Law profs, ex-SEC chair protest CommonWealth arbitration bylaw

Reuters
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Remember the fight over a mandatory shareholder arbitration bylaw adopted by the board of CommonWealth, an embattled $8 billion real estate investment trust? As I told you last month, when a couple of activist hedge funds sued in Maryland state court to invalidate the 2009 bylaw as part of their hostile takeover bid for the REIT, Baltimore Circuit Court Judge **Audrey Carrion** ruled that CommonWealth's mandatory shareholder arbitration clause is enforceable. The hedge funds, which had acquired their shares after the bylaw was enacted, subsequently dropped the suit and agreed to arbitrate their claims that CommonWealth's board had breached its fiduciary duty. But in the meantime, shareholders whose ownership predated enactment of the mandatory arbitration bylaw picked up the fight to invalidate the provision.

On Monday, after Judge Carrion granted their emergency motion to stay arbitration, lawyers for the Central Laborers' Pension Fund and two individual CommonWealth shareholders filed their opposition to CommonWealth's motion to compel arbitration. The brief – submitted by **Bernstein Litowitz Berger & Grossmann, Saxena White, Berger & Montague**, and **Tydings & Rosenberg** - repeats many of the arguments shareholders made in their emergency stay papers, citing a 2011 San Francisco federal court decision in Galaviz v. Berg that denied Oracle's motion to dismiss a shareholder derivative suit because the company's forum selection bylaw was imposed without the consent of shareholders who purchased stock before its enactment. Even though two of the plaintiffs in the CommonWealth derivative suit purchased additional shares after the 2009 mandatory arbitration bylaw took effect, the brief said, the third plaintiff did not. And in any event, according to the brief, shareholders never received adequate notice of a bylaw that impermissibly extinguishes their property rights and violates federal securities laws.

Shareholders have amassed some impressive support for their argument that, as a matter of policy, CommonWealth's mandatory arbitration bylaw must be ruled invalid. A group of 11 securities law professors, including **Bernard Black** of Northwestern, **John Coates** of Harvard and **James Cox** of Duke (the first three signatories), assert in a joint affidavit that mandatory arbitration of shareholder disputes would undermine U.S. capital markets. "Absent the transparency and visibility provided by legal proceedings in an open courtroom, and the possibility of a rebuke by a judge, fiduciaries would be much less deterred from violating their duties to shareholders," the joint filing said. "Thus, it is critically important that public shareholders be permitted to vindicate their rights in court." In particular, the law professors took issue with a provision in the CommonWealth bylaw that bars the award of fees to plaintiffs' lawyers, even if they prevail in the arbitration. That clause, the professors said, makes it too expensive for shareholders to bring breach-of-duty claims, thus insulating the board from accountability.

Harvard Law professor **Jesse Fried** filed a separate affidavit because the other law professors distinguished the rights of shareholders who bought CommonWealth stock prior to the bylaw's

enactment from those who acquired shares with knowledge of the mandatory arbitration provision. Fried said the REIT's bylaw was "so pernicious" that, as a matter of corporate governance policy, it should be held invalid even with regard to large and sophisticated shareholders like activist hedge funds.

Finally, former Securities and Exchange Commission chairman **Harvey Pitt** submitted an affidavit discussing the SEC's dim view of mandatory arbitration provisions barring shareholders from litigating claims. (The shareholders' brief pointed out that CommonWealth had to remove such a provision to satisfy the SEC when it registered an initial public offering of a REIT spin-off in 2012.) "The U.S. Securities and Exchange Commission has, as a matter of policy, refused to allow public companies unilaterally to divest shareholders of their ability to enforce state or federal rights," Pitt's affidavit said. "In this matter, CommonWealth provided no notice to any shareholder that it was about to adopt the arbitration bylaw, and most assuredly did not seek shareholder approval before doing so…. If the court were to enforce the arbitration bylaw against all CommonWealth shareholders, some shareholders would be deprived of rights upon with they relied (or upon which they should be deemed to have relied) when they purchased their CommonWealth securities, without even the semblance of notice and a right to be heard. Equally troublesome, if the arbitration bylaw is enforced against all CommonWealth shareholders, important fiduciary obligations of corporate insiders would effectively be negated or diminished."

According to the shareholders' experts, the SEC has never permitted the IPO of a company that required shareholders to resolve disputes with fiduciaries through arbitration rather than in court. The shareholders' brief said, indeed, that CommonWealth and other entities controlled by its founders are the only public companies in the United States with director-adopted mandatory arbitration bylaws. But you can be sure that if CommonWealth's provision is upheld, other corporations will attempt the same gambit.

A representative for CommonWealth told me that the plaintiffs' expert affidavits don't change the essential nature of the case – which the company describes as an attempt by plaintiffs' lawyers to protect their preferred forum – or the validity of the REIT's arbitration clause, which has already been determined by Judge Carrion in the hedge fund case. Distinguishing between classes of shareholders would be "unwieldy," the spokesperson said, particularly because the plaintiffs in the derivative suit held on to their shares after the arbitration bylaw was adopted.

CommonWealth, which is represented by **Skadden, Arps, Slate, Meagher & Flom**, also disputes the experts' policy arguments against mandatory shareholder arbitration. "Trustees will do what's right because they're men and women of honor, not because they have fear of being shamed or embarrassed in a public forum," the representative said, adding that the SEC's resistance to shareholder arbitration provisions is not relevant to state-law claims. And as for fees to plaintiffs' lawyers, CommonWealth said that's a matter for arbitrators to decide.

These are all really important corporate governance questions and the answers delivered in the CommonWealth case could have broad implications. Keep your eye on what happens in this litigation.