A Clear and Present Danger: The Continued Threat of Forced Arbitration of Investor Securities Claims

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The assault on investors' rights to sue in court continues, with yet another attempt to compel mandatory arbitration of investor claims through a change in company bylaws.

The latest onslaught is being championed by Hal Scott, a Harvard Law professor and frequent critic of securities lawsuits. In November, Scott submitted a shareholder proposal on behalf of a trust he represents to Johnson & Johnson, Inc., a New Jersey corporation, seeking to amend the company's corporate charter to require arbitration of all federal securities claims. Scott's draconian proposal further seeks to prohibit class and joined claims, as well as eliminate appeals or challenges of awards, rulings and decisions.

The stakes for shareholders are high. Arbitration is neither cost effective nor practicable for investors who have lost money due to corporate misconduct, and lacks important safeguards guaranteed by the court system—the rights to a jury trial, discovery and a public hearing, to name just three.

In response to Scott's proposal, J & J has asked the Securities and Exchange Commission to issue a no-action letter to allow the company to exclude the proposal and supporting statement from its 2019 proxy materials on the grounds that implementing the proposal would be contrary to the policies underlying the federal securities laws and cause J & J to violate federal law.

The ball is now in the SEC's court. A non-action letter, stating that the staff will not recommend enforcement action against J & J if the proposal is excluded, would be consistent with the SEC's long-standing policy banning forced arbitration. It would provide J & J support to omit the proposal from its proxy documents, though the omission could be challenged in court by its proponent. The SEC staff also could duck the issue—either by not responding (citing the government shutdown), saying the matter requires more study (in light of intervening development discussed below) or referring it to the Commission itself. The latter course would be consistent with the views expressed by SEC Chair Jay Clayton, who has previously said a decision to allow bylaws with forced arbitration provisions should not be made by the staff, but by the Commission "in a measured and deliberative manner."[1] Absent a no-action letter, J & J would likely include the shareholder proposal given the impending deadline for the materials.

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Importantly for investors opposed to such a severe restriction of their rights, a recent Delaware Chancery Court decision undercuts the idea that a company's bylaws or charters can provide the legal basis for mandatory arbitration of federal securities claims. In the closely watched case of *Sciabacucchi v. Salzberg, et. al.*, C.A. No. 2017-0931 (Del. Ch. December 19, 2018) (*Blue Apron*), Vice Chancellor Travis Laster invalidated charter provisions by three companies, Blue Apron Holdings, Inc., Stitch Fix, Inc. and Roku, Inc., requiring Section 11 claims under the Securities Act of 1933 to be litigated in federal court unless the directors otherwise agree. Vice Chancellor Laster explained that bylaws can only govern internal affairs that impact stockholders' rights as they relate to the corporation. Drawing a line between internal claims, which are governed through bylaws, and external claims involving a company, which are not, Vice Chancellor Laster wrote that the "distinction between internal and external claims answers whether a forum-selection provision can govern claims under the 1933 Act. It cannot, because a 1933 Act claim is external to the corporation. Federal law creates the claim, defines the elements of the claims, and specifies who can be a plaintiff or defendant." Further, the 1933 Act "provided that causes of action could be asserted in state or federal court."

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"*Blue Apron* is a very significant decision because it clearly delineates the point beyond which bylaws cannot qualify or eliminate the rights of investors," James D. Cox, a Duke Law School professor and leading academic in this area, told the *Shareholder Advocate*. "It is also sensible, as the Constitution's Supremacy Clause does not permit state law to eviscerate protections provided investors by the federal securities laws." Indeed, a month before the *Blue Apron* decision, Cox and 20 other prominent law professors analyzed Delaware corporate law on internal versus external matters and reached the same conclusion as the Chancery Court. "Delaware corporate law does not permit a corporate bylaw (or charter provision, for that matter) to require that claims arising under the federal securities laws be resolved in arbitration or indeed in any specified venue,"[2] the professors wrote.

In practice, permitting companies to force arbitration of federal securities law claims through corporate bylaws or charters would pose an existential threat to the rights and ability of investors to obtain redress or accountability from those who have defrauded them.

Some have said this threat goes to the very foundations of democracy. As Professor Cox explains: "In the classic work, *Democracy in America*, Alexis de Tocqueville wrote nearly 200 years ago that a central strength of the democracy in America was our country's commitment to access to justice through mechanisms such as the citizen's rights to be on juries and making the courts available for everyone. Mandated arbitration of investor and shareholder claims would be a grave departure from what makes America exceptional."

Given the clear and present danger posed, investors should be proactive and speak out against the threat posed to their rights. ■

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1 Letter from Chairman Jay Clayton to The Honorable Carolyn B. Maloney (Apr. 24, 2018) https://maloney.house.gov/sites/maloney.house.gov/files/MALONEY% 20ET%20AL%20-%20FORCED%20ARBITRATION%20-%20ES156546%20Response.pdf

2 https://secureoursavings.com/wp-content/uploads/2018/11/Arbitration-bylaw-white-paper.pdf