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Keeping Investors From Their Day in Court

The Fight to Shut Out Shareholders Continues with a New Twist

By Jacqueline Ma and Andrew Blumberg

Recently, throwing up yet another roadblock to investors seeking relief from the courts, corporations have begun including mandatory arbitration bylaws in their corporate charters.

For the last several years, attempts to deprive shareholders of their day in court have become increasingly common. These attempts took center stage after the Delaware Supreme Court, in its 2014 opinion *ATP Tour, Inc. v. Deutscher Tennis Bund,* endorsed a fee-shifting bylaw provision for nonstock corporations, which shifted the expense of litigation to stockholders whose claims against the corporation were ultimately unsuccessful, regardless of merit. *ATP* sparked a trend: after its release, thirty Delaware corporations adopted fee-shifting bylaws. In response, the Delaware bar noted that such bylaws would chill potentially meritorious securities and corporate governance litigation, as the risk of paying defense fees would discourage even meritorious claims.

Fortunately, to preserve the availability of stockholder litigation, the Delaware legislature amended the Delaware General Corporation Law in summer 2015 to prohibit fee-shifting bylaws. In the same amendment, the legislature took further steps to invalidate any bylaw that mandates arbitration *"if it would preclude litigating [internal corporate] claims in the Delaware courts."* As the significant portion of US companies are incorporated in Delaware, the law of this state regulates the behavior of the majority of US companies. The question following this 2015 amendment became: what does it mean to be an "internal corporate" claim for which mandatory arbitration provisions are precluded?

Given the Delaware legislature's 2015 amendment, the validity of a mandatory arbitration bylaw will likely turn on whether a corporation's governing documents — its charter and bylaws — can regulate anything other than the internal affairs of a corporation. Generally, a corporation's "internal affairs" pertain to the

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relationships among the corporation and its officers, directors, and shareholders. If the governing documents can only regulate the corporation's internal affairs, the question still remains whether the relevant internal affairs include shareholders' ability to bring federal securities claims against the corporation, and whether internal governance documents could be used to prevent shareholders from accessing federal courts.

Recently, corporations have more frequently added mandatory arbitration bylaws to their corporate charters — throwing up yet another roadblock to investors seeking judicial relief. As discussed in the winter 2018 edition of The Advocate, mandatory arbitration provisions create many pitfalls for investors. For example, if individual investors are required to arbitrate their claims arising under the federal securities laws — and can no longer access the class action mechanism — most wronged investors will not be able to afford to pursue relief. Additionally, if a securities claim is pursued on an individual basis, the wrongdoer is liable only to the investor who brought the claim — not to the entire class of investors harmed by the wrongdoer's conduct. Moreover, arbitration procedures can impair investors' access to procedural and substantive transparency due to constraints such as reduced discovery, lack of jury trial, and lack of meaningful appellate review. Finally, because arbitration is generally conducted privately, corporations that require claimants to arbitrate can avoid the public pressure to reform their conduct that often accompanies public litigation.

The validity of mandatory arbitration bylaws in connection with the securities laws is currently being litigated in the New Jersey courts. In a curious twist, the corporate behemoth Johnson & Johnson ("J&J") is arguing *against* the legality of mandatory arbitration bylaws for securities claims. In other words, the party defending shareholders' rights to bring a class action against the company is the company itself. The choice is an unusual one for a corporation, which usually prefers the more private and individualized mandatory arbitration proceedings.

The J&J action arose when Hal S. Scott, a longtime advocate against securities litigation and proponent of arbitration, submitted a proposal on behalf of a J&J shareholder, the Doris Behr 2012 Irrevocable Trust (the "Trust"), that stockholders be allowed to vote on whether the company should adopt a mandatory arbitration bylaw. J&J disagreed with the proposal and asked the SEC to confirm that it would not take action if J&J rejected the proposal. J&J took the position that the mandatory arbitration bylaw, if implemented, would cause the company to violate both the federal Securities Exchange Act of 1934 (the "Exchange Act"), which voids any contractual condition that waives the protections of the Exchange Act, and New Jersey state law, which states that federal securities claims are not internal corporate claims. The New Jersey Attorney General agreed with J&J's position.

On February 11, 2019, the SEC opined in favor of J&J and announced that the company could legally exclude this shareholder proposal from its proxy materials.

The SEC refused to determine, however, whether the proposal would cause the company to violate federal law. The company then issued its proxy without the mandatory arbitration provision.

The Trust filed suit in New Jersey federal court, alleging that the company violated federal securities laws by excluding the proposal from its proxy materials. The Trust asked the judge to declare that J&J would violate neither federal nor state law if it amended its bylaws to require arbitration of securities law claims. Specifically, the Trust argued that no law or court precedent clearly prohibits mandatory arbitration clauses, and that, in any event, the Federal Arbitration Act's requirement that mandatory arbitration provisions be enforced, would trump state law.

On May 23, 2019, cognizant of the curious posture of this case, the California Public Employees' Retirement System and Colorado Public Employees' Retirement Association — represented by BLB&G — moved to intervene. These two funds and J&J asked the Court to dismiss the Trust's lawsuit on the grounds that the proposed amendment would cause J&J to violate New Jersey law, that the Federal Arbitration Act does not apply to corporate bylaws, and even if it did, it would not preempt New Jersey's corporate law. The court has not yet issued a decision.

A bellwether case in the Delaware Court of Chancery which will likely have implications on the J&J action, *Sciabacucchi v. Salzberg*, recently addressed an attempt to keep shareholders out of Delaware courts by forcing them instead into federal courts. Specifically, *Salzberg* considered whether a corporation may include in their corporate charters federal forum-selection clauses mandating that shareholders litigate fraud claims relating to the corporation's initial public offering in federal court. In December 2018, Vice Chancellor J. Travis Laster invalidated the forum-selection clauses, reasoning that, because fraud claims stemming from an IPO do not concern a company's internal affairs, a corporation's governance documents cannot limit where those claims are litigated. *Salzberg* is currently on appeal to the Delaware Supreme Court.

For the first time in *Salzberg*, a Delaware court confronted the question of whether Delaware law permits corporations to use their charters and bylaws to restrict shareholders' control over their federal securities claims, and the location and manner in which they bring those claims. While the *Salzberg* ruling may carve the path for mandatory arbitration bylaws to be struck down, the trend is crystal clear: the number of corporations maneuvering to limit shareholder litigation is on the rise.

This is problematic for shareholders. As mentioned, mandatory arbitration would impair investors' access to justice, reduce public transparency, and discourage everyday investors from bringing meritorious securities claims. Given the seriousness of this issue, we will continue to update our readers as the *Salzberg* and *Johnson & Johnson* cases proceed through the courts. ■

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