A Template for Tamping Down Corporate Activism

Law360, New York (July 08, 2013, 4:04 PM ET) -- Until recently, no court had squarely addressed whether a company may require its shareholders to arbitrate (rather than litigate) their claims based on an arbitration provision contained only in the company's bylaws and never expressly approved by its shareholders. While courts in Delaware have implied that such bylaws may be enforceable,[1] the Circuit Court of Maryland in Baltimore City is the first to squarely address this issue.

On May 8, 2013, the Maryland court in Corvex Management LP v. CommonWealth REIT[2] set out to decide "whether a shareholder can be deemed to have constructively assented to a unilaterally imposed arbitration provision contained in a company's bylaws." Acknowledging that this was "an issue of first impression for the Maryland courts," the court's 27-page opinion ruled in the affirmative in a dispute relating to the battle for corporate control of CommonWealth REIT.

While Maryland courts are perhaps not on par with those of Delaware with respect to their familiarity with corporate law issues, Maryland is the domicile of many funds, trusts and other pooled investment entities and, thus, the court's holding could have significant corporate law ramifications.

This article briefly discusses the state of the law regarding the enforceability of arbitration provisions, examines the court's decision, and assesses its significance and potential impact.

Background of the Parties' Dispute

CommonWealth is a publicly traded Maryland real estate investment trust that, as of March 31, 2013, owned $7.2 billion of properties in 31 states, Washington, D.C., and Australia.[3] CommonWealth is managed by REIT Management, whose co-owners are also the managing trustees of CommonWealth.

Two CommonWealth shareholders — Corvex Management LP and Related Fund Management LLC (the "funds") — claimed to be the largest shareholders of CommonWealth, having acquired a combined 9.8 percent of CommonWealth's shares in February 2013. Shortly after acquiring those shares, the funds filed a lawsuit in the Circuit Court for Baltimore City seeking declaratory and injunctive relief to prevent certain alleged "value-destroying" and "self-interested" conduct by CommonWealth, its trustees and REIT Management (the "defendants").[4]

The defendants promptly initiated arbitration proceedings pursuant to a provision of CommonWealth's bylaws requiring that "[a]ny disputes, claims or controversies brought by or on behalf of any shareholder ... be resolved through binding and final arbitration ..."[5] The funds thereafter filed a petition to stay the arbitration, contending that (1) they never "assented" to the arbitration clause (instead, it was "unilaterally foisted upon" them); and (2) no "consideration" was exchanged and therefore no binding contract was formed.[6]

Law Governing Enforceability of Arbitration Clauses

Arbitration is a "creature of contract."[7] Accordingly, no party may be forced to arbitrate if it has not agreed to do so. Like any contract, however, an agreement to arbitrate may be either explicit or implicit.[8] In other words, a party need not expressly have agreed to arbitrate in order to be found to have validly contracted to arbitrate. For example, there is a

body of case law governing the circumstances in which a nonsignatory to a contract containing an arbitration clause may be bound to arbitrate pursuant to that contract.[9]

In addition, courts have recognized a well-settled "presumption in favor of arbitration" under both the Federal Arbitration Act (FAA) and Maryland law.[10] Under that presumption, doubts as to whether an arbitration agreement is enforceable are resolved in favor of arbitration. The presumption, however, is generally limited to the "scope" of the arbitration provision (e.g., whether it covers the parties' dispute) and not to whether a particular party has agreed to arbitrate.

In Corvex, before determining whether the arbitration clause was enforceable against the Funds, Maryland law required the court to assess whether it needed to apply the "presumption" of arbitrability in making that determination. The funds argued that the general presumption in favor of arbitration did not apply to the arbitration provision's "validity," and, in doing so, quoted recent decisions from the Third and Fourth Circuits: Kirleis v. Dickie McCamey & Chilcote PC[11] and Noohi v. Toll Bros. Inc.[12] Those cases, at least superficially, stood for the proposition that "the presumption in favor of arbitration does not apply to questions of an arbitration provision's validity, rather than its scope."[13]

The Maryland court, however, disagreed with the funds' position, explaining that these Circuit Court decisions declined to apply a presumption in favor of arbitrability only as to the question of who has agreed to arbitrate, but not to the question of whether an arbitration clause is enforceable against a particular party. The court explained further that the funds "do not — and cannot — complain that they did not know who the parties to the arbitration agreement were," and thus found that the question of whether the agreement was enforceable against the funds must be considered within the context of the presumption in favor of arbitration.[14]

Mutual Assent

The Maryland court also considered whether the funds had "assented" to the arbitration provision (which provision it found to be broad and to cover the funds' claims). Under general contract principles, a party cannot be bound to an agreement to which it did not assent. Arguing that they had not assented to the arbitration provision, the funds again pressed Kirleis, this time for the proposition that a shareholder's "mere constructive notice of or implicit agreement to an arbitration provision in corporate bylaws is insufficient to create an enforceable arbitration contract."[15]

In Kirleis, a partner at a law firm had sought to avoid arbitration under an arbitration agreement contained in the firm's bylaws, where the partner neither received a copy of the bylaws nor signed any agreement which incorporated the arbitration provision contained in the bylaws. Under those circumstances, the Kirleis court found that the partner had not assented to the arbitration provision.

The Maryland court disagreed with the Funds' view of Kirleis, noting first that the Third Circuit, subsequent to Kirleis, "backtracked" and "expressed more relaxed standards for arbitration agreements' enforceability," including a recognition that arbitration agreements need not be "express" to be valid.

The Maryland court also found that, unlike in Kirleis, each share certificate of CommonWealth stock bore a legend stating, inter alia, that "the holder of this Certificate ... agrees to be bound by all of the provisions of the ... Bylaws ..."[16] Based on this legend, the court concluded that the funds had "constructive knowledge" of the arbitration provision

and that it was "enough to constitute mutual assent of the parties to the" arbitration provision.

The Maryland court also found that, unlike in Kirleis, the funds were "sophisticated parties" who had "actual knowledge" of the arbitration provision because, before purchasing CommonWealth stock, they had "investigated" CommonWealth's bylaws.[17] Accordingly, the funds were determined to have assented to the provision through the purchase of CommonWealth stock.[18]

Consideration: A Question of "Mutuality of Obligation"

Having determined that the funds had assented to the arbitration provision, the court then concluded that sufficient consideration existed for the arbitration agreement to be binding. In so holding, the court rejected the funds' arguments to the contrary.

First, contrary to the funds' contention that the arbitration provision unfairly bound only the funds, and not CommonWealth, the court looked to the plain language of the arbitration provision, which stated that arbitration would initiate "on the demand of any party." Thus, the defendants, like the funds, promised to arbitrate their claims upon the funds' demand "even if defendants wished to litigate the dispute before a court."[19] The court found that this promise supplied adequate consideration.

Second, while the funds complained that the defendants could amend or revoke CommonWealth's bylaws "at their whim," thus arguably making the agreement illusory, the court determined that it could not consider that possibility unless it looked beyond the "four corners" of the bylaws, which it was "not permitted" to do.[20] The court further explained that the defendants' ability to amend the bylaws, including the arbitration provision contained therein, stemmed not from the bylaws themselves, but rather from CommonWealth's declaration of trust and Maryland REIT law.[21]

Significance and Impact of the Decision

The funds subsequently filed a notice of appeal, but then dismissed their appeal to pursue arbitration. While it remains to be seen how courts in other corporate-law focused jurisdictions (e.g., Delaware, Nevada, New York) will resolve this question, this decision should be seen as, at the very least, a significant incremental victory for boards and trustees who view arbitration as an effective means to manage the typically highly public nature of corporate activism. Indeed, this decision can be viewed as a green light for the boards (of Maryland companies at least) to include broad arbitration clauses in their bylaws without seeking shareholder approval (assuming that other unique factors or rules do not otherwise exist).

While shareholder activists may try to downplay this decision or cast it as an outlier, the facts involved here could easily exist in other situations. To wit, (1) it is often the case that shareholder plaintiffs, and activist shareholders in particular, are "sophisticated parties" with knowledge of a company's bylaws; (2) it is a simple enough proposition for a company to incorporate its bylaws into its stock certificates; and (3) a board, when crafting an arbitration provision, can easily ensure that all parties be bound.

It is unclear, of course, whether other states will follow the lead of the Maryland court. For example, while the court found that "constructive knowledge" of the arbitration provision, obtained through possession of the stock certificate, was sufficient to constitute "assent,"

and cited supporting authority from a number of jurisdictions, it did not address certain Delaware decisions cited by the funds. The funds argued that those Delaware cases rejected the principle that "stockholders somehow assent to provisions contained in company bylaws [] simply by virtue of being stockholders."[22]

In the authors' view, these cases do not address the question of when a party will be deemed to have assented to a contract containing an arbitration provision, but consider instead whether the particular disputes in those cases were subject to arbitration where it was argued that the subject arbitration clauses contained ambiguous language or did not otherwise require arbitration of the particular dispute.

But, in light of the prominence of the Delaware courts in matters of corporate governance (and that other courts often rely on Delaware precedent with respect to corporate law), it is possible that the Corvex reasoning will not be adopted elsewhere. In the meantime, boards and arbitration proponents can rejoice at a decision decidedly in their favor.

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[1] See, e.g., In re Revlon, Inc. Shareholders Litigation, 990 A.2d 940, 961 & n. 8 (Del.Ch. 2010) (noting in dicta that "if boards of directors and stockholders believe that a particular forum would provide an efficient and value-promoting locus for dispute resolution, then corporations are free to respond with charter provisions selecting an exclusive forum for intra-entity disputes" and citing to cases finding such provisions requiring arbitration to be enforceable in the context of LLC agreements). Additionally, the Delaware Chancery Court recently addressed a similar question: whether a venue selection clause contained in bylaws is enforceable to require shareholders to bring suit in Delaware. See Boilermakers Local 154 Retirement Fund and Key West Police & Fire Pension Fund v. Chevron Corp and IClub Investment Partnership v. Fedex Corp., Delaware Court of Chancery, Nos. 7220 and 7238 (June 25, 2013). The Chancery Court held that such clauses are contractually valid and enforceable, but it is probable that the Delaware Supreme Court will have the final say.

[2] Case No. 24-C-13-001111, 2013 Md. Cir. Ct. Lexis 3 (Md. Cir. Ct. May 8, 2013).

[3] http://www.cwhreit.com/

[4] Complaint, Corvex Management LP v. Commonwealth REIT, dated February 27, 2013.

[5] Corvex, 2013 Md. Cir. Ct. Lexis at *5.

[6] Id. at *20, 33. The funds also argued that the arbitration provision violated Maryland REIT law and was unenforceable as a matter of public policy. The court did not address these arguments and so we have not discussed them herein.

[7] Commc'n Workers of Am. v. Avaya, Inc., 693 F.3d 1295, 1300 (10th Cir. 2012) (citing AT&T Tech., Inc. v. Commc'n Workers, 475 U.S. 643, 648, 106 S. Ct. 1415 (1986)).

[8] Corvex, 2013 Md. Cir. Ct. Lexis at *26 (citing Century Indemnity Co. v. Certain Underwriters at Lloyd's, London, 584 F.3d 513, 532 (3rd Cir. 2009)).

[9] See, e.g., Thomson-CSF, S.A. v. American Arbitration Ass'n, 64 F.3d 773 (2d Cir. 1995) (explaining that a non-signatory may be bound where (1) it is a signatory to a contract that incorporates another contract's arbitration clause; (2) its "conduct indicates that it is assuming the obligation to arbitrate," e.g., by seeking to enforce the arbitration provision in another context; (3) its agent has bound it to arbitrate; (4) it is the "alter ego" of a signatory; or (5) it has exploited the agreement containing the arbitration provision and therefore must be "estopped" from disclaiming its obligation to arbitrate).

[10] See, e.g., AT&T Mobility v. Concepcion, 131 S. Ct. 1740, 1745 (2011) (citing Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24 (1983)).

[11] 560 F.3d 156 (3rd Cir. 2009).

[12] 708 F.3d 599 (4th Cir. 2013).

[13] Corvex, 2013 Md. Cir. Ct. Lexis at *17.

[14] Id. at *20.

[15] Id. at *24.

[16] Id. at *29.

[17] The court emphasized that, when the Funds acquired more than 5% of a voting class of CommonWealth stock, they were required to file a Schedule 13D with theSEC in which they disclosed their predetermined intention to seek a ruling that the bylaws' arbitration provision was unenforceable. Id. at *30.

[18] Id. at *31.

[19] Id. at *36 (emphasis omitted).

[20] Id. at *43 (explaining that "courts are not permitted, when assessing the enforceability of an arbitration agreement, to go beyond the confines of the arbitration agreement itself and into an analysis of the validity of the larger contract") (internal citations omitted).

[21] Id. at *45-46. The court explained that Maryland REIT law provides that a REIT "has the power to ... [m]ake and alter bylaws not inconsistent with law or with its declaration of trust to regulate the government of the [REIT] and the administration of its affairs." CommonWealth's declaration of trust, meanwhile, provides that the "Trustees may make or adopt and from time to time amend or repeal Bylaws." Id.

[22] See Memorandum in Support of Plaintiffs' Petition to Stay Arbitration at 12-13.