2 More Bullets To Fight Corporate Activism

Law360, New York (May 15, 2014, 1:16 PM ET) -- Last July, in an article titled "A Template for Tamping Down Corporate Activism,"[1] we reported on the first judicial decision to address squarely whether a company may require its shareholders to arbitrate (rather than litigate) their claims, pursuant to an arbitration provision contained only in the company's bylaws and never expressly approved by its shareholders.

In that case, Corvex Management LP v. CommonWealth REIT, the Circuit Court of Maryland in Baltimore City found such a bylaw arbitration provision to be enforceable against institutional investors in a real estate investment trust. The court explained that, inter alia, the shareholders had "constructively" assented to the provision by virtue of a legend contained within the REIT's stock certificates that referred to the REIT's bylaws and declaration of trust.

At that time, we noted that, while the decision was an "incremental victory" for arbitration-seeking corporate boards and trustees, it remained to be seen how courts in other jurisdictions would resolve this question. We also noted the role of the specific facts in Corvex, including that the shareholder plaintiffs were "sophisticated" — a factor that the court considered in deeming them to have had constructive notice of the arbitration provision.

Two recent cases — both relating to the same set of facts underlying the Corvex action — have elaborated upon and further supported the Corvex decision. As discussed below, these decisions offer additional ammunition to those fighting to keep activist-precipitated corporate wrangling out of the public sphere.

In the first case, Katz v. CommonWealth REIT,[2] the Circuit Court of Maryland in Baltimore City had an opportunity to revisit its earlier decision and addressed the same issue in a derivative action commenced by self-described "ordinary shareholders," as contrasted with the "sophisticated shareholders" found to be bound by the arbitration provision in Corvex.

The Katz shareholders argued that, because of their lack of "sophistication," they could not be found to have had knowledge of — and therefore to have assented to — the arbitration provision (or the unilateral ability of the board to amend the bylaws) at the time they purchased their shares.

The Maryland court disagreed. In doing so, the court looked to the Delaware Court of Chancery decision in Boilermakers Local 154 Retirement Fund v. Chevron Corp.,[3] which had assessed a somewhat related issue regarding the validity of a forum selection clause.

In that case, the Delaware court found corporate bylaws to be part of a "flexible" contract — as "investors know [] when they purchase stock in a Delaware corporation" — that may be amended unilaterally by corporate boards. Guided by that Delaware decision, the Maryland court found that Maryland law provides the trustees of REITs with similar unilateral power, of which investors have adequate notice.

Accordingly, the court concluded that all "CWH stockholders assent to a contractual framework that explicitly recognizes that they will be bound by bylaws adopted unilaterally" and, further,

that they have "purchased their shares with constructive knowledge that the arbitration bylaws were in effect and that their shares were subject to them." The Maryland court also explained that such constructive notice prior to purchase "is enough to constitute mutual assent of the parties."

Notably, the Maryland court also rejected an argument that enforcement of the arbitration provision would make the pursuit of derivative actions prohibitively expensive. Specifically, the derivative plaintiffs argued that shareholders would be unlikely to bring derivative actions against directors without the prospect of a subsequent court award of attorneys' fees and reimbursement of expenses — relief that may not readily be available in arbitration.

This argument is reminiscent of one considered in American Express Co. v. Italian Colors Restaurant,[4] in which the U.S. Supreme Court upheld the validity of contractual class waiver provisions in the face of an argument that such provisions make the pursuit of claims prohibitively expensive. The Maryland court, with reference to American Express, explained that "the fact that it is not worth the expense involved in proving a statutory remedy does not constitute the elimination of the right to pursue that remedy."[5]

In the second case, Delaware County Employees Retirement Fund v. CommonWealth REIT,[6] a federal court in Massachusetts faced another derivative action brought by shareholders of CommonWealth REIT. Although the Massachusetts court found that it was precluded from ruling on the enforceability of the arbitration provision under principles of res judicata (in light of the Maryland decision), the court went on to explain that, if it were not so precluded, it, too, would have found the provision to be enforceable.

Applying Maryland law, the court held that "constructive knowledge, constructive notice, and knowledge/notice through incorporation-by-reference are adequate to inform and bind a party to a contract." As in Corvex and Katz, the court held that the stock legend, together with Maryland REIT law, was sufficient to bind shareholders to the bylaw arbitration provision. Further, the Massachusetts court likewise rejected the argument that requiring derivative plaintiffs to arbitrate would render the prosecution of derivative actions cost-prohibitive.[7]

While it's true that more than a year after the Corvex decision, the Delaware courts have not yet had the opportunity to join this particular conversation, these more recent decisions (and, in particular, the Katz court's reliance on the Delaware Chancery Court's Boilermakers decision) suggest that other jurisdictions may view such provisions favorably. At a minimum, these recent decisions should be seen as additional incremental victories for corporate boards and trustees in their battle to minimize the attention that corporate activists so often seek.

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[1] Stern, Kaplan & Muenz, July 8, 2013, Law360.com.

[2] Case No. 24-C-13-001299 (Md. Cir. Ct. Feb. 19, 2014).

[3] 73 A.3d 934 (Del. Ch. 2013). In citing Boilermakers, the Maryland court explained that, "given the respect the Delaware courts command in corporate matters and their expertise in that field, along with the dearth of Maryland precedent in accord, this court shall adhere to the Court of Chancery's view."

[4] 133 S. Ct. 2304 (2013).

[5] In both Corvex and Katz, the Maryland court rejected arguments that the arbitration provision was invalid due to a lack of consideration. In both cases, the court found that the obligation of all parties to arbitrate provided ample consideration.

[6] No. 13-10405-DJC (D. Mass. Mar. 26, 2014).

[7] The Massachusetts court also rejected arguments that enforcement of the bylaw arbitration provision would be contrary both to the Private Securities Litigation Reform Act of 1995, to the extent that the PSLRA contemplates an award of attorneys' fees to successful litigants, as well as to the anti-waiver provision of Section 29(a) of the Securities Exchange Act of 1934. The court reasoned that the Supreme Court has held that the anti-waiver provision of the Exchange Act does not apply to "procedural provisions," including compulsory arbitration, and further that the PSLRA merely caps attorneys' fees but does not require that plaintiffs recover any such fees.