

# Caution: Slippery Slope



**How Delaware Supreme Court's Blue Apron Decision Could  
Harm Investors and Undermine Market Integrity**

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## How Delaware Supreme Court's Blue Apron Decision Could Harm Investors and Undermine Market Integrity

### Introduction

In March of this year, the Delaware Supreme Court handed down a decision in *Salzberg v. Sciabacucchi*<sup>1</sup> (commonly referred to as “Blue Apron”) with the potential to upend the balance of power between management and shareholders of public companies. While the decision on its face addressed a fairly narrow, though consequential issue – whether it is permissible under Delaware law for public companies to adopt charter provisions requiring certain securities law claims to be brought exclusively in federal court – its implications for investor protection are potentially much broader and more harmful than it might initially appear. Ironically, depending on how things unfold, it also has the potential to greatly diminish the importance of Delaware corporate law and the state’s courts.

At the most basic level, the decision makes it easier for corporations to prevent shareholder access to state courts when they seek compensation for losses due to violations of the Securities Act of 1933. Because federal courts are widely considered to be less friendly to shareholder claims – and lack the expertise of Delaware courts regarding shareholder rights – this has the potential to make it more difficult for shareholders to hold corporate managers accountable when they make false and misleading statements or otherwise engage in wrongdoing. Moreover, logic dictates that the companies where effective shareholder oversight is most needed – those, for example, with highly concentrated ownership and entrenched boards – are also the companies most likely to adopt exclusive federal forum provisions and to do so through means that deny shareholders a say in the policy.

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<sup>1</sup> The case is variously referred to as *Salzberg*, *Sciabacucchi*, or *Blue Apron*. Except in direct quotes, we will generally refer to it as Blue Apron.

But the Blue Apron decision has potential implications that go well beyond the question of whether shareholders will retain their ability to bring '33 Act claims in state court. In light of the decision, and its interaction with other recent decisions, interested parties are asking: What if any limits remain on corporations' ability to adopt provisions in their governing documents that limit shareholder rights? That issue is being debated at a time when the Securities and Exchange Commission (SEC) seems to be engaged in its own campaign to limit shareholder rights and cannot be relied on as an ally to resist such efforts.

In this environment, the question must be asked: If a corporation can force investors to bring certain securities law claims in federal rather than state court, what else can it force upon shareholders?<sup>2</sup>

- ◆ Can corporations regulate all federal securities law claims, not just Securities Act claims, including with regard to fraud?
- ◆ Can corporations force investors to litigate federal securities law claims in arbitration, on an individual basis?
- ◆ Can corporations adopt fee-shifting provisions for federal securities law claims, requiring investors to shoulder the corporation's legal expenses?
- ◆ Can corporate boards do these things through, not just charters, but also corporate bylaws, without shareholders' express consent?

In other words, to what extent can a corporation use its governing documents, specifically the charter or bylaws, to bind current and future shareholders in ways that would, as a practical matter, have the effect of insulating the

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<sup>2</sup> As one law review article following the decision stated, "[I]t follows fairly naturally that Delaware corporations can adopt other non-Delaware forums to resolve 1933 Act disputes. They may even attempt to adopt a mandatory, individual arbitration provision for 1933 Act claims. A fee-shifting provision (perhaps even similar to the version we saw in *ATP Tour Inc. v. Deutscher Tennis Bund* with respect to 1933 Act claims is also a possibility." Dhruv Aggarwal, Albert H. Choi, and Ofer Eldar, *Federal Forum Provisions and the Internal Affairs Doctrine*, April 8, 2020, <https://bit.ly/3lnUWUV>. The article continued, stating, "One may go even further. For instance, while the federal courts have the exclusive jurisdiction with respect to claims arising under the 1934 Exchange Act (claims, for instance, alleging material misstatement or misrepresentation in a company's periodic filings), under the *Salzberg* reasoning, such claims can be thought of as also belonging to the 'intra-corporate affairs' and be regulated through charters and bylaws. For instance, a charter or a bylaw provision may dictate that such claims must be brought only in the federal district court of Delaware. They may also be inclined to include a fee-shifting provision." *Id.* at note 128.

corporation and its management from being held accountable for wrongdoing?

It is too soon to predict with any certainty how courts will answer those questions. But it is already clear that at least some corporations and their counsel are exploring ways to capitalize on Blue Apron to further restrict shareholder litigation rights. The outcome is of great significance to investor advocates, who have long viewed private litigation as an essential supplement to Securities and Exchange Commission (SEC) enforcement and as playing a critical role in promoting market integrity and corporate accountability.<sup>3</sup> If corporations are successful in winning court decisions based on Blue Apron that further limit shareholders' private rights of action under federal securities laws, the fairness, transparency, and stability of our securities markets could be severely damaged.

This paper is not intended to predict how these questions will be decided. Instead, it seeks to shed light on the range of potential implications that the Blue Apron decision *could* have on shareholder rights and, by extension, what effect it *could* have on investor protection and market integrity. As such, it is intended to provide an analysis of whether a policy response is warranted, without going into significant detail regarding what form that policy response might take.



## The Interplay between State Corporate Law and Federal Securities Laws

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In the United States, corporations are subject to both state and federal law. Corporate governance issues are generally a function of state law, while the federal securities laws regulate corporations' activities related to the issuance and trading of securities. But what happens when a corporation is formed in one state and operates in another? Corporate law has addressed this issue with the internal affairs doctrine.

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<sup>3</sup> See Barbara Roper and Micah Hauptman, *A Settled Matter: Mandatory Shareholder Arbitration Is Against the Law and the Public Interest*, Consumer Federation of America (August 2018), <https://bit.ly/3b2mlHc>.

The internal affairs doctrine is a choice of law principle that says the corporate law of the state in which the company was incorporated should govern “matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders.”<sup>4</sup> So, a corporation that is incorporated in one state, Delaware for example, while having business activities and shareholders in all 50 states, would be subject to Delaware law on issues regarding the company’s internal corporate governance. That includes “specify[ing] the rights, powers, and privileges of a share of stock, determin[ing] who holds a corporate office, and adjudicat[ing] the fiduciary relationships that exist within the corporate form.”<sup>5</sup>

## **Under the Internal Affairs Doctrine, Delaware Plays an Out-size Role**

Because corporations can choose the state corporate law to which they are subject, states have an incentive to compete for corporations’ business. One common way of offering companies an attractive environment in which to incorporate is by providing broad latitude and deference to corporate decision-making.<sup>6</sup> Another way of attracting companies is by providing courts with specialized expertise in resolving corporate law disputes. Delaware’s corporate law statute, the Delaware General Corporation Law (DGCL), its specialized Court of Chancery, and the internal affairs doctrine have all helped to make Delaware the state where most corporations choose to incorporate.<sup>7</sup>

According to University of Oregon Law Professor Mohsen Manesh, “The internal affairs doctrine is what has enabled Delaware to play a unique and outsized role in regulating corporate America. Although Delaware represents less than one-third of 1 percent of the U.S. population, more than half of all publicly traded companies, including two-thirds of the Fortune 500, are incorporated under Delaware law. Thus, because of the internal affairs

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<sup>4</sup> *Edgar v. MITE Corp.*, 457 U.S. 624, 645 (1982).

<sup>5</sup> *Sciabacucchi v. Salzburg*, 2018 WL 6719718, at 3-4 (Del. Ch. Dec. 19, 2018), <https://bit.ly/2YFqRXb> [“Chancery Opinion”]. A corporation will still be subject to other states’ laws if a company engages in activities in another state that don’t involve the company’s internal corporate governance.

<sup>6</sup> For example, under the Business Judgment Rule, Delaware corporate directors are presumed to be acting with care in executing their fiduciary duties to the company and that presumption must be overcome by a showing that they acted with gross negligence. Simple negligence is not sufficient. See *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

<sup>7</sup> Delaware Corporate Law, Why Businesses Choose Delaware, <https://bit.ly/2EA7V5x> (last visited August 25, 2020).

doctrine, Delaware sets the rules of corporate governance for most of the nation's largest businesses.”<sup>8</sup> More recent data suggests that preference for incorporating in Delaware is even stronger for new public companies, with 88% of corporations engaged in an initial public stock offering between 2017 and 2019 being incorporated in Delaware.<sup>9</sup> That makes a decision of the Delaware Supreme Court on matters that implicate corporate conduct particularly significant. These decisions effectively establish what the law is nationally in determining shareholder rights.<sup>10</sup>

## **Federal Law Governs the Sale and Trading of Securities**

While corporate governance issues are generally a function of state law, federal securities laws regulate corporations to the extent their activities relate to the issuance and trading of securities. In the wake of the stock market Crash of 1929 and the ensuing Great Depression, Congress passed the Securities Act of 1933 (“’33 Act”) and the Securities Exchange Act of 1934 (“Exchange Act”), which were “designed to restore investor confidence in our capital markets by providing investors and the markets with more reliable information and clear rules of honest dealing.”<sup>11</sup> The ’33 Act requires securities sold to the public to be registered and to provide certain information about the financial condition and operations of the company, and it imposes liability for false statements. The Exchange Act requires public companies to provide for ongoing disclosures after their initial offering and regulates other entities, including broker-dealers and exchanges, which are involved in the purchase and sale of securities.

The main purposes of these laws, as described on the SEC’s website, can be reduced to two common-sense notions:

- ◆ “Companies publicly offering securities for investment dollars must tell the public the truth about their businesses, the securities they are selling, and the risks involved in investing.

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<sup>8</sup> Mohsen Manesh, *The Contested Edges of Internal Affairs*, The CLS Blue Sky Blog, September 23, 2019, <https://bit.ly/34DIRWY>; See also Mohsen Manesh, *The Contest Edges of Internal Affairs*, 87 Tenn. L. Rev. (2020, Forthcoming), <https://bit.ly/2Qu6RCH>.

<sup>9</sup> Wilmer Hale 2020 IPO Report, at 8, June 29, 2020, <https://bit.ly/3hC1UTZ>.

<sup>10</sup> For example, if a corporation is incorporated in Delaware and its board of directors breaches its fiduciary duties to the company, that lawsuit will be brought in the Court of Chancery under Delaware law.

<sup>11</sup> SEC, What We Do, <http://bit.ly/2MngEXy> (last visited August 25, 2020).

- ◆ People who sell and trade securities – brokers, dealers, and exchanges – must treat investors fairly and honestly, putting investors’ interests first.”<sup>12</sup>

To achieve these goals, Congress recognized the importance of providing both public and private enforcement mechanisms to deter unlawful conduct in the market, to hold accountable those who violate the federal securities laws, and to help ensure investors recover losses that they’ve suffered when they are victims of wrongdoing.

Accordingly, Congress endowed the SEC with authority to enforce both the ’33 Act and the Exchange Act. In addition, under the ’33 Act, Congress gave investors the ability to bring lawsuits against participants in the Initial Public Offering (“IPO”) process when a company’s IPO disclosures contain material misstatements or omissions. The ’33 Act authorizes both federal and state courts to exercise jurisdiction over those private suits and bars removal of such suits from state to federal court. Under the Exchange Act, Congress gave investors the ability to bring lawsuits against those who defraud them. In contrast to the ’33 Act, the Exchange Act provides exclusive jurisdiction to federal courts.

The federal securities law framework, including its powerful combination of SEC enforcement and private legal enforcement, has worked for over eighty years. It is the bedrock on which this country built capital markets that are the envy of the world, fueling an extraordinary and extended period of economic growth and innovation. We tamper with it at our own risk.



## **Blue Apron’s Potential to Change the Legal Landscape**

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The Delaware Supreme Court’s decision in Blue Apron is best considered in the context of a decades-long tug-of-war between shareholders and corporations over the extent and nature of shareholders’ private rights of action under the federal securities laws. Compared to earlier fights over restrictions on shareholder class action lawsuits, which culminated in the

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<sup>12</sup> *Id.*



passage of the Private Securities Litigation Reform Act of 1995 (“PSLRA”) and the Securities Litigation Uniform Standards Act of 1998 (“SLUSA”), the latest tussle over where claims under the ‘33 Act should be litigated seems relatively modest in scope. Just as in those earlier debates, however, at stake is the balance of power between shareholders and management of public companies and the ability of shareholders to hold management accountable for wrongdoing.

## The U.S. Supreme Court Preserves State Jurisdiction

In 2018, in a case called *Cyan v. Beaver County Retirement Fund*, the U.S. Supreme Court considered whether the Securities Litigation Uniform Standards Act stripped state courts of their longstanding jurisdiction to adjudicate shareholder class actions brought under the ‘33 Act.<sup>13</sup> The Court ruled that it did not. On the contrary, the Court ruled that SLUSA left in place state courts’ jurisdiction over such claims, including when brought in class actions, and that defendant corporations cannot remove these claims from state to federal court. Following the *Cyan* decision, there was an increase in ‘33 Act claims filed in state courts.<sup>14</sup>

State courts are often considered to be a more favorable forum for shareholders, because they do not impose the same stringent procedural rules as federal courts.<sup>15</sup> For example, as explained by Stanford University Law School Professor Joseph Grundfest: 1) pleading standards in many state courts are considered “more plaintiff-friendly” than in federal court; 2) federal courts provide for automatic stays of discovery while motions to dismiss are pending, which is not uniformly the case in state court; and federal law imposes restrictions on the identity of class representatives and class counsel that do not exist in state court proceedings.<sup>16</sup> These differences, according to Grundfest, “could have a major impact on litigating and resolving these cases”

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<sup>13</sup> *Cyan, Inc. v. Beaver County Employees Retirement Fund*, 583 U.S. \_\_\_ (2018).

<sup>14</sup> See Michael Klausner et al., *State Section 11 Litigation in the Post-Cyan Environment (Despite Sciabacucchi)*, *The Business Lawyer*, Vol. 75, (Spring 2020), at 1769, <https://stanford.io/35PgLHJ>.

<sup>15</sup> *Id.* See also, Joseph A. Grundfest, *The Limits of Delaware Corporate Law: Internal Affairs, Federal Forum Provisions, and Sciabacucchi*, Rock Center for Corporate Governance at Stanford University Working Paper No. 241, September 12, 2019, <https://bit.ly/2FX3MsA> (highlighting differences in procedural rules between state and federal court, including more lenient pleading standards and more reluctance to dismiss cases in state court).

<sup>16</sup> Grundfest, *The Limits of Delaware Corporate Law* at 5. Grundfest highlighted how, because “Section 11 claims are less frequently dismissed in state than in federal court,” they “are therefore likely more valuable to plaintiffs, on average, if filed in state court.”).

and provide plaintiffs with “powerful incentives to prefer state to federal court when litigating Section 11 claims.”<sup>17</sup>

In response to the post-*Cyan* increase in filing of ‘33 Act claims in state court, corporate defendants began to look for new ways to force these cases into federal court. In particular, they began including a type of forum selection clause, known as a federal forum provision, in their corporate charters.<sup>18</sup> Federal forum provisions require that any claims under the ‘33 Act be litigated in federal rather than state court. As such, they effectively negate the *Cyan* ruling.

Among the companies that included a federal forum provision in their charters as they were preparing to go public were Blue Apron Holdings, Roku, and Stitch Fix.<sup>19</sup> Matthew Sciabacucchi bought shares of common stock of each company, either in their initial public offerings or shortly afterwards. He then filed a class action complaint against the companies and their directors, seeking a declaratory judgment that the federal forum provisions were invalid under Delaware law.

## **Delaware Court of Chancery Rules Against Federal Forum Provisions**

When the case came before the Delaware Court of Chancery, it ruled in Sciabacucchi's favor, holding that federal forum provisions are “ineffective and invalid.” The court held that “constitutive documents of a Delaware corporation cannot bind a plaintiff to a particular forum when the claim does not involve rights or relationships that were established by or under

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<sup>17</sup> *Id. See also*, James D. Cox, Don't Tread on Me: Delaware Corporate Law and The Constitution, Working Paper (citing evidence that “settlements occur in nearly 80 percent of state court findings even if the parallel federal case had been dismissed.”)

<sup>18</sup> Charters are also known as articles of incorporation.

<sup>19</sup> The charter provisions at issue were substantively identical, stating that “Unless the company consents in writing to the selection of an alternative forum, the federal district courts of the United States of America shall be the exclusive forum for the resolution of any complaint asserting a cause of action arising under the Securities Act of 1933. Any person or entity purchasing or otherwise acquiring any interest in any security of [the Company] shall be deemed to have notice of and consented to [this provision].” Blue Apron's provision hedged a bit, stating that “the federal district courts of the United States of America shall, to the fullest extent permitted by law, be the sole and exclusive forum for the resolution of any complaint asserting a cause of action arising under the Securities Act of 1933.”

Delaware's corporate law."<sup>20</sup> In the Chancery Court's view, claims brought under the '33 Act derive from an investor's share purchase rather than from their share ownership, and the purchaser of a stock is "not yet a stockholder and lacks any relationships with the corporation that is grounded in corporate law." Accordingly, in the view of the court, claims under the '33 Act are external to the rights or relationships established by or under Delaware's corporate law.<sup>21</sup> In arriving at its decision, the Chancery Court cited a 2013 decision, *Boilermakers Local 154 Retirement Fund v. Chevron*, in which the court held that a corporation could adopt a forum-selection bylaw to regulate matters of internal corporate affairs, but not one attempting to regulate an "external" matter.<sup>22</sup>

The Chancery Court also pointed to the Delaware General Assembly's 2015 enactment of legislation that amended the DGCL, adding Section 115, as offering support for this position. This section states that a corporation's certificate of incorporation or its bylaws may require internal corporate claims to be brought solely and exclusively in Delaware, and that no provision of a corporation's certificate of incorporation or bylaws may prohibit bringing such claims in Delaware courts.<sup>23</sup> Section 115 also defines "internal corporate claims" to include claims that are "based upon a violation of a duty by a

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<sup>20</sup> *Chancery Opinion*. According to the Chancery Court, "As the sovereign that created the entity, Delaware can use its corporate law to regulate the corporation's internal affairs...[b]ut Delaware's authority as the creator of the corporation does not extend to its creation's external relationships, particularly when the laws of other sovereigns govern those relationships." *Id.* at 3-4. Furthermore, "[t]his limitation applies even when shares of a Delaware corporation comprise the property that is the subject of the external claim," according to the court. *Id.* at 4.

<sup>21</sup> In other words, because '33 Act claims don't "implicate the internal affairs of the corporation," (because they do not "turn on the rights, powers, or preferences of the shares, language in the corporation's charter or bylaws, a provision in the DGCL, or the equitable relationship that flow from the internal structure of the corporation"), a corporation cannot use its charter or bylaws to regulate the forum in which parties bring '33 Act claims, the Chancery Court ruled.

<sup>22</sup> *Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934 (Del. Ch. 2013) (Strine, C.), <https://bit.ly/34FOB1k>. The Boilermakers court identified the type of bylaw that seeks to regulate internal corporate affairs as one which seeks to regulate "the kind of claims most central to the relationship between those who manage the corporation and the corporation's stockholders." The court offered as an example of a bylaw that seeks to regulate external matters, a forum selection bylaw "that purported to bind a plaintiff, even a stockholder plaintiff, who sought to bring a tort claim against the company based on a personal injury she suffered that occurred on the company's premises or a contract claim based on a commercial contract with the corporation." *Id.* at 26-27. The court stated that such a bylaw would be unlawful because "the bylaws would not deal with the rights and powers of the plaintiff-stockholder *as a stockholder*." *Id.*

<sup>23</sup> See Del. S.B. 75 syn., 148th Gen. Assem. (2015) (amending 8 Del. C. §§ 102, 109, adding § 115). The amendments also banned fee-shifting provisions from both charters and bylaws.

current or former director or officer or stockholder in such capacity” and “as to which this title confers jurisdiction upon the Court of Chancery.”<sup>24</sup>

The Chancery Court reasoned that by defining what constitutes an “internal corporate claim” and allowing such claims to be subject to a forum selection provision in charters and bylaws, the General Assembly was indicating by negative implication that claims that do not fall within that definition are external and therefore outside the scope of what can permissibly be included in a corporation’s charter or bylaws.<sup>25</sup> According to the Chancery Court, because federal securities law claims fall outside that definition, it would not be permissible to include provisions relating to those types of claims in a corporate charter.<sup>26</sup>

## **The Delaware Supreme Court Takes the Opposite View**

Many observers expected the Delaware Supreme Court to reach a similar conclusion. In a unanimous decision issued in March 2020, however, the Delaware Supreme Court reversed the Chancery Court’s ruling, finding that federal forum provisions in corporate charters are facially valid under Delaware law with respect to at least some ’33 Act claims.<sup>27</sup>

In reaching this conclusion, the court highlighted the broad statutory language in the Section 102(b)(1) of the DGCL allowing a corporation to include in its charter “*any* provision for the management of the business and for the conduct of the affairs of the corporation” and “*any* provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders, or any class of the stockholders, . . . if such provisions are not contrary to the laws of this State.” The court concluded that a federal forum provision “could easily fall within either of these broad categories.” It reasoned that “litigation arising out of the Board’s disclosures to current and prospective stockholders in connection with an IPO or secondary offering,”

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<sup>24</sup> 8 Del. C. § 115.

<sup>25</sup> *Chancery Opinion*. According to the Chancery Court, “The omission comports with the precedent leading up to Section 115, which recognized that the charter and bylaws can only address internal-affairs claims.”

<sup>26</sup> Rather, the Chancery Court viewed a claim under the ’33 Act as indistinguishable from causes of action that do not involve internal corporate affairs, such as tort or contract claims that do not depend on the stockholder’s rights as stockholder.

<sup>27</sup> *Salzberg v. Sciabacucchi*, No. 346, 2019 (Del. Mar. 18, 2020), <https://bit.ly/32x4jiX> [“*Salzberg*” or “*Sciabacucchi*” or “*Blue Apron*”].

including the “drafting, reviewing, and filing of registration statements by a corporation and its directors,” is “an important aspect of a corporation’s management of its business and affairs and of its relationship with its stockholders.”

The Delaware Supreme Court further concluded that federal forum provisions are not contrary to the policies or laws of Delaware. Again, the court pointed to the “broadly enabling” scope of Section 102(b)(1), reasoning that “[Federal forum provisions] in stockholder-approved charter amendments should be respected as a matter of policy.” The court also highlighted how the “DGCL allows immense freedom for businesses to adopt the most appropriate terms for the organization, finance, and governance of their enterprise.”

In contrast to the Chancery Court, the Delaware Supreme Court held that the 2015 amendments to the DGCL did not limit the scope of provisions that are permissible under Section 102(b)(1). The court reasoned that, just because a charter provision does not fall within the definition of “internal corporate claims,” that does not mean that such a provision is outside the scope of what can permissibly be included in a charter. In this case, despite the fact that ’33 Act claims do not fall within the DGCL’s definition of “internal corporate claims,” that does not mean that provisions relating to ’33 Act claims are outside the scope of what can permissibly be included in a charter. In the court’s view, “Boilermakers did not establish the outer limit” of what can be included in a charter or bylaw. This suggests that the “outer limit” may be far broader than many previously thought.

### **Blue Apron Extends the Outer Limit of What Can be Included in a Charter or Bylaw**

Reinforcing the argument that the outer limit of what corporations can permissibly include in their governing documents is much broader than many previously thought, the Delaware Supreme Court dismissed the notion of a “binary world of only ‘internal affairs’ claims and ‘external’ claims” [that] the Court of Chancery “superimposed onto the internal affairs doctrine” and the DGCL. Rather, the court stated that there is a category of matters – “situated on a continuum” between the Boilermakers definition of “internal affairs” and purely “external” claims – that includes certain types of “intra-corporate” claims. As such, charter provisions that relate to the “management of the

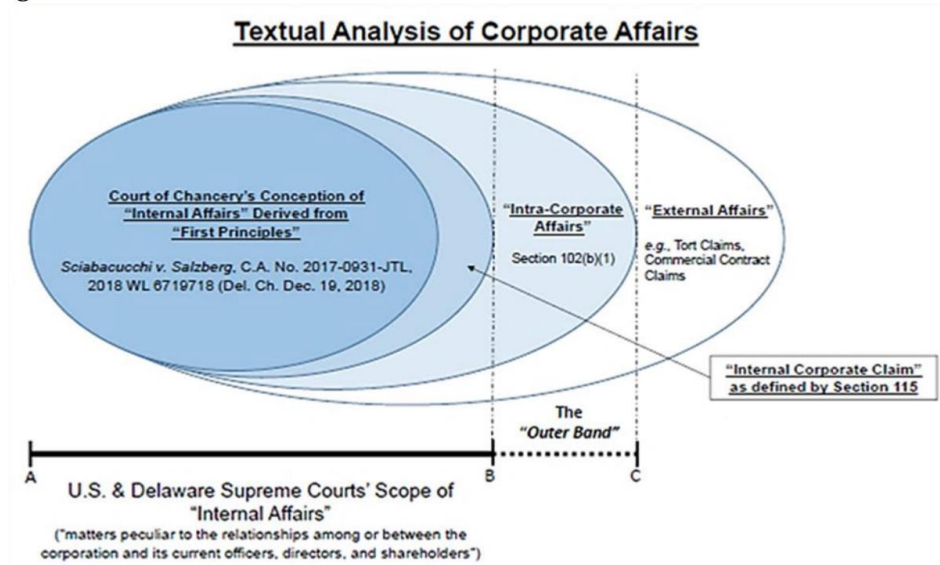
business” and the “conduct of the affairs of the corporation” would be facially permissible, in the court’s view.

Under this framework, in determining whether it is permissible to include a particular provision in a charter, there appear to be three categories.

- ◆ The first category includes claims that are clearly within the definition of “internal corporate claims,” (i.e., cases that meet the statutory definition of Section 115), which arise under Delaware corporate law. The classic example is a case alleging that the directors breached their fiduciary duties under Delaware law. Under Section 115, corporations may require these cases to be litigated in Delaware courts, and they may not prohibit shareholders from litigating these cases in Delaware courts.
- ◆ The second category includes claims that are not clearly within the definition of “internal corporate claims” but are still “intra-corporate,” because they relate to the management of the business and the conduct of the affairs of the corporation, its board and its shareholders. Because these claims do not meet Section 115, they may be the subject of a charter provision restricting where claims can be brought. In the Blue Apron case, provisions forcing ’33 Act claims into federal court fell into this category.
- ◆ The third category includes external claims that do not relate to the management of the business and the conduct of the affairs of the corporation, its board, and its shareholders. Such claims, which include tort or commercial contract claims, fall outside the bounds of what can be included in a charter.

The Delaware Supreme Court included a graphic in its decision attempting to illustrate its analysis. (See Figure 1)

Figure 1:



Applying this framework, the Delaware Supreme Court ruled that Section 11 claims under the '33 Act relate to the management of the business and the conduct of the affairs of the corporation. According to the court's reasoning, Section 11 claims, which arise from material misstatements or omissions in registration statements, necessarily implicate actions taken by a corporation's board of directors and relate to the corporation-stockholder relationship.

The Delaware Supreme Court disagreed with the Chancery Court's analysis that claims brought under the '33 Act necessarily arise from the purchase of shares, as opposed to share ownership. Rather, the Delaware Supreme Court said that, because it was possible for '33 Act claims to be asserted by existing stockholders, that undermined the Chancery Court's analysis. "For example, existing stockholders could assert that a prospectus relating to shares of stock the directors were selling in a registered offering, signed by the directors of a Delaware corporation, contained material misstatements and omissions." More specifically, according to the court, "The drafting, reviewing, and filing of registration statements by a corporation and its directors is an important aspect of a corporation's management of its business and affairs and of its relationship with its stockholders." In the court's view, "That is enough to survive a facial challenge."

Next, the Delaware Supreme Court concluded that federal forum provisions do not violate federal law or policy. In arriving at this conclusion, the court cited the U.S. Supreme Court case *Rodriguez de Quijas v. Shearson/American Express, Inc.*, which held that an arbitration provision in a brokerage firm's standard customer agreement that precludes state court litigation of '33 Act claims is permissible. In that case, the U.S. Supreme Court stated that arbitration clauses are "in effect, a specialized kind of forum selection clause" that "should not be prohibited under the Securities Act, since they, like the provision for concurrent jurisdiction [of federal and state courts], serve to advance the objective of allowing buyers of securities a broader right to select the forum for resolving disputes, whether it be judicial or otherwise." The Delaware Supreme Court concluded that the same logic should permit federal forum provisions in corporate charters.<sup>28</sup>

### **Blue Apron Raises Questions Regarding How It Will Be Applied**

The Delaware Supreme Court recognized that its decision was unlikely to provide finality and certainty on the types of provisions corporations could include in their charters that seek to regulate shareholder securities litigation. First, the court acknowledged that it was only addressing a facial challenge and was "not considering hypothetical, contextual situations regarding the adoption or application" of federal forum provisions. According to the court, "charter and bylaw provisions that may otherwise be facially valid will not be enforced if adopted or used for an inequitable purpose." The court reasoned that "'as applied' challenges are an important safety valve in the enforcement context," and it suggested that those determinations will be made on a case-by-case basis but that the burden to prove that a provision is unlawful will be high.<sup>29</sup>

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<sup>28</sup> As discussed below, the *Salzberg* court did not recognize the important procedural safeguards that distinguish broker-dealer arbitration from other types of arbitration and which were critical to the Supreme Court's conclusion that arbitration in the brokerage context would be "adequate to protect the substantive rights at issue."

<sup>29</sup> The court stated that forum-selection clauses are "presumptively valid" and cited three bases on which forum-selection provisions might be invalidated on an "as applied" basis: (i) they will not be enforced if doing so would be "unreasonable and unjust;" (ii) they would be invalid for reasons such as fraud or overreaching; or (iii) they could be not enforced if they "contravene[d] a strong public policy of the forum in which suit is brought, whether declared by statute or by judicial decision." (citing *M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 15 (1972)).



The Delaware Supreme Court also acknowledged “the most difficult aspect of this dispute is not with the facial validity of [federal forum provisions], but rather, with the ‘down the road’ question of whether they will be respected and enforced by our sister states.” The court recognized the possibility that an investor would file suit outside Delaware, and the sister state “would not necessarily follow Delaware’s lead in enforcing the federal-forum provision.” But the court suggested that “there are persuasive arguments” for other states to uphold a provision in a Delaware corporation’s charter requiring Section 11 claims to be brought in a federal court. In its view, federal forum provisions in corporate charters are essentially contractual in nature, and contracts among the corporation’s stockholders and traditional choice-of-law principles should be given deference.<sup>30</sup>

Finally, in a much-debated footnote, the court noted that “much of the opposition to [federal forum provisions] seems to be based upon a concern that if upheld, the ‘next move’ might be forum provisions that require arbitration of internal corporate claims.” The court dismissed that concern, stating that, “Such provisions, at least from our state law perspective, would violate Section 115 which provides that, ‘no provision of the certificate of incorporation or the bylaws may prohibit bringing such claims in the courts of this state.’” As discussed below, however, the footnote has not put this issue to bed.

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<sup>30</sup> As discussed later in this paper, these issues are currently being litigated in the Dropbox case in California state court. Also, for a more comprehensive discussion of how these and other issues might play out between different states, See Mohsen Manesh, *The Contested Edges of Internal Affairs*, The CLS Blue Sky Blog, September 23, 2019, <https://bit.ly/34DIRWY> (“The ability of other states to contest the scope of the internal affairs doctrine puts Delaware – and, therefore, the many corporations that rely on Delaware law – in a precarious position. Some states may take a more cramped view of the doctrine, enacting laws like California’s gender diversity statute that encroach on matters otherwise governed exclusively by Delaware. And other states may take a more expansive view of the doctrine, authorizing their domestic corporations to adopt governance provisions of the type that Sciabacucchi invalidated and thus attracting corporate charters away from Delaware. In either scenario, the scope of Delaware’s lucrative regulatory domain shrinks....Challenges at the edges of the internal affairs doctrine, like those that emerged in late 2018, are a problem unlikely to go away for Delaware. Since California enacted its first-in-the-nation board diversity statute, state legislatures in Illinois and New Jersey have considered similar bills. And earlier this year, an activist shareholder initiated litigation against the New Jersey-chartered Johnson & Johnson, pressing it to adopt a bylaw provision mandating arbitration for all shareholder claims brought under federal securities law. These developments suggest that skirmishes at the frontiers of the internal affairs doctrine are likely to persist. And these skirmishes could both erode Delaware’s hegemony and fundamentally reshape the regulation of corporate America.”).



## Blue Apron's Potentially Far-Reaching and Troubling Effects

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The direct and immediate effect of the Delaware Supreme Court decision was to effectively negate the U.S. Supreme Court's *Cyan* decision. Blue Apron allows corporations to force '33 Act claims into federal court despite the fact that *Cyan* held that Congress intended to allow investors to bring such cases in both federal and state court.<sup>31</sup> Under Blue Apron, if a shareholder brings a '33 Act claim in state court against a Delaware corporation that has a federal forum provision in its charter, then that corporation could move to dismiss the case on the grounds that the shareholder was contractually bound by the federal forum provision and must therefore sue in federal court.

In the wake of Blue Apron, clearly we should expect to see an increase in the use of federal forum provisions in Delaware corporate charters and a resulting decrease in the number of '33 Act cases brought in state court. Those cases will be channeled to federal court, where they may be subject to more stringent procedural requirements, as discussed above, which in turn may result in higher dismissal rates, to the detriment of investors.<sup>32</sup>

The indirect effects of the Blue Apron decision are much less predictable. Yet they are potentially far-reaching and very troubling. Put

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<sup>31</sup> Quinn Emanuel, Firm Memoranda, Delaware Supreme Court Upholds Forum Selection Clause Provisions For Securities Act Claims, <https://bit.ly/3hCAy05> ("First, the decision may effectively overturn the flexibility afforded plaintiffs under the *Cyan* decision. The explosion of Securities Act class actions in state court will likely cease as more Delaware corporations adopt forum selection clause provisions.").

<sup>32</sup> Duke University Law Professor James D. Cox believes that "[t]his outcome can pose a serious statute of limitation problem, and more so if the gravamen of the complaint, as is typical with Section 11 and Section 12(a)(2) claims, is the defendant acted without being aware of committing a material misrepresentation or with reckless disregard of the truth of the statements that were made. This is because the limitation period for statements committed without such a level of consciousness is one year from the date the plaintiff's purchase. It can easily be understood that this is a relatively short limitations period after considering not only the time needed for the investor to discover that a material misrepresentation was committed, to next engage counsel to initiate the suit, counsel to assess the viability of the suit, and for the corporation to exercise its rights under the forum protection provision, and likely doing so with a strategic eye on the limitations period." Cox Working Paper (on file with authors).

simply, the decision creates a slippery slope, with the potential for its logic to be applied beyond '33 Act claims and to charter and bylaw provisions that address a broader range of issues than whether claims will be heard in federal or state court. This may include using corporate governing documents to bind current and future shareholders in ways that contract around and effectively negate the policies and purposes underlying the federal securities laws, subverting the will of Congress. Taken to the extreme, the decision could effectively insulate corporations and their management from being held accountable for wrongdoing, to the detriment of shareholders and market integrity.

Given the broad latitude the Delaware Supreme Court has given corporations, it is likely they will continue to test the bounds of what is permissible.<sup>33</sup> And, as noted above, those corporations most in need of strong shareholder oversight seem most likely to avail themselves of this new freedom.



### **Will Corporations Be Able to Bind Shareholders without their Express Consent?**

In Blue Apron, the provisions at issue requiring '33 Act claims to be brought in federal court were included in the charters of pre-IPO corporations. Following the decision, law firms are counseling corporate clients to include a federal forum provision in their charters to direct '33 Act claims to federal court. Under the DGCL, however, amendments to corporate charters must be approved by shareholders. After an IPO has taken place and shareholder ownership of the company is much more dispersed, a company may not be able to secure shareholder approval for a charter amendment.<sup>34</sup> Yet the company may still be subject to '33 Act liability, for example from a follow-on offering.<sup>35</sup>

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<sup>33</sup> See Megan W. Shaner, *Interpreting Organizational Documents in the Private Ordering Era*, The CLS Blue Sky Blog, July 3, 2019, <https://bit.ly/31zo111> (“Stockholder activists and boards of directors alike are testing the bounds of the freedom to contract in the charter and bylaws, adopting provisions aimed at reshaping the balance of power in corporations. In considering recent efforts, the courts have largely shown a willingness to uphold these governance arrangements.”).

<sup>34</sup> 8 Del. C. § 242(b)(1) requires a board resolution and stockholder vote for a proper amendment to a corporation’s certificate of incorporation.

<sup>35</sup> A mature public company may not see much if any benefit of amending its bylaws to include a federal forum provision regarding the litigation of '33 Act claims because without a new registered offering, there will be no potential for '33 Act liability to begin with.

Bylaws, unlike the charter, can be amended by the board *without* shareholder approval, assuming that authority is provided in the charter. Given corporate concerns regarding the challenges of amending charters, law firms are counseling corporations to adopt federal forum provisions, not just through charter amendments, but also through bylaw amendments for post-IPO corporations. Like a contract of adhesion, this would allow corporate boards to bind shareholders without their express consent, or even the patina of negotiation or consent.

The question, therefore, arises: Would such a bylaw amendment be permissible under Delaware law? The answer appears to be yes.

On one hand, certain statements by the Delaware Supreme Court seem to suggest that the court would be less amenable to a bylaw amendment than a charter amendment on the grounds that it was not “stockholder-approved.” For example, the Delaware Supreme Court emphasized several times that federal forum provisions in “stockholder-approved” charters should be respected as a matter of policy. It stated, for example, “[Federal forum provisions], as charter provisions, must be subjected to, and approved by a vote of the stockholders. The logic underlying the validity of traditional contractual forum-selection clauses has some force in this stockholder-approved charter context.” The same cannot be said of bylaw amendments that are adopted post-IPO, without shareholder approval.

On the other hand, the court did not clearly state, or even suggest, that a board’s unilateral adoption of a federal forum provision in a company’s bylaws would alter its analysis. On the contrary, the court did not appear to distinguish between charters and bylaws in its analysis. In one place, the decision even appears to use the word bylaw when it appears to mean charter. It states, “Accordingly, a *bylaw* that seeks to regulate the forum in which such ‘intra-corporate’ litigation can occur is a provision that addresses the ‘management of the business’ and the ‘conduct of the affairs of the corporation,’ and is, thus, facially valid under Section 102(b)(1).”<sup>36</sup> Given the court’s mixed use of terms, as well as the court’s citation to previous decisions approving forum selection and fee-shifting clauses in bylaws that were

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<sup>36</sup> *Salzberg* at 11. (emphasis added). As the court’s analysis makes clear, Section 102(b)(1) governs the matters contained in a corporation’s certificate of incorporation, while 109(b) governs the matters contained in a corporation’s bylaws.

amended without shareholder approval, we think it is reasonable to assume that a court could uphold a forum or other provision that was unilaterally adopted by a corporation's board of directors.

As discussed above, in upholding the charters at issue in this case, the Delaware Supreme Court highlighted the broad statutory language in the Section 102(b)(1) of the DGCL, which governs the contents that can be contained in a certificate of incorporation. Section 109 of the DGCL, which governs what contents can be contained in a corporation's bylaws, is similarly broad.<sup>37</sup> For this reason, it is reasonable to assume that the Delaware Supreme Court would analyze them similarly. Professor Grundfest, a former SEC Commissioner who is credited with being the intellectual force behind federal forum provisions, has stated his belief that the Blue Apron opinion will extend to bylaws. Following the decision, he opined, “[Sections] 109 and 102, as a practical matter, I don’t think there’s any daylight between them, given the breadth and strength of the opinion.”<sup>38</sup>

Second, in its decision, the Delaware Supreme Court cited extensively to the 2013 *Boilermakers* Chancery Court decision.<sup>39</sup> In that case, the Chancery Court upheld the use of forum selection clause bylaw amendments that were unilaterally adopted by boards of directors, requiring internal affairs claims to be brought in Delaware.<sup>40</sup> The Chancery Court reasoned in *Boilermakers* that, “[T]he bylaws constitute a binding part of the contract between a Delaware corporation and its stockholders”<sup>41</sup> The Chancery Court stressed that this is the case even when those bylaws were not in place when the stockholders initially purchased their shares. “Where, as here, the certificate of

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<sup>37</sup> 8 Del. C. § 109(b). Bylaws. The bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees.

<sup>38</sup> Cornerstone Research, *Implications for Federal Forum Provisions in Salzberg v. Sciabacucchi*: Cornerstone Research hosted a virtual presentation by Professor Joseph Grundfest of Stanford Law School, March 19, 2020, <https://bit.ly/2EqI558>.

<sup>39</sup> While the Chancery Court decision came to a different conclusion regarding the permissibility of the charters at issue in this case, it also cited to the *Boilermakers* decision for the proposition that the “[t]he parallelism between Sections 109(b) [in *Boilermakers*] and 102(b)(1) [in *Salzberg*]” should mean that the analysis should apply equally to both. The Chancery Court also cited leading commentators who observed, “[t]he language of Section 109(b) dealing with the subject matter of bylaws parallels in large measure the language of Section 102(b)(1) dealing with what may be included in a certificate of incorporation.” *Chancery Opinion*, note 98.

<sup>40</sup> *Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934 (Del. Ch. 2013).

<sup>41</sup> *Id.* at 939.

incorporation has conferred on the board the power to adopt bylaws, and the board has adopted a bylaw consistent with 8 Del. C. § 109(b), the stockholders have assented to that new bylaw being contractually binding,”<sup>42</sup> according to the court. In other words, by purchasing shares whose charter allows the board to change the bylaws, stockholders implicitly consent to bylaw changes without their approval.

The Delaware Supreme Court also cited extensively to the 2014 *ATP* decision, stating, “ATP Suggests [federal forum provisions] are Permissible Under Section 102(b)(1).”<sup>43</sup> In that case, the Delaware Supreme Court upheld a fee-shifting (or “loser pays”) bylaw provision that was unilaterally adopted by a non-stock corporation.<sup>44</sup> Because the Delaware Supreme Court in this case relied extensively on cases that upheld bylaw amendments that were unilaterally adopted by boards and did not suggest a different result if a federal forum provision were unilaterally adopted by a board, it suggests the court would not distinguish between federal forum provisions adopted through charters and those adopted through board-adopted bylaw amendments without shareholder approval.

Corporate attorneys clearly believe that board-adopted bylaws would be permissible, as they are counseling clients to adopt them. For example, Wilson Sonsini, the firm that litigated Blue Apron, recommended that companies do just that in a recent discussion of the effects of the case. It noted that, “[A]lthough the Supreme Court’s decision dealt specifically with the validity of Federal Forum Provisions contained in corporate charters, the Court’s reasoning should apply equally to federal forum selection provisions in board-adopted bylaws.”<sup>45</sup> Similarly, the corporate law firm Fenwick & West recommended that, “For Delaware corporations that do not have [federal forum provisions]: It makes sense to adopt a provision promptly. The easiest

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<sup>42</sup> *Id.* at 958.

<sup>43</sup> *ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554, 557 (Del. 2014).

<sup>44</sup> The 2015 amendments to the DGCL effectively reversed the *ATP* ruling with regard to stock-corporations, clarifying that corporate charters or bylaws may not contain fee-shifting provisions in connection with internal corporate claims, as defined in § 115.

<sup>45</sup> Wilson Sonsini, Practical Considerations for Private and Public Company Clients in Light of the Delaware Supreme Court’s Decision Upholding Federal Forum Provisions, March 23, 2020, <https://bit.ly/2QxPWPz>.

way to do so is by means of a bylaw amendment, which may be accomplished via board action and does not require a stockholder vote.”<sup>46</sup>

If, as we expect, bylaw amendments adding federal forum provisions are permitted without express shareholder consent, it would further undermine shareholder rights with regard to the choice of forum in which they are entitled to bring claims. Because corporate boards will have an incentive to direct claims to the venues least friendly to shareholder claims, and because shareholders will have no practical means of resisting such actions, this increases the likelihood that the corporation and management will be insulated from being held accountable for wrongdoing, to the detriment of shareholders and market integrity.

Allowing corporate boards to unilaterally adopt provisions regulating “intra-corporate” litigation would be particularly problematic if those provisions regulate a broader range of claims, a broader range of forums, such as private arbitration, or a broader range of anti-litigation tools, such as fee-shifting provisions. The following discussion looks at the potential for the decision to result in each of these outcomes.



### **Will Corporate Boards Be Able to Regulate a Broader Range of Investor Claims?**

The most common claim asserted by shareholders against corporations and their management is for securities fraud. These claims are brought pursuant to section 10(b) and Rule 10b-5 of the Exchange Act, which prohibit making any material misstatement or omission in connection with the purchase or sale of any security.<sup>47</sup> Although Blue Apron considered only the facial validity of federal forum provisions for ‘33 Act claims, it invites the question: would the decision also permit corporate boards to adopt charter or bylaw provisions regulating fraud claims under the ‘34 Act?<sup>48</sup> Because ‘34 Act

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<sup>46</sup> Fenwick & West Delaware Supreme Court Rules That Corporations May Require Securities Act Claims to be Litigated in Federal Court, March 18, 2020, <https://bit.ly/34Fd076>.

<sup>47</sup> Cornerstone Research, Securities Class Action Filings, 2019 Year in Review, <https://bit.ly/2EA8trX>.

<sup>48</sup> While this section discusses whether, as a general matter, corporate boards could adopt provisions regulating fraud claims through bylaw or charter amendments, there would have to be a separate case-by-case consideration regarding the nature of any such amendments and whether they would raise anti-waiver considerations. (See, e.g., discussion in the next section on derivative claims.)

claims are already required to be brought in federal court, this would arise primarily in the context of other types of charter or bylaw provisions that could be adopted under the Blue Apron reasoning. Taken to its logical extreme, the decision could lay the groundwork for allowing corporations to use their charters or bylaws to regulate *all* federal securities law claims, and potentially other types of claims as well.<sup>49</sup>

Applying the framework in the Blue Apron decision, claims under Section 10(b) of the Exchange Act may, but do not necessarily, implicate board conduct. As such, they may arise from conduct that is or is not related to the “corporation’s management of its business and affairs and of its relationship with its stockholders.”<sup>50</sup> For example, a company may issue a 10-K with a material misstatement, in violation of Section 10(b), which investors could rely upon to make purchase or sale decisions. Following the Court’s logic, the “drafting, reviewing, and filing” of quarterly disclosures are “an important aspect of a corporation’s management of its business and affairs and of its relationship with its stockholders.” Since, according to that interpretation, such a violation would arise from internal corporate conduct on the part of the board, it is possible that the Delaware Supreme Court would view that conduct as being sufficiently intra-corporate to permit a charter or bylaw provision regulating such claims.

In contrast, an executive acting outside his or her role on the board could make the same fraudulent statement on Twitter, for example. Such a violation would not arise from any drafting, reviewing, or filing of corporate disclosure documents that constitute “an important aspect of a corporation’s management of its business and affairs and of its relationship with its stockholders,” nor would it arise from internal corporate conduct on the part of the board. On the one hand, such a violation would arguably resemble a case in which the director committed a tort against a shareholder. As the

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<sup>49</sup> For example, it is not even clear that the framework established by the court in Blue Apron – relying on whether it involves “an important aspect of a corporation’s management of its business and affairs” – would definitively prevent a corporate board from adopting charter or bylaw provisions to regulate non-securities claims brought by a current shareholder, such as a RICO or antitrust claim.

<sup>50</sup> See Ann Lipton, *So the Salzberg v. Sciabacucchi Decision is In!*, Business Law Prof Blog, March 21, 2020, <https://bit.ly/34AB9Md> (“[T]he decision opens with a description of how both Section 11 and Section 12 claims operate. Section 12, like 10(b), also does not necessarily involve directors. But the opinion doesn’t discuss whether such claims count as intra-corporate, even though the forum provisions at issue in the case cover both types of claims.”).



Delaware Supreme Court in *Blue Apron* acknowledged, “[t]here are purely ‘external’ claims, for example tort, which are clearly outside the bounds of Section 102(b)(1).” On the other hand, executives can’t fully divorce their activities from the board or the company, even when they appear to be acting without the approval of the board. The board and company are still ultimately responsible for the activities of its executives, including when its executives engage in securities fraud. Would that be enough for the court to view that conduct as intra-corporate?

In short, there is nothing “clear” about the boundary the decision draws between the types of claims that can be regulated through provisions adopted by way of charter and bylaw amendments and those that cannot. What is clear is that the decision creates a slippery slope. If the court were to expand the reach of its ruling to include the full range of securities and non-securities claims that involve “an important aspect of a corporation’s management of its business and affairs,” this could have a devastating impact on investors’ ability to recover losses and to hold corporations and their management accountable for wrongdoing in areas that go well beyond ’33 Act claims regarding omissions and misrepresentations in IPO offering documents. Because of the critically important role such claims play in providing an incentive for compliance with laws that are essential to the fair functioning of our capital markets, the effect on market integrity could be equally damaging.



### **Could the Decision Effectively Eliminate Shareholders’ Ability to Bring Securities Law Claims Derivatively?**

Shareholders can bring claims against corporations for wrongdoing either in their individual capacity directly against a corporation and its management<sup>51</sup> or derivatively on behalf of the company.<sup>52</sup> The classic example

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<sup>51</sup> For example, an investor can bring a case against the corporation and its directors for fraud.

<sup>52</sup> See James D. Cox and Thomas Lee Hazen, *Treatise on the Law of Corporations* § 15:2 (3d ed.) (“The derivative suit plaintiff . . . presents himself as spokesman for the corporate interest.”). See also Keith F. Higgins, Paul M. Kinsella, and Peter L. Welsh, *A Fresh Look at Exclusive Forum Provisions*, Harvard Law School Forum on Corporate Governance, May 28, 2019, <https://bit.ly/3hCBdi5> (“Most corporate lawyers instinctively think of a derivative claim as necessarily relating to a state law breach of fiduciary duty that is being pursued against the directors or officers in the right of the corporation by one or more of its stockholders. However, federal courts recognize derivative claims brought against corporate directors and officers alleging violations of federal law. One easy example is a suit brought against a Section 16 insider to recover short-swing profits under Section 16(b) of the Exchange Act. Less obvious are claims alleging that a breach of fiduciary duty by the directors caused the corporation to violate Section 14(a) of the Exchange Act and Rule 14a-9 promulgated thereunder when the corporation is alleged to have issued a misleading proxy

of a derivative suit is one in which a shareholder sues the corporation alleging that the corporation's directors breached their fiduciary duties to the corporation.<sup>53</sup> Derivative claims also include claims brought under Section 14(a) of the Exchange Act to prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation.<sup>54</sup> When combined with separate action taken by the courts to limit derivative claims, Blue Apron could have a particularly devastating impact on such claims.

In particular, a recent decision in the Northern District of Illinois suggests corporations may be permitted to include provisions in their charter or bylaws that effectively eliminate shareholders' ability to bring federal securities law claims derivatively. In that case, *Seafarers Pension Plan v. Bradway*,<sup>55</sup> the Seafarers Pension Plan, a shareholder of the Boeing Company, filed a derivative action against Boeing in the Northern District of Illinois, a federal district court. Seafarers sued pursuant to Section 14(a) of the Exchange Act, alleging that Boeing disseminated materially false and misleading proxy statements. Because the '34 Act gives federal courts exclusive jurisdiction over suits filed under the act, including those that are filed derivatively, Seafarers could only file this case in federal court. Boeing moved to dismiss the suit based on a bylaw it had adopted that restricts the filing of derivative suits to a Delaware state court.

Despite the fact that the court recognized that a derivative claim under the Exchange Act cannot be filed in Delaware state court, the Northern District of Illinois nonetheless ruled in Boeing's favor, concluding that the filing of a

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statement. Still another species of derivative action is brought under Rule 10b-5 under the Exchange Act, where a controlling stockholder may be alleged to have violated the rule by causing the corporation to repurchase stock at a time at which the price was inflated because of a failure to disclose material adverse information.").

<sup>53</sup> See *Meyer v. Fleming*, 327 U.S. 161, 167 (1946) ("[T]he purpose of the derivative action [is] to place in the hands of the individual shareholder a means to protect the interest of the corporation from the misfeasance and malfeasance of 'faithless directors and managers'" (quoting *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 548 (1949))).

<sup>54</sup> See *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964) ("[W]e believe that a right of action exists as to both derivative and direct causes. The purpose of 14 (a) is to prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation. The section stemmed from the congressional belief that "[f]air corporate suffrage is an important right that should attach to every equity security bought on a public exchange." H. R. Rep. No. 1383, 73d Cong., 2d Sess., 13.").

<sup>55</sup> *Seafarers Pension Plan v. Robert A. Bradway, et al.* [Boeing], Case No. 19 C 8095 (N.D. Ill. June 8, 2020).

derivative lawsuit in federal court would be in contravention of Boeing's corporate bylaws.<sup>56</sup> While the court was "sympathetic to Plaintiff's arguments because it is denied the right to proceed in federal court under a duly enacted federal law," the court stated that, "the weight of authority backs Boeing's position."<sup>57</sup> As a result, Boeing's bylaw effectively cut off shareholders' ability to bring a derivative 14(a) claim at all.<sup>58</sup>

Notably, among Seafarers' arguments was that enforcing the forum selection clause in Boeing's bylaws as written would foreclose a federal derivative action. As such, it would act as a waiver of a shareholder's right to file a federal derivative suit under the '34 Act, in violation of the anti-waiver provision contained in the '34 Act. The court rejected this argument, however, suggesting that the availability of other claims that are "substantially similar" to a federal derivative cause of action could act as adequate substitutes to ensure that the shareholders' substantive rights are vindicated.

At the very least, the *Seafarers* decision appears to raise serious problems going forward, if other courts follow its analysis. According to Tulane Law School Professor Ann Lipton, for example, courts will be forced to veer outside their lanes in trying to determine whether adequate substitutes exist to ensure investors' substantive rights are vindicated. According to Lipton, "that means going forward, courts will constantly have to determine if Delaware law is equivalent to/provides similar protections to federal law. Federal courts will have to construe and reconstrue the contours of Delaware law and its similarity to federal law – and Delaware law is known for shifting and altering its precedent – and possibly may involve Delaware courts in interpreting federal law." Lipton, who does not believe this dynamic will end well, opined, "Determining the enforceability of these provisions will require federal intrusion into the Delaware space in a manner that Delaware will, I believe, come to regret."<sup>59</sup>

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<sup>56</sup> The decision does not analyze whether a bylaw provision relating to Section 14(a) of the Exchange Act is permissible under Section 109(b). But applying the Court's analysis in *Blue Apron*, litigation arising out of Section 14(a) would likely be considered to implicate a board's involvement, including the drafting, reviewing, and filing of a proxy statement to current stockholders.

<sup>57</sup> The court cautioned that "neither *Salzberg* nor *Boilermakers* involved a situation where a plaintiff was denied the right to bring a federal securities case in a federal court. Consequently, neither of these cases dictate a result favoring Boeing."

<sup>58</sup> Shareholders can still bring direct claims under the Exchange Act in federal court.

<sup>59</sup> Ann Lipton, *And the Salzberg v. Sciabacucchi fallout begins*, Business Law Prof Blog, June 11, 2020, <https://bit.ly/2EFEYVo> (also raising other issues with the decision, including that the bylaw at

In short, extending the reasoning of Blue Apron not only has the potential to allow corporations to use charter or bylaw provisions to effectively eliminate shareholders' ability to bring securities law claims derivatively, it could draw the state into a larger debate over the appropriate limits on its authority and invite federalization of broader aspects of governance law.



### **Could corporations opt shareholders out of aspects of the federal securities laws, such as shareholder proposals?**

The Blue Apron decision raises at least the possibility that corporations could use charter or bylaw provisions to limit shareholder rights with regard to shareholder proposals. This would be damaging to shareholder interests, as shareholder engagement is a vital component of our capital markets, and shareholder proposals provide an essential mechanism for shareholders to communicate both with the executives of the companies they own and with other shareholders. As SEC Commissioner Allison Herren Lee has observed, “For decades, shareholders have succeeded in effecting significant improvements in corporate governance, including majority vote rules for the election of directors, staggered board terms, limits on poison pills that serve to entrench management, and increased adoption of proxy access bylaws. Shareholder proposals often highlight the need for important corporate reforms that are later adopted.”<sup>60</sup> Moreover, evidence compiled by Former SEC Commissioner Robert Jackson and his staff suggests that shareholder proposals on average increase long-term value, to investors' benefit.<sup>61</sup>

Corporate management, however, often views shareholder proposals as a nuisance or an inappropriate burden, particularly proposals from a small subset of activist investors. They have attempted to erect various barriers to make it more difficult for shareholders to access the corporate ballot. This includes amending the securities laws to raise eligibility and resubmission

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issue might violate Section 115, be invalid contractually, and the directors' might violate their fiduciary duties by insisting on the bylaw's application.)

<sup>60</sup> Commissioner Allison Herren Lee, *Statement on Shareholder Rights*, November 5, 2019, <https://bit.ly/2FVLTdE>.

<sup>61</sup> Commissioner Robert J. Jackson Jr., *Statement on Proposals to Restrict Shareholder Voting*, November 5, 2019, <https://bit.ly/3jqM0wx> (“On average, we show, inclusion of shareholder proposals by an American public company tends to increase long-term value.”).

thresholds for the shareholder proposal process.<sup>62</sup> The Blue Apron decision may provide corporations with new tools to suppress shareholder proposals. Specifically, in the wake of Blue Apron, corporations might attempt to suppress the exercise of shareholder rights through corporate governing documents by amending their charters or bylaws to prohibit shareholders from voting on certain matters.

As far as we know, no Delaware corporation has so far attempted to use this tactic. But the SEC has recently permitted the use of this tactic by at least two closed-end funds and a Maryland Real Estate Investment Trust (RAIT Financial Trust). In each case, the fund in question argued that the proponents of the shareholder proposals did not hold securities entitled to vote on the matter.<sup>63</sup> In the case of RAIT Financial Trust, for example, RAIT's Declaration of Trust, the functional equivalent to a corporate charter, provides the trust's shareholders with very limited voting rights on specifically enumerated matters. When faced with a shareholder proposal, the trust sought to exclude it from coming to a shareholder vote, arguing that, since the proposal was not within the specifically enumerated matters in the trust, shareholders were not entitled to vote on the proposal.<sup>64</sup> The other cases proceeded along similar lines.

In each case, the SEC staff granted the request for no-action relief, stating that there appears to be a basis for the view that the proposal in question could be excluded from the proxy statement under rule 14a-8(b). In the RAIT case, for example, the letter states, "You represent that the proponent holds securities that are entitled to vote only on certain matters, which do not include the subject of this proposal. Rule 14a-8(b) requires that

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<sup>62</sup> Securities and Exchange Commission, File No. S7-23-19, Procedural Requirements and Resubmission Thresholds under Exchange Act Rule 14a-8, Final Rule (Sep. 23, 2020), <https://www.sec.gov/rules/final/2020/34-89964.pdf>.

<sup>63</sup> Securities and Exchange Commission, Letter from Raymond A. Be, Attorney-Adviser, to Thomas A DeCapo, Esq., Skadden, Arps, Slate, Meagher & Flom LLP, Re: Dividend and Income Fund, Omission of Shareholder Proposal Submitted by Alison Pampinella Pursuant to Rule 14a-8 (Apr. 10, 2020), <https://www.sec.gov/investment/dividend-income-fund-041020-14a8>; and Securities and Exchange Commission, Letter from Yoon Choo, Attorney-Adviser, to Jonathan Koff, Esq., Chapman and Cutler LLP, Re: First Trust Senior Floating Rate Income Fund II, Omission of Shareholder Proposal Submitted by Saba Capital Management, L.P., on behalf of Saba Capital Master Fund, Ltd., Pursuant to Rule 14a-8 under the Securities and Exchange Act of 1934, as amended (Jun. 17, 2020), <https://www.sec.gov/investment/first-trust-senior-floating-rate-income-fund-ii-2020-06-17>.

<sup>64</sup> Phillip Goldstein, *Can a Public Company Effectively Opt Out of Rule 14a-8?*, Harvard Law School Forum on Corporate Governance, March 30, 2020, <https://bit.ly/2ECB1kv>.

in order to be eligible to have a proposal included in a company's proxy materials, a shareholder must hold 'securities entitled to be voted on the proposal.' Accordingly, we will not recommend enforcement action to the Commission if RAIT omits the proposal from its proxy materials in reliance on rule 14a-8(b)."<sup>65</sup> The two other examples cited here use substantially similar language.

Phillip Goldstein of Bulldog Investors recently discussed this issue on the Harvard Law School Forum on Corporate Governance. He stated that this tactic could "permit issuers to effectively opt out of the [14a-8] rule entirely." Goldstein stated that, while he was not aware of the tactic's having been used by a corporation, "there is no reason a corporation could not use it, e.g., by adopting a bylaw to limit proposals that shareholders may vote upon to those submitted by the board or mandated by statute." He voiced concerned that, "Allowing each company to determine what proposals shareholders can vote upon (other than those legally requiring a vote by shareholders)—and, hence, under Rule 14a-8, rendering them excludable from its proxy materials could make the rule an empty shell."<sup>66</sup>

In the wake of the Blue Apron decision, it is possible that a Delaware corporation would attempt to limit shareholder proposals through a charter or bylaw amendment along the lines discussed here. The validity under state law of such a charter or bylaw provision would likely depend on whether the provision was deemed to cover intra-corporate activity. And, given the SEC staff's response with regard to use of such a provision by closed-end funds and a Maryland trust, it does not appear that the SEC staff would stand in the way if a Delaware corporation sought to employ the same tactic.

Despite the SEC staff response in the RAIT case, a provision seeking to evade and effectively nullify Section 14(a) proxy rules would appear to violate the anti-waiver provision of the Exchange Act.<sup>67</sup> The Third Circuit Court of Appeals considered this issue more than 60 years ago in *Securities and Exch. Commn. v. Transamerica Corp.*<sup>68</sup> Specifically, the court considered the

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<sup>65</sup> *Id.* (Emphasis added.)

<sup>66</sup> *Id.*

<sup>67</sup> Section 29(a) of the Exchange Act provides: "Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void." Securities Exchange Act of 1934, § 29(a), 15 U.S.C. 78cc (1976).

<sup>68</sup> *Securities and Exch. Commn. v. Transamerica Corp.*, 163 F.2d 511, 518 (3d Cir. 1947).

permissibility of a corporate bylaw that effectively prevented any shareholder proposal to amend the bylaws that the board deemed unsuitable from reaching a vote at the annual shareholder meeting of stockholders.<sup>69</sup> The court ruled that such a bylaw was unlawful because it would “serve to circumvent the intent of Congress in enacting the Securities Exchange Act of 1934. It was the intent of Congress to require fair opportunity for the operation of corporate suffrage. The control of great corporations by a very few persons was the abuse at which Congress struck in enacting Section 14(a)...This seems to us to end the matter. The power conferred upon the Commission by Congress cannot be frustrated by a corporate by-law.”<sup>70</sup>

While we believe these arguments still apply, it is not clear how a court would rule if presented with a similar bylaw today. If a court were to permit a corporate bylaw to evade Section 14(a), it would further undermine shareholder rights already under attack at the SEC.



### **Could corporations force investors to litigate federal securities law claims in private arbitration on an individual basis?**

While the federal forum provisions at issue in *Blue Apron* required '33 Act claims to be brought in federal court, they did not further restrict claims, for example by requiring all such claims to be heard in a *particular* federal court.<sup>71</sup> As a result, the decision did not address whether federal forum provisions can be drafted in ways that are more restrictive than were at issue

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<sup>69</sup> See Stephen M. Bainbridge, *Can a corporation opt out of Rule 14a-8?*, ProfessorBainbridge.com, May 24, 2020, <https://bit.ly/2Qxq9qx>.

<sup>70</sup> *Id.* (citing Susan W. Liebler, *A Proposal to Rescind the Shareholder Proposal Rule*, 18 Ga. L. Rev. 425, 461–62 (1984) (“I suggest that corporations adopt bylaw provisions placing reasonable restrictions on the ability of security holders to bring matters before a shareholders meeting. Transamerica does not preclude corporations from adopting bylaw provisions, which are valid under state law, to restrict the rights of shareholders to bring matters before the stockholders' meeting. First, the statement that bylaw provisions could not be used to thwart the shareholder proposal rule was dictum. Transamerica should be limited to its holding: rule 14a-8 requires inclusion of those shareholder resolutions which are proper subjects under state law, without regard to bylaw notice provisions. Second, since state law arguably would have prevented Transamerica's management from ruling Gilbert's motions out of order on the basis of a procedural technicality within management's control, Transamerica may stand for the proposition that no action which violates state law can be used to circumvent the rule. Finally, it is clear that the Commission's authority under the rule would not be frustrated by all state restrictions on the right of a shareholder to present resolutions at a shareholders meeting.”).

<sup>71</sup> The provisions stated, “The federal district courts of the United States of America shall be the exclusive forum” for bringing '33 Act claims.

in that case. One could imagine, for example, a corporation trying to force claims into a federal district court or circuit that is perceived as particularly skeptical of shareholder claims.<sup>72</sup> Potentially more dangerous, however, is the possibility that corporations will attempt to use the Blue Apron decision to force federal securities claims out of federal court altogether. For example, they might rely on the decision to try to force federal securities claims into private arbitration, where the claims would have to be pursued on an individual basis.

In a much-debated footnote, the court attempted to address this issue. First, it recognized that “much of the opposition to [federal forum provisions] seems to be based upon a concern that if upheld, the ‘next move’ might be forum provisions that require arbitration of internal corporate claims.” Then the court appeared to reject this concern, stating that, “Such provisions, *at least from our state law perspective*, would violate Section 115 which provides that, ‘no provision of the certificate of incorporation or the bylaws may prohibit bringing such claims in the courts of this state.’”<sup>73</sup> However, the footnote has not put this issue to bed, in large part because it does not tackle the question of whether a Delaware corporation may try to use its governing documents to force federal securities law claims into private arbitration.

As the decision makes clear, ’33 Act claims are not “internal corporate claims” within the meaning of Section 115, which means that the statutory ban on arbitration does not apply to these claims.<sup>74</sup> Rather, according to the

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<sup>72</sup> See Wilson Sonsini, Practical Considerations for Private and Public Company Clients in Light of the Delaware Supreme Court’s Decision Upholding Federal Forum Provisions, March 23, 2020, <https://bit.ly/2QxPWPz> (“Nothing in the Supreme Court’s analysis on the facial validity of Federal Forum Provisions suggests a provision limiting ’33 Act claims to a specific federal court or courts would be inherently problematic, but such a provision would likely be more difficult to defend on an ‘as applied’ challenge.”); See also John F. Sylvia, Patrick E. McDonough, Ellen Shapiro, Supreme Court of Delaware Overturns Court of Chancery, Allowing Corporations To Enact Federal Forum Provisions to Keep Securities Act Claims In Federal Court, Mintz, March 20, <https://bit.ly/32pAvhG> (“Corporations adopting Federal Forum Provisions may consider steering Securities Act claims to a specific federal district.”); James L. Hallowell, Mark H. Mixon, Jr. and Andrew Kuntz, Gibson Dunn, ‘Salzberg’ Opens Door to Creativity in the ‘Outer Band’ of ‘Intra-Corporate Affairs,’ DELAWARE BUSINESS COURT INSIDER, April 8, 2020, <https://bit.ly/3lstdun1> (“The same rationale underlying the facial validity of an FFP designating all federal district courts likely supports the facial validity of an FFP designating a single federal court.”).

<sup>73</sup> *Salzberg* at 53, note 169 (emphasis added).

<sup>74</sup> According to an article written by UCLA Law Professor Stephen M. Bainbridge, “Note, however, that the footnote only addresses mandatory arbitration of state law-based claims. It does not speak to the question of whether a charter might mandate arbitration of federal securities law claims.”



court's own analysis, Section 115 was drafted narrowly to prohibit bringing "internal corporate claims," those arising under Delaware corporate law, outside of Delaware courts.<sup>75</sup> The court provided further dicta in a footnote, stating, "We think Section 115 likely was intended to address claims requiring the application of Delaware corporate law as opposed to federal law. Stated differently, we do not think the General Assembly intended to encompass federal claims within the definition of internal corporate claims."<sup>76</sup> Thus, the court intentionally or unwittingly left open the critical question of whether provisions relating to intra-corporate claims, including federal securities laws claims, would be permissible under Delaware law.<sup>77</sup>

Since a provision regulating intra-corporate litigation would be outside the scope of Section 115, according to the court's analysis, the next question would be whether such a provision is permissible under Section 102(b)(1) or Section 109(b) of the DGCL. If you apply the Delaware Supreme Court's broad reading of these statutory provisions, it appears that it could be. If a corporation can use its charter or bylaws to include a forum provision to force particular federal claims into federal court, could it similarly use its charter or bylaw to include a forum provision to force particular federal claims into private court and require that those claims be litigated on an individual basis? As we have discussed elsewhere, that is tantamount to preventing the claims from being brought at all in a large majority of cases.<sup>78</sup>

As we have discussed elsewhere, we believe forced shareholder arbitration clauses are not just bad public policy, they are contrary to federal

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Stephen M. Bainbridge, *Delaware Supreme Court Validates Forum Selection Articles Sending Cases to Federal Court*, Washington Legal Foundation, March 25, 2020, <https://bit.ly/2YGGVYT>. Similarly, the corporate law firm Ropes and Gray stated in a client alert, "The decision, however, does not address the highly contentious and heavily debated issue of whether a charter provision could validly require that '33 Act claims—or other 'intra corporate' claims that are not 'internal' under Section 115—be subject to arbitration." Ropes & Gray, *Delaware Supreme Court Authorizes Inclusion of Federal Forum Provisions in Corporate Charters*, April 16, 2020, <https://bit.ly/31Bc8yF>.

<sup>75</sup> *Salzberg* at 23 ("Read holistically, Section 115 indicates a concern for centering particular claims— 'internal corporate claims'—in Delaware. This makes sense given Delaware's interest and expertise in corporate law. As Section 11 claims are not 'internal corporate claims,' Section 115 does not apply.").

<sup>76</sup> *Id.* at note 79.

<sup>77</sup> Hal Scott's proposal to amend Johnson and Johnson's bylaws raises this very issue, as discussed below.

<sup>78</sup> See Roper and Hauptman, *A Settled Matter*.

securities laws.<sup>79</sup> But the possibility that shareholders could be forced to arbitrate such claims is too dire an outcome to be left to questions about how the decision could be interpreted, and aspects of the Blue Apron decision create cause for concern.

For example, the fact that the court's analysis relied on *Rodriguez de Quijas v. Shearson/Am. Exp.*<sup>80</sup> lends credence to the concern that it could be used to require arbitration of federal securities law claims. In that case, the U.S. Supreme Court upheld a provision in a brokerage firm's standard customer agreement forcing the investor to arbitrate claims under the '33 Act. The arbitration clause at issue precluded federal or state court litigation of '33 Act claims, despite the fact that the '33 Act provides concurrent federal and state court jurisdiction. According to the Delaware Supreme Court in Blue Apron, "The holding in *Rodriguez* provides forceful support for the notion that [federal forum provisions] do not violate federal policy by narrowing the forum alternatives available under the Securities Act." The Delaware Supreme Court also highlighted the fact that *Rodriguez* described the arbitration provision as "in effect, a specialized kind of forum selection clause."<sup>81</sup>

Despite the Delaware Supreme Court analogy to *Rodriguez*, we do not think *Rodriguez* applies in the context of arbitration against issuers. Specifically, in upholding arbitration in the broker-dealer context, the U.S. Supreme Court in both *Rodriguez* and *Shearson/American Express Inc. v. McMahon* recognized the unique and important features that distinguish broker-dealer arbitration, features that provided the Court sufficient confidence that arbitration would be "adequate to protect the substantive rights at issue."<sup>82</sup> Those critical features, including the fact that the SEC has broad authority to oversee and regulate the rules adopted by FINRA relating to customer disputes and to ensure the adequacy of the arbitration

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<sup>79</sup> *Id.*

<sup>80</sup> *Rodriguez de Quijas v. Shearson/Am. Exp.*, 490 U.S. 477 (1989).

<sup>81</sup> *Salzberg* at 43.

<sup>82</sup> *Rodriguez de Quijas v. Shearson/Am. Exp.*, 490 U.S. 477, 483 (internal citations omitted) ("And in *McMahon*, we explained at length why we rejected the *Wilko* Court's aversion to arbitration as a forum for resolving disputes over securities transactions, especially in light of the relatively recent expansion of the Securities and Exchange Commission's authority to oversee and to regulate those arbitration procedures. We need not repeat those arguments here.").

procedures employed by FINRA,<sup>83</sup> would not be present in the context of shareholder arbitration against issuers.

There are differing views about whether a forced arbitration charter or bylaw provision would be upheld under state law. On one end of the spectrum, Professor Grundfest insists that, “Concerns that Federal Forum Provisions are a ‘gateway drug’ to mandatory Securities Act arbitration are ... not only misplaced, they have the argument backward. Federal Forum Provisions expressly preclude arbitration. They force litigation into federal or Delaware state court. It stands logic on its head to argue that a provision that prohibits arbitration facilitates arbitration. ... Put another way, by mandating that litigation proceed in federal court, Federal Forum Provisions assure those claims will not proceed in arbitration. This is powerful anti-arbitration medicine.” Following the Blue Apron decision, Grundfest stated, “mandatory arbitration of ‘33 Act claims is now dead and buried in Delaware.”<sup>84</sup>

Similarly, William B. Chandler III, of Wilson Sonsini, a former chancellor of the Delaware Court of Chancery who litigated the case, told *Reuters’* Alison Frankel that the footnote in Blue Apron “should help alleviate the ‘irrational fear’ that forum selection provisions for Securities Act claims will lead to mandatory shareholder arbitration clauses.”<sup>85</sup> According to the *Reuters* article, he reasoned that the SEC has never allowed a public company to adopt mandatory arbitration, “and now the Delaware justices have said state law doesn’t allow it.”<sup>86</sup> Chandler also opined that, “I don’t think any board of directors has the stomach for it because they know they’d be voted out.”<sup>87</sup>

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<sup>83</sup> *Shearson/American Express v. McMahon*, 482 U.S. 220, 233-234 (1987) (“the Commission has had expansive power to ensure the adequacy of the arbitration procedures employed by the SROs....In short, the Commission has broad authority to oversee and to regulate the rules adopted by the SROs relating to customer disputes, including the power to mandate the adoption of any rules it deems necessary to ensure that arbitration procedures adequately protect statutory rights. We conclude that where, as in this case, the prescribed procedures are subject to the Commission's § 19 authority, an arbitration agreement does not effect a waiver of the protections of the Act.”).

<sup>84</sup> Cornerstone Research, *Implications for Federal Forum Provisions in Salzberg v. Sciabacucchi*: Cornerstone Research hosted a virtual presentation by Professor Joseph Grundfest of Stanford Law School, March 19, 2020, <https://bit.ly/2EqI558>.

<sup>85</sup> Alison Frankel, *Dela. Supreme Court: Companies can pick forum for shareholders’ Section 11 claims*, *Reuters*, March 18, 2020, <https://reut.rs/2YENICp>.

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*

On the other end of the spectrum, some clearly view the Blue Apron decision as being extremely helpful in delivering their ultimate goal of requiring all federal securities law claims be forced into arbitration on an individual basis. According to the corporate law firm Arnold and Porter, for example, “*Sciabacucchi* arguably brings us one big step closer to a world in which securities claims are routinely arbitrated instead of litigated on a class-wide basis.”<sup>88</sup>

Several law firms even appear to be signaling to clients and potential clients their interest in testing whether they can adopt such clauses. For example, according to the corporate law firm Sidley Austin, “The flexibility *Sciabacucchi* exemplifies leaves open the potential adoption of other alternative forum provisions. Some have hypothesized this could extend as far as mandatory arbitration provisions governing certain securities claims. In the wake of the *Sciabacucchi* decision, corporations and directors should discuss with their counsel the possibility of these and other specific forum provisions designed to facilitate the efficient resolution of intra-corporate disputes.”<sup>89</sup> Similarly, Gibson Dunn states, “The outcome of *Salzberg* ‘has interesting potential ramifications for Delaware corporations seeking to benefit from arbitration provisions in corporate charters and bylaws.’...For the moment though, a pathway to creative charter provisions addressing at least some commonplace corporate litigation may well have been opened.”<sup>90</sup>

Of course, the Delaware Supreme Court could only determine whether such clauses in corporate governing documents are valid under state law. It would not have the final say on whether forced arbitration of federal securities claims is valid under federal law. If the Delaware Supreme Court permits the use of forced arbitration clauses for securities law disputes under state law, however, it would bring corporations one step closer to that goal. A sympathetic SEC could deliver the next step by taking the view that forced arbitration is lawful under the federal securities laws. The federal question is likely to be litigated as well, leaving open the possibility that forced

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<sup>88</sup> Allon Kedem, *The End of Securities Class Actions?*, Arnold and Porter, April 21, 2020, <https://bit.ly/3gBbup4>.

<sup>89</sup> Sidley Austin, *Delaware Supreme Court Upholds Federal-Forum Provisions*, March 23, 2020, <https://bit.ly/34D9Kcz>.

<sup>90</sup> James L. Hallowell, Mark H. Mixon, Jr. and Andrew Kuntz, Gibson Dunn, *‘Salzberg’ Opens Door to Creativity in the ‘Outer Band’ of ‘Intra-Corporate Affairs,’* DELAWARE BUSINESS COURT INSIDER, April 8, 2020, <https://bit.ly/3lsdun1>.

arbitration provisions could ultimately be deemed valid under state and federal law alike.

This is not just a remote, theoretical possibility. The issue of whether forced arbitration clauses are permitted under federal securities laws arose recently and the SEC did not use the occasion to lay the issue to rest.

In 2018, Hal Scott, who represents a trust that holds Johnson & Johnson (J&J) shares, submitted a shareholder proposal to J&J that would strip investors of their ability to bring securities claims in court and would instead force all shareholder disputes into arbitration on an individual basis.<sup>91</sup> Johnson & Johnson sought “no action” relief from the SEC to exclude the issue from its proxy ballot, first arguing that implementation of the proposal would cause J&J to violate federal law. The SEC staff has granted relief at least three times in the past, when other companies were faced with similar proposals, on the basis that forced arbitration provisions would violate the federal securities laws.<sup>92</sup>

J&J followed up its initial request with a supplementary letter, arguing that implementation of the proposal would also cause the company to violate state law in New Jersey, where the company was incorporated. The company argued that New Jersey corporations may not lawfully mandate arbitration in their constitutive documents as the forum to resolve claims of shareholders for alleged violations of the federal securities laws. In addition, the company stated its belief that a New Jersey court presented with the question would likely conclude that shareholders who did not approve an arbitration provision in a New Jersey corporation’s bylaws would not have provided the mutual assent required to enforce an arbitration agreement, as determined under customary principles of contract law, such that a mandatory arbitration bylaw would likely be held inconsistent with New Jersey law and, therefore, invalid.

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<sup>91</sup> SEC, Johnson & Johnson; Rule 14a-8 no-action letter (Exhibit A), <https://bit.ly/3lmoKRT>.

<sup>92</sup> Ann Lipton, *Limiting securities claims in the corporate governance documents - no, we're not done with this yet*, Business Prof Law Blog, February 16, 2019, <https://bit.ly/2YFtk3T> (“In the past, the SEC has taken the position that bylaws of this sort would violate federal law, specifically, the anti-waiver provisions of the securities laws, but the Supreme Court’s recent jurisprudence on arbitration has weakened that argument.” (citing *American Express Co, et al., v. Italian Colors Restaurant*, 570 U.S. 228 (2013))).

The New Jersey Attorney General (NJ AG) provided an opinion stating his belief that the adoption of the proposed bylaw would cause J&J to violate applicable state law. In concluding that New Jersey law does not authorize a business corporation's bylaws to provide for mandatory arbitration of federal securities law claims, the NJ AG stated that, in the absence of controlling New Jersey authority, New Jersey courts frequently look for guidance on matters of corporate law to Delaware. At the time the NJ AG opinion was issued, the Chancery Court's decision in *Sciabacucchi* that a bylaw provision affecting federal securities claims was impermissible had been issued, but the Supreme Court had not yet issued its ruling. NJ AG relied on the Chancery Court's decision to come to the conclusion that New Jersey, like Delaware, does not authorize bylaw amendments that dictate the forum for litigation arising under the federal securities laws.<sup>93</sup>

While the SEC staff granted no-action relief to J&J, it took a different approach than it had previously when presented with the same question. Whereas SEC staff previously accepted the argument that forced arbitration provisions violate the federal securities laws, the staff took no position on that question this time around. Instead, it stated that it was "not expressing a view as to whether the Proposal, if implemented, would cause the Company to violate federal law." The letter pointed instead to state law and the NJ AG's opinion as providing the basis for excluding the proposal. It stated, "We view this submission as a legally authoritative statement that we are not in a position to question. In light of the submissions before us, including in particular the opinion of the Attorney General of the State of New Jersey that implementation of the Proposal would cause the Company to violate state law, we will not recommend enforcement action to the Commission if the Company omits the Proposal from its proxy materials in reliance on rule 14a-8(i)(2)." Even there, however, the SEC staff cautioned that, "The staff is not 'approving' or 'disapproving' the substance of the Proposal or opining on the legality of it." Moreover, it suggested that, if the parties did not believe the no-action letter had a valid basis, the "Parties could seek a more definitive determination from a court of competent jurisdiction."

SEC Chairman Jay Clayton issued a statement on the matter, recognizing the NJ AG's opinion as the state's "chief law enforcement officer and legal

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<sup>93</sup> See Jacob Hale Russell, *Mandatory Securities Arbitration's Impermissibility Under State Corporate Law: An Analysis of the Johnson & Johnson Shareholder Proposal* (Rock Ctr. for Corp. Governance, Working Paper Series, Paper No. 237, 2019), <https://bit.ly/3jeCLiG>.

advisor” as providing the basis for allowing J&J to exclude the proposal. Chairman Clayton stressed that that decision was appropriate in light of this “complex matter of state law.”<sup>94</sup> However, in a move that cast doubt on whether the Commission would continue to take the position that such provisions are inconsistent with federal securities laws, Chairman Clayton went on to state that, “The staff of the Division of Corporation Finance explicitly noted that it was not expressing a view as to whether the proposal, if implemented, would cause the company to violate federal law.”

Chairman Clayton added that, “Since 2012, when this issue was last presented to staff in the Division of Corporation Finance in the context of a shareholder proposal, federal case law regarding mandatory arbitration has continued to evolve. ... In light of the unsettled and complex nature of this issue, as well as its importance, I agree with the approach taken by the staff to not address the legality of mandatory shareholder arbitration in the context of federal securities laws in this matter, and would expect our staff to take a similar approach if the issue were to arise again.” Finally, Chairman Clayton emphasized that, “The views expressed in these responses are not binding on the Commission or other parties, and do not and cannot definitively adjudicate the merits of a company’s position with respect to the legality of a shareholder proposal. A court is a more appropriate venue to seek a binding determination of whether a shareholder proposal can be excluded.”

According to Professor Ann Lipton, the staff no-action letter and Chairman Clayton’s statement were both unusual and troubling. Lipton stated, “Such action is quite extraordinary as a matter of SEC procedure, especially the part where Clayton came close to inviting Professor Scott or a similarly-minded proponent to take the issue to court.”<sup>95</sup> And indeed, following the SEC’s no-action letter and Chairman Clayton’s statement, Scott sued J&J in New Jersey federal court. Citing the need to protect shareholders’ interest in the matter and arguing that it “made no sense to leave J&J as the only party tasked with protecting shareholders’ interest in policing J&J’s conduct through class-action litigation against J&J,” two public pension funds that invest on

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<sup>94</sup> Chairman Jay Clayton, *Statement on Shareholder Proposals Seeking to Require Mandatory Arbitration Bylaw Provisions*, U.S. Sec. & Exch. Comm’n (Feb. 11, 2019), <https://bit.ly/3hzVftF>.

<sup>95</sup> Ann Lipton, *Limiting securities claims in the corporate governance documents - no, we’re not done with this yet*, Business Law Prof Blog, February 16, 2019, <https://bit.ly/2YFtk3T>.

behalf of retirement savers and hold significant positions in J&J, CalPERS and Colorado PERA, intervened in the case.<sup>96</sup> That case is still pending.

Even if this particular case is resolved to shareholders' satisfaction, the issue is likely to arise again. The concern is that, if the reasoning that the NJ AG relied on – that the proposal if implemented would violate state law, based on the *Sciabacucchi* Chancery Court decision – no longer applies after the Delaware Supreme Court reversed that decision, such a provision may not be excludable under state law in the future. In other words, that state bulwark against forced arbitration of federal securities law claims appears to be gone. That leaves federal law as potentially the last bastion against forced arbitration of federal securities law claims. Given the refusal of SEC leadership and staff to express a view as to whether a proposed bylaw that forced federal securities claims to be arbitrated on an individual basis, if implemented, would cause the company to violate federal law, it appears that bulwark too is at risk of crumbling.

Reuters' Alison Frankel summed it up this way: "Mandatory shareholder arbitration once seemed unthinkable in the face of staunch opposition from the Securities and Exchange Commission. But it has become a less remote prospect after the Supreme Court's most recent pro-arbitration rulings and softening attitudes at the SEC."<sup>97</sup> According to Frankel, "The Blue Apron forum selection litigation was seen as a critical test of corporate power to restrict shareholders' autonomy over federal securities claims."<sup>98</sup> Unfortunately, the case decided in corporate power's favor, leaving shareholders' available defenses under siege.

As we discussed at length in our white paper on shareholder forced arbitration, *A Settled Matter: Mandatory Shareholder Arbitration is Against the Law and the Public Interest*,<sup>99</sup> there are compelling legal and policy arguments for maintaining the view that provisions in corporate organizational documents that force shareholders to bring federal securities law claims in

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<sup>96</sup> Matthew Jacobs (CalPERS), Adam Franklin (Colorado PERA) and Megan Peitzmeier (Colorado PERA), *Why CalPERS and Colorado PERA Moved to Intervene in the Johnson & Johnson Mandatory Arbitration Case*, Harvard Law School Forum on Corporate Governance, June 4, 2019, <https://bit.ly/32w8PI3>.

<sup>97</sup> Alison Frankel, *Companies ask Delaware Supreme Court to restore forum selection clauses*, Reuters, September 23, 2019, <https://reut.rs/3b44pw3>.

<sup>98</sup> *Id.*

<sup>99</sup> See Roper and Hauptman, *A Settled Matter*.



arbitration would violate the federal securities laws. Briefly, the arguments are:

- ◆ The Federal Arbitration Act (FAA) should not apply to corporate organizational documents. While advocates of forced shareholder arbitration claim that the FAA preempts any state law purporting to restrict the use of arbitration,<sup>100</sup> the FAA generally applies to provisions in contracts between parties who are operating at arms-length, and to disputes arising out of those contracts. While corporate governing documents have been characterized as being viewed as a “contract” between a corporation and its shareholders,<sup>101</sup> critical differences between contracts and corporation organizational documents render that characterization invalid in this context.<sup>102</sup>

As more than two dozen of the top securities and corporate law professors in the country have explained: “[T]he FAA has never been interpreted to require the enforcement of bylaws or similar provisions unilaterally adopted to remove judicial oversight of investor disputes. ... [C]orporate bylaws – particularly in public corporations that form the basis of the nation’s financial markets – are vastly dissimilar to the kind of contractual agreements that have been enforced by courts, including

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<sup>100</sup> Hal Scott argued in his J&J correspondence and subsequent lawsuit that if New Jersey law prohibited his proposed bylaw, the FAA would preempt such a law.

<sup>101</sup> *Salzberg* at 48 (“[C]orporate charters are viewed as contracts among the corporation’s stockholders, as we recently reiterated in *BlackRock Credit Allocation Income Trust v. Saba Capital Master Fund, Ltd.*, 2020 WL 131370 (Del. Jan. 13, 2020) (“Because corporate charters and bylaws are contracts, our rules of contract interpretation apply.”).

<sup>102</sup> See Ann M. Lipton, *Manufactured Consent: The Problem of Arbitration Clauses in Corporate Charters and Bylaws*, 104 GEO. L.J. 583, 601-39 (2016) (arguing that corporate charters and bylaws are fundamentally unlike traditional contracts and therefore should not be subject to the FAA) (“Shareholder power is sharply limited by legal ground rules that vest directors with broad discretion to take action on behalf of the corporation as they see fit. The justification for this power differential is that corporate directors are better positioned to make decisions on behalf of the corporation, and that shareholders are too uninformed, selfish, or heterogeneous to be trusted with the power to determine the corporation’s fate. Such an approach is at odds with the general concept of ‘contract,’ which is predicated on the assumption that each party is capable of bargaining for his or her self interest, and that welfare across parties is maximized when the parties are permitted to bind themselves to arrangements they believe best for themselves. Unlike in contract, within the corporation, shareholders are not treated as autonomous arm’s length bargainers.”); See also Jill E. Fisch, *Governance by Contract: The Implications for Corporate Bylaws*, (California Law Review, forthcoming) <https://bit.ly/3lmpy9n> (arguing that the resulting power imbalance between corporate boards and shareholders offers reasons to question the scope of the contract paradigm).

the Supreme Court, under the FAA.<sup>103</sup> Put simply, the waiver of rights made unilaterally through a corporate charter or other corporate document is fundamentally different than one made as a result of entering into a contract.”<sup>104</sup>

Given these critical differences between contracts and corporate organizational documents, corporate organizational documents should not be considered contracts subject to the FAA.

- ◆ Even if a court were to conclude that a company’s governing documents somehow constituted a contract that falls within the FAA’s reach, the fact remains that the FAA’s mandate has been overridden by a contrary congressional command. The FAA predates the federal securities laws, in which Congress expressly included the right to sue, conferred appropriate jurisdiction onto the courts, and included strong anti-waiver language.<sup>105</sup> The Supreme Court has ruled, moreover, that a provision waiving a shareholder’s right to sue in court would violate the anti-waiver provisions “where arbitration is inadequate to protect the substantive rights at issue.” Unlike mandatory arbitration clauses in investors’ brokerage account contracts, shareholder arbitration does not meet this test, in part because it would not be subject to the same degree of SEC oversight and in part because arbitration does not allow for class actions, and only a small percentage of shareowners could afford to arbitrate such claims individually.<sup>106</sup>
- ◆ More recently, and even more conclusively, both the PSLRA and SLUSA expressly discussed the methods, standards, and procedures for private

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<sup>103</sup> Letter from James D. Cox, et. al, to Mary Jo White, Oct. 30, 2013, <https://bit.ly/2EAKe86> (signed by 29 of the leading securities and corporate law professors in the United States, including Professor James Cox (Duke University School of Law), Professor John Coates (Harvard Law School), Professor John C. coffee, Jr. (Columbia Law School), J. Robert Brown, Jr. (University of Denver), Professor Donald C. Langevoort (Georgetown University Law Center), and Robert Jackson, Jr. (Columbia Law School).

<sup>104</sup> *Id.*

<sup>105</sup> Both the Securities Act of 1933 and the Securities Exchange Act of 1934 include strong “anti-waiver” provisions, which expressly provide that “[a]ny condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision” or related rules or regulations “shall be void.” The Supreme Court has ruled that the Exchange Act’s anti-waiver language is violated if a provision “weakens [investors’] ability to recover under the Exchange Act.” For a variety of reasons detailed in our earlier white paper and summarized below, forced shareholder arbitration does so.

<sup>106</sup> *See supra* note 75, discussing the unique and important features that the U.S. Supreme Court highlighted that distinguish broker-dealer arbitration, which are not present in arbitration against issuers.

legal action. Far from permitting mandatory shareholder arbitration, in both instances Congress clearly expressed its intent that the right to bring class actions should be preserved and that, when litigated, such actions should be litigated in federal court. Congress could, at any time, have taken action to permit mandatory shareholder arbitration, but it has not. Instead, even as it was acting to limit “frivolous” securities class action lawsuits, it reiterated its view that meritorious private lawsuits serve a necessary and positive public purpose.

How a court analyzes these issues will likely determine whether provisions in corporate governing documents forcing shareholders to bring federal securities claims in arbitration on an individual basis are deemed valid under state and federal law. Should such provisions be upheld under state and federal law, it would spell the end of private securities litigation, with devastating effects for investor protection and market integrity.

As we discussed at length in *A Settled Matter*, forced shareholder arbitration would seriously undermine the deterrent effect of private class action lawsuits by:

- ◆ Making it uneconomical to bring meritorious claims. The complex frauds that are often the subject of shareholder class actions are costly to prosecute, involving out-of-pocket expenses for experts and other litigation costs that can easily amount to more than a million dollars. Without the ability for shareholders to participate in class actions, only the largest institutional investors would have claims of sufficient size to support the litigation costs. Smaller investors would be shut out.
- ◆ Reducing settlement amounts. Private class action lawsuits typically settle for significantly larger amounts than the SEC recovers. By eliminating the threat of large private settlements, mandatory shareholder arbitration would also eliminate an important deterrent to fraud and misconduct.
- ◆ Eliminating an important tool for identifying misconduct. Private lawsuits have played an important role in identifying misconduct that might otherwise go undetected by the SEC. Indeed, academic research indicates that private lawsuits more accurately identify and target misconduct than SEC enforcement.
- ◆ Frustrating the development, clarification, and publication of the law. Because of arbitration’s often confidential nature, the absence of any

requirement for arbitrators to follow the law, and the extremely limited opportunity for judicial review, mandatory shareholder arbitration would provide almost none of the public record of facts and precedential value of lawsuits. The publication of legal opinions resulting from litigation in court offers guidance to executives, lawyers, businesses, and transaction planners on how to comply with the federal securities laws and, as a result, helps to deter future misconduct by providing public notice of permissible and impermissible behavior.

For many of these same reasons, mandatory shareholder arbitration would also dramatically reduce defrauded investors' ability to recover their losses. If class actions were no longer available, SEC enforcement actions would constitute the primary means of compensating defrauded investors. And, as noted above, these SEC actions typically result in dramatically less compensation to fraud victims than private class actions.

Smaller investors would be particularly hard hit, as they would rarely if ever have claims of sufficient size to support the costs of litigation. Because larger investors might still be incentivized and able to bring their claims, the system would essentially bifurcate, so that larger investors might recover for frauds while smaller investors would not. Worse, assuming that both large and small investors still owned the defendant companies (as is common), smaller investors who are victims of the same fraud, but unable to recover, could end up bearing the cost of compensating larger investors.

Mandatory shareholder arbitration would have a number of other harmful impacts. It would, for example:

- ◆ Undermine the fair and consistent application of the law, posing risks to investors and issuers alike. Investors could be harmed if meritorious claims are unfairly denied or inadequately compensated. But companies could also face the risk that meritless claims that could not meet PSLRA's heightened pleading standards were nonetheless permitted to move forward in arbitration. At the very least, it would be difficult to ascertain whether the law was being fairly applied, given the opacity of the arbitration process.
- ◆ Deny the SEC the ability to assert its jurisdiction over the development of the law. For decades, the SEC has weighed in with courts as amici to assert its views and interpretations with regard to legal issues that

affect its regulatory and enforcement efforts and important policy formulation. This opportunity would not be available in arbitration, and the opportunity for the SEC to shape the interpretation of the securities laws in this way would be significantly diminished.

- ◆ Undermine U.S. capital markets and our economic competitiveness. Proponents of mandatory arbitration have argued that, while U.S. markets may attract investors, the threat of litigation drives away foreign listings. The opposite is true. As Ernst and Young reported in 2017, “Attracted to the stability and liquidity of US capital markets, foreign companies today overwhelmingly choose the US when they list outside of their home markets.”<sup>107</sup> This can be attributed to the lower cost of capital and higher valuations that companies enjoy as a direct result of the U.S. market’s high level of public and private enforcement.

In short, the repercussions for investor protection and market integrity would be severe if Blue Apron were interpreted to permit corporations to adopt forced shareholder arbitration provisions through their bylaws without shareholder consent.



### **Could the decision enable corporations to include fee-shifting provisions for federal securities law claims?**

The Blue Apron decision raises the possibility that corporate boards could unilaterally adopt fee-shifting (or “loser pays”) provisions in their bylaws requiring shareholders to shoulder the corporation’s litigation expenses for federal securities law claims. Often promoted as limiting frivolous litigation, such fee-shifting provisions would create an overwhelming disincentive to bring even meritorious claims, seriously undermining shareholders’ ability to hold corporations and their executives accountable for corporate malfeasance.

As a general rule in the United States, parties pay their own attorneys’ fees, but they can agree by contract to obligate the losing party to pay the winning party’s fees. These types of clauses can take various forms, from simple loser pays versions to more extreme versions requiring the plaintiff to pay unless they “substantially achieve, in substance and amount, the full

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<sup>107</sup> Ernst and Young, *Looking behind the declining number of public companies: An analysis of trends in US capital markets*, May 2017, <https://bit.ly/3b9ub1V>.

remedy sought.”<sup>108</sup> In 2015, the Delaware Supreme Court in *ATP* upheld the use of a fee-shifting bylaw provision that a non-stock corporation’s board unilaterally adopted.<sup>109</sup> In response to widespread concern regarding the possibility that boards of stock corporations might unilaterally adopt such provisions with regard to investor suits, the Delaware General Assembly passed amendments to the DGCL effectively reversing the *ATP* ruling with regard to stock corporations. The amendments state that corporate charters or bylaws may not contain fee-shifting provisions in connection with internal corporate claims, as defined in Section 115.<sup>110</sup>

Based on the Court’s analysis in *Blue Apron*, however, it appears that corporations could adopt fee-shifting provisions in their charters or bylaws for federal securities law claims.<sup>111</sup> As discussed above, because federal securities law claims are not internal corporate claims as defined by Section 115, Section 115 would not apply.<sup>112</sup> Instead, the validity of a fee-shifting charter or bylaw provision affecting federal securities law claims would be determined based on DGCL Sections 102(b)(1) and 109(b). Again, as discussed above, based on the decision’s broad reading of those provisions, it appears likely those provisions of law would allow such provisions.

Further supporting this reading, the decision makes the argument that fee-shifting bylaws could cover claims that are not considered “internal corporate claims.” The decision states, “The language in Section 102(f) implies

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<sup>108</sup> See *ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554 (Del. 2014).

<sup>109</sup> *Id.*

<sup>110</sup> 8 Del. C. § 102(f). The certificate of incorporation may not contain any provision that would impose liability on a stockholder for the attorneys’ fees or expenses of the corporation or any other party in connection with an internal corporate claim, as defined in § 115 of this title.

§ 109(b) The bylaws may not contain any provision that would impose liability on a stockholder for the attorneys’ fees or expenses of the corporation or any other party in connection with an internal corporate claim, as defined in § 115 of this title.

<sup>111</sup> See Ann Lipton, *So the Salzberg v. Sciabacucchi Decision is In!*, Business Law Prof Blog, March 21, 2020, <https://bit.ly/34AB9Md> (“I note that since the decision permits charters to govern securities claims, there is now apparently no barrier to inserting a loser-pays provision in corporate constitutive documents for federal securities claims. After all, the DGCL only bars loser-pays for internal claims.”). See also Stephen M. Bainbridge, *Delaware Supreme Court Validates Forum Selection Articles Sending Cases to Federal Court*, Washington Legal Foundation, March 25, 2020, <https://bit.ly/2YGGVYT> (“[T]he Court’s diagram itself suggests that there are a range of shareholder claims as to which § 115 would not ban fee shifting bylaws.”).

<sup>112</sup> *Salzberg* at 23. (“Read holistically, Section 115 indicates a concern for centering particular claims— ‘internal corporate claims’—in Delaware. This makes sense given Delaware’s interest and expertise in corporate law. As Section 11 claims are not ‘internal corporate claims,’ Section 115 does not apply.”).

that Section 102(b)(1) can address claims other than ‘internal corporate claims.’ Otherwise, the reference to ‘internal corporate claims’ in new Section 102(f) would not have been necessary.” Given that federal securities law claims are not internal corporate claims and can be the subject of a charter and likely a bylaw provision, “there is now apparently no barrier to inserting a loser-pays provision in corporate constitutive documents for federal securities claims,” according to Professor Lipton.

If fee-shifting provisions for federal securities law claims are permitted under Delaware state law, that could have the effect of insulating companies from being held accountable for violating the federal securities laws. For example, a company could make a material misstatement or omission in its registration statement, or defraud investors into buying its securities. Knowing that in all likelihood a plaintiff shareholder will be footing the ultimate bill for their attorneys’ fees, a defendant company has an incentive to engage in a war of attrition, dragging the case on interminably and racking up exorbitant legal fees. With the threat of having to pay those astronomical fees, no reasonable shareholder is likely to bring suit, no matter how meritorious his or her claim. Depending on how the fee-shifting provision is drafted, it could ensure that, even if plaintiffs are awarded damages, they could end up having to pay the corporation’s legal fees – fees that could be many times greater than the amount of the plaintiff’s award – if the damage award is “substantially” less than the amount they sought.

Professor Lipton has discussed how the economics of this proposition decrease the likelihood that shareholder suits will be brought. According to Lipton, “Most stockholder litigation is representative; therefore, the nominal plaintiff expects to personally recover only a small fraction of the benefit obtained on behalf of the class. If the plaintiff is responsible for the full amount of the defendant’s costs, the risks may be too great to make litigation economical, particularly if – as the *ATP* bylaw was drafted – plaintiffs must pay defendants’ fees even when they are partially successful. Fee-shifting also creates perverse incentives: the more meritorious the claim, the longer the litigation continues, and the higher the plaintiff’s potential costs. Thus, fee-shifting is likely to deter the strongest cases.”<sup>113</sup>

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<sup>113</sup> Ann M. Lipton, *Limiting Litigation Through Corporate Governance Documents*, Research Handbook on Representative Shareholder Litigation (Sean Griffith, et al., eds. 2018) (citing John Coffee, *Fee-Shifting Bylaw and Charter Provisions: Can They Apply in Federal Court? – The Case for*

In short, the use of provisions in corporate organizational documents requiring fee-shifting for federal securities law claims would erect virtually insurmountable barriers that immunize companies and their management from having to answer to their shareholders for their conduct, no matter how egregious it may be. As such, it could effectively nullify private enforcement of the federal securities laws, weakening investor protections and undermining the integrity of our nation’s capital markets.

Offering some reassurance on this point, Columbia Law School Professor John Coffee has argued that the federal securities laws would preempt fee-shifting clauses for federal securities law claims. Coffee reasoned that, “PSLRA is a comprehensive statute that regulates the smallest details of securities class actions, including how attorneys’ fees are to be calculated and specifying when they should be at least presumptively shifted.” This, according to Coffee, suggests that, “Congress has so dominated the field that it has left little or no room for state action.” Coffee continued: “Congress could hardly have contemplated when it passed the PSLRA in 2005 that states would attempt to regulate fee-shifting in federal court actions. Nor would Congress have wanted the states to adopt rules that could trump the hard-and-fast rules standards it was adopting.”<sup>114</sup> But Coffee acknowledges that, “Strong as these arguments may be, relatively few cases have dealt with the preemption of procedural rules.” As a result, the outcome is uncertain.



### **Could the decision create a path for corporations to force internal corporate claims into arbitration?**

According to Professor Manesh, Section 115 of the DGCL “ensures that Delaware state courts—the crown jewel of the state’s corporate law—remain the central regulatory authority for the nation’s corporations, and that those courts continue to produce new precedents to address emergent and novel issues relevant to corporations.” Furthermore, as discussed above, the Blue Apron decision includes a footnote suggesting that arbitration of internal affairs claims would be impermissible under Section 115. According to the

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*Preemption*, Testimony Before the SEC Advisory Committee, (2014), available at <https://bit.ly/34G6gpM>.

<sup>114</sup> John C. Coffee, Jr., *Federal Pre-Emption and Fee-Shifting*, The CLS Blue Sky Blog, January 26, 2015, <https://bit.ly/3b43fRc> (also discussing how the PSLRA sets forth at least two important federal policies that are frustrated by a “loser pays” rule.).



footnote, “Such [arbitration] provisions, at least from our state law perspective, would violate Section 115 which provides that, ‘no provision of the certificate of incorporation or the bylaws may prohibit bringing such claims in the courts of this state.’”<sup>115</sup>

Despite these reassurances, the decision appears to create a potential path for corporations to force internal corporate claims, in addition to federal securities law claims, to be arbitrated. If corporate governing documents are deemed contracts subject to the FAA, then advocates for arbitration will likely argue that the FAA preempts Section 115 of the DGCL.<sup>116</sup> Specifically, they are likely to argue that the FAA preempts state-based restrictions on parties’ contractual ability to arbitrate and, because Section 115 requires internal corporate claims to be brought in Delaware, that type of restriction against arbitration is preempted by the Federal Arbitration Act and therefore invalid. If a court determines that the FAA preempts Section 115, that could effectively eliminate all internal corporate claims, rendering the Chancery Court a relic. Thus, the conclusion that provisions in corporate governing documents are contracts could ultimately pose an existential threat to Delaware sovereignty.

That is essentially the argument that Hal Scott made regarding federal securities law claims both in his correspondence with the SEC regarding his proposed bylaw amendment to require all such claims against J&J to be forced into arbitration and in his subsequent lawsuit. Specifically, Scott argued that a “basic principle of corporate law [is] that bylaws are contracts between a

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<sup>115</sup> *Salzberg* at 53, note 169.

<sup>116</sup> See Ann M. Lipton, *Manufactured Consent: The Problem of Arbitration Clauses in Corporate Charters and Bylaws*, 104 *Geo. L.J.* 583, 588 (2016) (“The FAA, however, preempts any state law or policy that would interfere with the enforcement of contractual arbitration clauses. Thus, if corporate governance arrangements are deemed ‘contractual’ for FAA purposes and corporate directors can funnel claims into arbitration by amending corporate bylaws without shareholder input, it could represent an existential threat to an entire substantive field of law, and states—particularly Delaware, which dominates in this area—would be powerless to do anything about it. For example, Delaware recently amended its General Corporation Law to ban the use of exclusive arbitration provisions in corporate charters and bylaws—but if the FAA applies, that legislation is likely preempted.”). See also Mohsen Manesh, *Regulating Federal Securities Law Claims In Corporate Charters: The Dilemma Confronting Delaware*, *The FinReg Blog*, October 14, 2019, <https://bit.ly/2YCoGDJ> (“The problem for Delaware is that if the FAA compels enforcement of arbitration provisions covering federal securities law claims, then Delaware’s statutory ban against mandatory arbitration provisions governing state corporate law claims—codified in DGCL 115—is almost certainly preempted by the FAA.”).

corporation and its shareholders.” Scott further argued that a bylaw provision requiring disputes to be arbitrated are valid contracts. Moreover, Scott argued that any state-based restriction against arbitration should be preempted by the FAA and therefore be deemed invalid. While Scott’s argument related to federal securities law claims – which the Delaware Supreme Court has characterized as intra-corporate – there is no reason the argument, if accepted, wouldn’t apply equally to internal corporate claims.<sup>117</sup>

Professor Lipton finds Scott’s argument “quite unpersuasive, since the FAA only prohibits laws that disparately target arbitration; a rule that restricts charters and bylaws to matters of internal affairs does not single out arbitration, as the *Sciabacucchi* case itself demonstrates.”<sup>118</sup> But if forced arbitration advocates are successful with regard to forcing federal securities law claims into arbitration, it’s unlikely that they will stop there. Their “next move” could be to try to force all claims, including internal corporate claims, into arbitration.<sup>119</sup> Given the courts’ recent record favoring arbitration, there is at least a possibility that their efforts could meet with success.

If arbitration advocates are successful with regard to preempting Section 115, such a result would harm investors and market integrity. It would effectively immunize corporate directors from being held liable for breaching their fiduciary duties. Specifically, they could engage in gross negligence or even reckless or intentional misconduct, violating their duty of care, or engage in self-dealing transactions, violating their duty of loyalty, without any meaningful ability for shareholders to hold them accountable. According to Lipton, “Thus, not only will *Salzberg’s* chain reaction put an end to securities law private enforcement, it will do so for corporate law enforcement as well.” Even more concerning, for internal affairs claims, “there is nothing equivalent to the SEC; in many cases, private enforcement is the

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<sup>117</sup> See Ann Lipton, *So the Salzberg v. Sciabacucchi Decision is In!*, Business Law Prof Blog, March 21, 2020, <https://bit.ly/34AB9Md> (“Scott’s lawsuit, for example, argues that the FAA renders arbitration bylaws valid, regardless of any New Jersey law to the contrary. Again, his lawsuit only deals with a bylaw mandating arbitration of federal claims, but there is no reason the logic would not extend to bylaws purporting to mandate arbitration of internal affairs claims.”).

<sup>118</sup> Ann Lipton, *Limiting securities claims in the corporate governance documents - no, we’re not done with this yet*, Business Prof Law Blog, February 16, 2019, <https://bit.ly/2YFtk3T>.

<sup>119</sup> See Lipton, *So the Salzberg v. Sciabacucchi Decision is In!*, (“A certiorari will then be sought from the U.S. Supreme Court, which might well grant it. The decision in the internal affairs arbitration case will echo the ‘contract’ language from the Johnson & Johnson case. This will be in line with Concepcion, etc., striking down state laws ‘preempted’ by the Federal Arbitration Act.”).

only thing separating fiduciaries from standing above the law,” according to Lipton.<sup>120</sup>

The prospects for investor protection and market integrity from this potential outcome are grim. As Lipton stated, “The fact that shareholder litigation, although imperfect, is an inherent part of law enforcement – as evidenced by countless successful cases (take *Americas Mining*, 51 A.3d 1213 (Del. 2012), for one prominent example) – will be cast aside. Disloyal fiduciaries, such as those in *Americas Mining*, will be able to take \$2 billion of other peoples’ money into their own pockets, with no sanction or remedy whatsoever.”<sup>121</sup>

Such a result would also harm Delaware, effectively rendering the state irrelevant with regard to corporate law. According to Mohsen, “The widespread use of arbitration to resolve state corporate law disputes would strip Delaware courts of their regulatory authority and, thus, retard the development of the state’s corporate law.”<sup>122</sup> For this reason, according to Lipton, the preemption of DGCL 115 and the widespread use of arbitration “could represent an existential threat to an entire substantive field of law, and states—particularly Delaware, which dominates in this area—would be powerless to do anything about it.” And while Lipton finds Scott’s arbitration argument unpersuasive, as discussed above, she doesn’t rule out the possibility that it could prevail. “In other words, this decision hands corporations the keys to challenging the viability of DGCL 115, and in that respect, I have a sinking fear that it signs Delaware’s death warrant,” she stated.<sup>123</sup>



### **Does the decision intrude on other states’ ability to protect their citizens and raise other federalism concerns?**

One thing that all commentators seem to agree on about the Blue Apron decision is that it raises profound uncertainty about whether other state courts will follow the decision. The Delaware Supreme Court acknowledged this risk, stating that “the most difficult aspect of this dispute is not with the

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<sup>120</sup> *Id.*

<sup>121</sup> *Id.*

<sup>122</sup> See Manesh, *Regulating Federal Securities Law Claims In Corporate Charters: The Dilemma Confronting Delaware*.

<sup>123</sup> See Lipton, *So the Salzberg v. Sciabacucchi Decision is In!*

facial validity of [federal forum provisions], but rather, with the ‘down the road’ question of whether they will be respected and enforced by our sister states.” The court recognized that an investor might file suit in state court outside of Delaware, alleging ’33 Act violations, and the other state “would not necessarily follow Delaware’s lead in enforcing the federal-forum provision.” While at least one state court in California has enforced a federal forum provision in accordance with the Blue Apron decision, the question is far from resolved.

Professor Manesh, who has written on the potential reach and interaction between this decision and other state corporate laws,<sup>124</sup> suggested the Blue Apron decision was a power grab by Delaware. “[F]rom a cynical perspective, the newly announced ‘outer band’ between internal affairs and external matters sure looks like an attempt by Delaware to stave [off] horizontal regulatory competition,” Manesh commented in a tweet following the decision.<sup>125</sup> Whereas Delaware’s role was historically confined to regulating the internal affairs of corporations, the decision appeared to be expanding that role to regulating a much broader swath of conduct, Manesh suggested. “According to the Delaware Supreme Court, Delaware gets to regulate securities law disputes, even though such disputes are not subject to the internal affairs doctrine.”<sup>126</sup> Duke University Law School Professor James D. Cox believes that Delaware has altered not only the power dynamic between states, but also the federal-state power dynamic. “Heretofore, Delaware’s fear was the regulation of public companies would be federal not state based; now, in *Salzberg*’s long shadow, it is federalism that is at risk of becoming irrelevant,” Cox states in a working paper on the decision.<sup>127</sup>

If other state courts view the Blue Apron decision as allowing Delaware to veer outside its lane – creating a mechanism for Delaware to both intrude on other states’ ability to protect their citizens and negate federal law – it won’t be viewed favorably by those other state courts. That was demonstrated earlier this month when a California Superior Court judge dismissed a case

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<sup>124</sup> Manesh, *The Contest Edges of Internal Affairs*.

<sup>125</sup> Mohsen Manesh (@MohsenManesh), TWITTER, March 20, 2020, <https://bit.ly/3gCcedv>.

<sup>126</sup> *Id.* at <https://bit.ly/31xqxeX>.

<sup>127</sup> James D. Cox Working Paper

challenging a federal forum provision adopted by a Delaware corporation, in a decision that nonetheless sharply criticized the Blue Apron decision.<sup>128</sup>

In this case, *Wong v. Restoration Robotics, Inc.*, the Court had previously denied the motion to dismiss, citing the Chancery Court decision in *Sciabacucchi*. Although the ruling granting the motion to dismiss criticizes the Delaware Supreme Court decision for “jumb[ing] together different cases on different topics, subject to different tests” in reaching its conclusion that federal forum provisions are consistent with federal law, it found that the exclusive federal forum provision is not illegal under California law and does not violate any California state or public policy. Specifically, the Court found the federal forum provision to be procedurally unconscionable – “Indeed, glaringly so” – but not substantively unconscionable.<sup>129</sup> The Court included one notable caveat, finding that the federal forum provision is not substantively unconscionable “*unless shown to be unconstitutional or illegal under federal law.*”<sup>130</sup>

That question is front and center in separate California state court litigation arising from Dropbox, Inc.’s 2018 IPO.<sup>131</sup> In that case, the plaintiff shareholders are arguing that federal forum provisions – or “Grundfest Clauses,” as they call them – are unconstitutional for several reasons. First, according to the plaintiffs, federal forum provisions violate the Commerce Clause of the U.S. Constitution, because a Delaware statute cannot regulate whether a California court may exercise jurisdiction expressly given to it by Congress over a claim arising under federal law. According to the plaintiffs, “What could be more ‘offen[sive to] sister [s]tates’ than applying Delaware law to divest other states’ courts of jurisdiction over 1933 Act claims expressly protected by Congress.”<sup>132</sup>

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<sup>128</sup> *Wong v. Restoration Robotics, Inc.*, Cal. Super. Ct. Case No. 18-CIV-02609 (Sept. 1, 2020). See, National Law Review, California Court Rules Federal Forum Bylaw Provision.

<sup>129</sup> *Wong v. Restoration Robotics, Inc.* (“Procedural unconscionability looks at whether it is an adhesion contract, imposed and drafted by the party with superior bargaining power on take-it-or-leave-it basis, and whether there are elements of oppression or surprise. ... Substantive unconscionability looks at the fairness of the terms, and that they are not overly harsh, unduly oppressive or unfairly one-sided, or so one-sided as to shock the conscience.”)

<sup>130</sup> *Id.*, emphasis added.

<sup>131</sup> *In re: Dropbox, Inc. Securities Litigation*, Lead Case No. 19-CIV-05089 (Consolidated with Nos. 19-CIV-05217, 19-CIV-05417 and 19-CIV-05865).

<sup>132</sup> *Id.* Plaintiffs’ Opposition to Defendants’ Motion to Dismiss for Forum Non Conveniens Citing (*Edgar*, 457 U.S. at 643), 15 U.S.C. §77v(a); *Cyan, Inc. v. Beaver Cty. Emps. Ret. Fund*, \_\_ U.S. \_\_, 138 S. Ct. 1061, 1066 (2018).

Next, the plaintiff shareholders are arguing that federal forum provisions violate the Supremacy Clause of the U.S. Constitution for at least two reasons. First, they argue that if these clauses were enforced, it would negate the congressional determination to provide concurrent federal and state court jurisdiction over '33 Act claims and to bar removal from state to federal court of such claims. Allowing corporations to evade this determination would constitute a “dramatic change ... in the 1933 Act’s jurisdictional framework” and be inconsistent with the *Cyan* decision, the plaintiffs argue.<sup>133</sup> Second, they argue that Delaware is discriminating against federal law as it applies differentially to federal and state causes of action. Specifically, they argue that the Blue Apron decision inappropriately creates a regime in which Delaware law permits a corporate charter to eliminate state court jurisdiction over federal law claims, but not over parallel state-law claims. That discrimination violates the Supremacy Clause, the plaintiffs argue.

Moreover, the plaintiffs argue that charter or bylaw provisions do not constitute contracts. “[I]n all of its decisions involving forum selection clauses, the United States Supreme Court has only found classic bilateral contracts give rise to forum selection,” they argue. This is important, according to the plaintiffs, because whether or not bylaws or charters constitute a valid

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<sup>133</sup> *Id.* (citing *Cyan* at 1065. Plaintiffs also cite to a forthcoming ruling as holding that federal forum provisions are “directly contrary to the explicit provisions of the 1933 Act, providing state court and federal court jurisdiction, which concurrent jurisdiction was affirmed in a unanimous decision of the United States Supreme Court in *Cyan*.” *Wong v. Restoration Robotics, Inc., et al.*, No. 18CIV02609 (Cal. Super Ct. San Mateo Cty. 2019). Professor Cox also argues that the federal securities laws should preempt Delaware law. In his working paper, he states, “There are many patterns by which state law is examined to determine if it is preempted by the Constitution’s Supremacy Clause. The most directly implicated basis for such preemption is so called “obstacle” preemption whereby the state law is an obstacle to the “full purpose and objectives” Congress sought to carry out with the federal legislation.” According to Cox, “Delaware’s authorization of federal forum provisions does not, however, appear [to require] any speculation whatever regarding congressional intent; the federal act explicitly provides suits can be maintained in federal or state court and the effect of the federal forum provision is to eliminate suits being filed in state court.” Cox expressed surprise that the Delaware Supreme Court did not tackle this thorny issue, stating, “The Delaware Supreme Court did not finesse obstacle preemption; it ignored it. How the court could reach the result it reached without openly addressing possible, or more likely, highly probable, obstacle preemption, is a matter for speculation. But viewed within a constellation of Delaware cases the outcome reached in *Salzberg* can be seen as part of a chain of constitutionally laden decisions where the court’s approach can best be understood as a consequence of political necessity and not fidelity to logic, to the law, and more importantly, to the Constitution.” James D. Cox Working Paper (on file with authors).

contract under California law “turns on whether the elements of a contract are present.”<sup>134</sup> Because none of the essential elements of a contract are present, bylaws or charters do not constitute contracts, they argue. Accordingly, they argue, the federal forum provision at issue is unenforceable under California law.

A decision in the *Dropbox* case has not yet been issued. Regardless of the ruling, it is unlikely that a lower court decision will resolve these issues. Notably, one of the nation’s most experienced U.S. Supreme Court practitioners, Thomas C. Goldstein, is co-counsel for the plaintiffs in this case, which may be an indication that the case is expected to be litigated all the way up to the Supreme Court.



## **Where Do We Go From Here?**

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As discussed above, the possible effects of the Blue Apron decision are potentially far-reaching and very troubling. Without appropriate intervention, they may play out in ways that are devastating for investor protection and market integrity. We therefore believe intervention is warranted. But what form should that intervention take? Two main options appear to be available.

If it determines it to be appropriate, the Delaware General Assembly could step in. The Blue Apron decision specifically addressed the possibility, stating: “If our General Assembly wishes to narrow the scope of Section 102(b)(1) to be aligned perfectly with the boundaries of the internal affairs doctrine, it could do so.” Such a response would bring Delaware back into its lane of only regulating matters that are purely within the internal affairs of a corporation. The effect of such a legislative change would be to prohibit the use of any provision in a corporation’s governing documents that regulates matters that are not based on Delaware law. This should render invalid any provision in a corporation’s governing documents that seeks to regulate the federal securities laws.

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<sup>134</sup> *Id.* (citing *O’Byrne v. Santa Monica-UCLA Med. Ctr.*, 94 Cal. App. 4th 797, 808 (2001) (citing *Scott v. Lee*, 208 Cal. App. 2d 12, 15 (1962))).

An alternative, and perhaps cleaner approach, would be to make that change directly, by enacting legislation specifying that Delaware corporations cannot adopt provisions regulating federal securities law claims through their charters or bylaws. Delaware could take the added step of clarifying that corporate governing documents are not contracts under state contract law. This would protect against the risk that the FAA would be deemed to preempt Section 115 of the DGCL. These suggested fixes would have the added benefit of settling uncertainty about what Delaware's sister states might do in response to the decision and allaying other federalism concerns.

Additionally, Congress could pass the Forced Arbitration Injustice Repeal Act (FAIR Act), which would prohibit pre-dispute arbitration agreements that force arbitration of future consumer disputes and prohibit agreements and practices that interfere with the right of individuals to participate in class actions related to consumer disputes.<sup>135</sup> While this legislation would protect against the risk that corporations might try to force shareholders into arbitration on an individual basis, it would not stop corporations from the specific issue that was considered in Blue Apron forcing '33 Act claims into federal instead of state court. Nor would it stop corporations from adopting fee-shifting bylaws for federal securities claims. For these reasons, Delaware action limiting the reach of the Blue Apron decision may be necessary regardless of whether Congress acts to adopt the FAIR Act.

## Conclusion

While not especially groundbreaking by its own terms, the Blue Apron decision has potentially far-reaching and troubling implications. Based on their past actions and current statements, we fully expect that companies will try to use the decision to push the limits and see just how far they can go in binding current and future shareholders. If the most severe potential fallout from the decision becomes reality, investors' ability to monitor corporate management going forward will be meaningfully neutered. The result would be to effectively insulate corporate America and management from being held accountable for wrongdoing, to the detriment of shareholders and market integrity and, ultimately, the health of the economy.

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<sup>135</sup> H.R. 1423 (116th Congress).