actions designed to prevent or delay a shareholder vote on a takeover bid. The REIT's bylaws, however, contained a broad mandatory arbitration provision and ban on class actions, including shareholder derivative suits. Citing the Supreme Court precedent on the FAA, a Circuit Court in Maryland dismissed the litigation, holding that the shareholder's claims had to be submitted to arbitration even though the REIT's board unilaterally adopted the bylaw without

¹ 131 S. Ct. 1740 (2011) (Scalia, writing for 5-4 majority).

² 133 S. Ct. 2304 (2013) (Scalia, writing for 5-3 majority).

³ *Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 2013 WL 3191981, *2 (Del. Ch. June 25, 2013).

⁴ 24-C-13-00111, slip op. (Cir. Ct. Baltimore City, May 8, 2013)



shareholder approval.⁵ Just a week later, a court in New Jersey similarly forced investors into arbitration based on provisions in a hedge fund's engagement letters with its auditor.⁶ There, the plaintiffs—limited partners of feeder funds for Madoff—brought suit against auditor KPMG after being advised by the manager that the funds had lost substantially all of their value. Holding that the claims were derivative in nature, the New Jersey court dismissed the claims as being subject to an arbitration provision in the fund's engagement letter with KPMG, despite the fact that the limited partners had no say in retaining KPMG and did not consent to the terms of engagement.

Perhaps unwittingly, the Delaware Chancery Court now has set the stage for the virtual elimination of judicial oversight of corporations. In *Boilermakers Local 154 Ret. Fund v. Chevron Corp.*,⁷ Chancellor Strine upheld the enforceability of bylaws, unilaterally adopted by corporate boards, which required all litigation relating to the internal affairs of the corporations be conducted in Delaware.⁸ Chancellor Strine's decision may have significant consequences, which may or may not have been considered by the Court. If Delaware law allows corporate boards, through the adoption of bylaws, to dictate unilaterally the forum for resolution of all shareholder disputes, this may allow directors of Delaware corporations to require arbitration of any shareholder disputes, even if Delaware courts are available to hear the case.⁹ To explain, once it is established that corporate boards are empowered under state law to designate a forum for the resolution of shareholder disputes, these corporate directors can rely on federal law—and in particular the Supreme Court's expansion of the FAA—to designate forced arbitration as the only available forum. In other words, by creating a contractual right for boards to adopt forum selection clauses in corporate bylaws, Chancellor Strine may have opened Pandora's Box that now is difficult to close. As Alison Frankel of *American Lawyer* noted: "It would be frighteningly ironic if Strine's ruling on corporate by-laws, which seems intended to drive

⁵ *Id.* at 27.

⁶ *Sandalwood Debt Fund A, L.P. et al. v. KPMG, LLP*, 2013 WL 3284126 (N.J. Super. Jul. 1, 2013)

⁷ 2013 WL 3191981.

⁸ As of September 30, 2012, three hundred publicly-traded companies had adopted some sort of provision in their bylaws or governing instruments purporting to designate an exclusive forum for the resolution of any claim a shareholder may have against, or on behalf of, the corporation. Joseph A. Grundfest & Kristen A. Savelle, *The Brouhaha over Intra-Corporate Forum Selection Provisions: A Legal, Economic, and Political Analysis*, 68 Bus. Law. 325, 330 (2013).

⁹ Compare *Elf Atochem North Americas, Inc. v. Jaffari*, 727 A.2d 286, 288-89 (Del. 1999) (enforcing provision in the charter of a Limited Liability Company to require arbitration derivative claims in California); *Douzinis v. American Bureau of Shipping, Inc.*, 888 A.2d 1146, 1149 (Del. Ch. 2006) (enforcing provision in the governing instruments for a Delaware LLC requiring arbitration under Texas law).



shareholder litigation to Delaware, ended up driving corporations to arbitration instead of litigation in any forum.”¹⁰ Once that takes place, class action waivers will quickly follow.¹¹

Mandatory arbitration clauses eliminate shareholders’ access to the courts, and instead funnel all claims into a private arbitration system set up by corporations to favor corporations. If judicial oversight is eliminated, corporate law—and the existence of the fiduciary standard that underlies the integrity of the public markets—no longer would be developed by judges in the public eye, but would be written in secret by arbitrators who may or may not have any particular expertise, and whose decisions are unreviewable in any event. Class actions under Rule 10b-5 of the Securities Exchange Act of 1934 may be eliminated as well.

Of course, we have a vested interest in this issue. However, we believe all investors in our capital markets also have a vested interest in protecting their access to the courts. Arbitration simply is not an equivalent remedy to meaningful judicial oversight. Appeals and other important litigation procedures are unavailable in arbitration. The secretive nature of arbitration is a boon to defendants, and eliminates an important device for shareholders to force change. As for class action waivers in bylaws, disallowing the right of shareholders to proceed collectively essentially means the end of any legal remedy for many investors and will effectively immunize defendant companies and their directors and officers.

¹⁰ Alison Frankel, *Wake up Shareholders! Your Right to Sue Corporations May Be In Danger*, REUTERS, June 25, 2013

¹¹ Kevin LaCroix, *Up Next: Arbitration Clauses with Class Action Waivers in Corporate Charters?*, THE D&O DIARY, June 24, 2013