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# Securities Law Alert

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## Tenth Circuit: Rejects Motion to Compel Arbitration of ESOP Claims, Holding That the Effective Vindication Exception Applies

On February 9, 2023, the Tenth Circuit affirmed a district court's denial of a motion to compel arbitration in a lawsuit brought by an ESOP (Employee Stock Ownership Plan) participant, alleging that the plan fiduciaries breached their fiduciary duties to the plan under ERISA. [*Harrison v. Envision Mgmt. Holding*, 59 F.4th 1090 (10th Cir. 2023) (Briscoe, J.)]. The Tenth Circuit held that enforcing the arbitration provisions in the plan document would prevent plaintiff from vindicating the statutory causes of action listed in his complaint, and concluded "that the effective vindication exception applies in this case."

### Background

Plaintiff filed a lawsuit in the district court, alleging that the plan fiduciaries engaged in a prohibited transaction in which the company's founders retained control of the company while selling their shares of the company to the ESOP for more than they were worth, causing the ESOP to incur substantial debt. Defendants moved to compel arbitration based on Section 21 of the plan document entitled ERISA Arbitration and Class Action Waiver. After the district court denied defendants' motion to compel arbitration based on the effective vindication exception, defendants appealed.

### The Court Sets Out the Effective Vindication Exception Standard

On appeal, the Tenth Circuit held that the district court properly invoked the effective vindication exception to invalidate the arbitration provision, explaining that the exception "finds its origin in the desire to prevent prospective waiver of a party's right to pursue statutory remedies" (quoting *Am. Express v. Italian Colors Restaurant*, 570 U.S. 228 (2013)). The court stated that under *American Express*, the "key question is whether 'the prospective litigant effectively may vindicate its statutory cause of action in the arbitral forum.'" The court explained that, to determine whether the effective vindication exception applies, it "must first identify the statutory remedies [plaintiff] is seeking" and "then determine whether the arbitration provisions contained in the Plan Document effectively prevent [plaintiff] from obtaining those statutory remedies in the arbitral forum."

### The Statutory Remedies Plaintiff Sought

The court noted that the statutory remedies plaintiff sought were under ERISA subsections 502(a)(2) and (a)(3),[1] and included a declaration that defendants breached their fiduciary duties under ERISA; an injunction of further fiduciary duty violations; the appointment of a new fiduciary to manage the ESOP; removal of the ESOP trustee; and an order directing the ESOP trustee to restore all losses to the plan that resulted from the fiduciary breaches and to disgorge all profits made through use of the ESOP's assets.

### The Arbitration Provisions Would Prevent Vindication of the Statutory Remedies

As to whether the arbitration provisions effectively prevented plaintiff from vindicating the statutory remedies, the court focused on the language in the plan document stating that "each arbitration shall be limited solely to one Claimant's Covered Claims, *and that Claimant may not seek or receive any remedy which has the purpose or effect of providing additional benefits or monetary or other relief to any Eligible employee, Participant or Beneficiary other than the Claimant*." (emphasis in original). The court found that the "this sentence would clearly prevent [plaintiff] from obtaining at least some of the forms of relief that he seeks in his complaint pursuant to [Section 502(a)(2)]," including, among other things, a declaration that all defendants breached their fiduciary duties under ERISA, an order removing the trustee, and an order enjoining all defendants from further violations. The court explained that these forms of relief would provide additional benefits to the plan as a whole or to all of the plan participants and beneficiaries and would thus be barred by the arbitration provisions. The court concluded that "Section 21(b) is not problematic because it requires [plaintiff] to arbitrate his claims, but rather because it purports to foreclose a number of remedies that were specifically authorized by Congress in the ERISA provisions cited by [plaintiff]."

## Southern District of New York: Denies Dismissal of Claims Alleging That NFTs Were Securities Under *Howey*

On February 22, 2023, in a decision of first impression, the Southern District of New York denied dismissal of a putative class action alleging that a company violated the Securities Act by offering for sale to the public NFTs (non-fungible tokens) without filing a registration statement with the SEC, in violation of Sections 5 and 12(a)(1) of the Securities Act.[2] *Friel v. Dapper Labs*, 2023 WL 2162747 (S.D.N.Y. 2023) (Marrero, J.). Looking to *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), to analyze whether the NFTs constituted a security, the court held that plaintiffs adequately pleaded all three prongs of *Howey*.

1. Subsection 502(a)(2) provides, in relevant part, that a civil action may be brought "for appropriate relief under section 1109 of this title." 29 U.S.C. § 1132(a)(2). Section 1109(a) provides that a fiduciary who breaches their duties shall be personally liable to make good any losses resulting from the breach, to restore any such profits, and shall be subject to such other equitable or remedial relief as the court may deem appropriate. 29 U.S.C. § 1109. Subsection 502(a)(3) provides that a civil action may be brought "to enjoin any act or practice which violates any provision of this subchapter or the terms of the plan, or (B) to obtain other appropriate equitable relief (i) to redress such violations or (ii) to enforce any provisions of this subchapter or the terms of the plan . . . ." 29 U.S.C. § 1132(a)(3).

2. Section 5 prohibits persons from offering, selling, or delivering any security, unless a registration statement is filed with the SEC. 15 U.S.C. § 77e(a), (c). Section 12 creates a private right of action for any person who purchased a security in violation of Section 5 to recover from the seller the consideration paid for such security, with interest. 15 U.S.C. § 77l(a).

## Background

The NFTs at issue are digital video clips of professional sports highlights. The defendant company may produce multiple copies of a given highlight, but each copy has a unique serial number. The authenticity and ownership of the NFTs is recorded on a private blockchain—a decentralized digital ledger—that the company developed. The company also created an application to provide a platform to sell the NFTs and a digital token to validate transactions on its private blockchain. The NFTs at issue could be acquired only when the company sold "packs" of them on its application, or through a secondary marketplace hosted on the company's application.

## Whether the NFTs Are Securities Depends on Whether They Amount to an Investment Contract

The issue before the court was whether plaintiffs had sufficiently pled that the company's offer and sale of the NFTs amounted to an offer or sale of a security. The Securities Act's definition of a "security" includes an "investment contract." The U.S. Supreme Court defined an "investment contract" in *SEC v. W.J. Howey Co.* as "a contract, transaction or scheme whereby a person invests their money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." The Southern District of New York explained that at the motion to dismiss stage, plaintiffs "must plead facts adequate to establish the three prongs of the *Howey* test: (1) an investment of money (2) in a common enterprise (3) with the expectation of profit from the essential entrepreneurial or managerial efforts of others." Because the parties did not dispute the first prong, the court focused on the second and third prongs.

As to the second prong, the court noted that a common enterprise can be alleged under a theory known as "horizontal commonality," which requires "(1) a sharing or pooling of the funds of investors and (2) that the fortunes of each investor in a pool of investors are tied to one another and to the success of the overall venture." *Revak v. SEC Realty*, 18 F.3d 81 (2d Cir. 1994). The court explained that "[g]enerally, pooling occurs when the funds received by the promoter through an offering are, essentially, reinvested by the promoter into the business. In turn, such reinvestment increases the value of the instrument offered" (referencing *Milnarik v. M-S Commodities*, 457 F.2d 274 (7th Cir. 1972)). The Southern District of New York held that plaintiffs adequately alleged a pooling of assets because they alleged that the company's NFT sales and the related transaction fees generated revenue that was used to support and grow the company's blockchain. The court also determined that plaintiffs adequately pled that the fortunes of each investor were tied to the success of the overall venture because the company controlled the enterprise, including its private blockchain. Further, plaintiffs plausibly alleged that the continued value of the NFTs depended on the company's success because the NFTs had no value outside of the private blockchain that the company controlled.

The court also determined that plaintiffs adequately pled the third *Howey* prong by alleging that the company's NFT offer came with "a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others." The court found that the company's public statements and marketing materials, including tweets promoting a recent sale or statistics of recent sales, objectively led purchasers to expect profits. Notably, while the court acknowledged that the word "profit" did not appear in any of the tweets, it concluded that the "rocket ship" emoji, "stock chart" emoji, and "money bags" emoji objectively suggested a financial return on investment. The court also determined that plaintiffs plausibly alleged that the "promise of profits must also be derived from the entrepreneurial or managerial efforts of others." The court stated that the "allegations that [the company] created and maintains a *private* blockchain is fundamental" to its conclusion. The court explained that privatizing the blockchain on which the NFTs' value depend and restricting their trade to only its blockchain, forces purchasers to rely on the company's "expertise and managerial efforts, as well as its continued success and existence."

## Delaware Court of Chancery: Dismisses Derivative Lawsuit on Demand Futility Grounds

On March 1, 2023, the Delaware Court of Chancery dismissed two breach of fiduciary duty claims against the board of a global fast-food company: (i) for failing to take action to address "red flags" indicating that sexual harassment and misconduct were occurring at the company; and (ii) in connection with various executive employment decisions. *In re McDonald's S'holder Derivative Litig.*, 2023 WL 2293575 (Del. Ch. Mar. 1, 2023) (Laster, V.C.). On the same day, the court also issued a Rule 23.1 order dismissing—on the ground of demand futility—the remainder of plaintiffs' derivative lawsuit, which asserted breach of fiduciary duty claims against the company's former Global Head of HR, related to the allegations of sexual harassment and misconduct at the company. Previously, in January 2023, the court had denied dismissal

of the breach of fiduciary duty claims[3] against the former Global Head of HR, on the basis of its groundbreaking holding that officers, in addition to directors, have a duty of oversight.[4]

Because plaintiffs had not made a demand on the company's board before commencing their lawsuit, the court explained that their claims against the former Global Head of HR were subject to dismissal unless they could plead demand futility under the three-part test in *UFCW Union & Participating Food Industry Employers Tri-State Pension Fund v. Zuckerberg*, 262 A.3d 1034 (Del. 2021).[5] Plaintiffs had asserted that demand on the board was futile and should be excused because the board faced a "substantial risk of liability" from plaintiffs' claims. However, as discussed below, because the court dismissed these claims on March 1, demand on the board was not excused, and the court stated in its Rule 23.1 order that "the road to establishing demand futility that the plaintiffs sought to travel is closed."

### Plaintiffs Failed to State a "Red-Flags" Claim Against the Board

In its March 1 decision, the court held that plaintiffs failed to state a claim against the board for breach of the duty of oversight under the second prong of *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996), for failing to take action to address red flags indicating that sexual harassment and misconduct were occurring at the company. The court explained that "[a]lthough they have pled facts supporting an inference that red flags came to the attention of the Director Defendants, they have not alleged facts supporting a reasonable inference that the Director Defendants acted in bad faith in response to those red flags." The facts supporting the inference that the board was on notice included, among other things, a second round of coordinated EEOC

3. Plaintiffs alleged that the former Global Head of HR breached his fiduciary duties by: (i) consciously ignoring red flags regarding sexual harassment and misconduct at the company (duty of oversight), and (ii) personally engaging in sexual harassment (duty of loyalty).

4. Please click here to read our discussion of the court's January 2023 decision in *In re McDonald's Stockholder Derivative Litigation*, 2023 WL 387292 (Del. Ch. Jan. 26 2023).

5. Please click here to read our discussion of *Tri-State*.

complaints, a ten-city strike, a Congressional inquiry, and that the board learned in December 2018 that the CEO had personally engaged in two acts of sexual harassment. However, the court determined that plaintiffs' allegations fell short regarding the board's response to the red flags, noting that at the end of 2018 the board began taking various responsive steps that included, among other things, hiring outside consultants, revising the company's policies, implementing new training programs, providing new levels of support to franchisees, and setting up an employee hotline.

## Plaintiffs Failed to State a Claim Related to the Board's Decision-Making

On March 1, the court also held that plaintiffs failed to state a claim against the board for breach of fiduciary duty in connection with three executive employment decisions[6] because the business judgment rule protected each decision. The court applied the business judgment rule because "[n]one of the established situations in which enhanced scrutiny applies are present in this case, rendering that standard inapplicable." The court went on to determine that plaintiffs failed to plead facts sufficient to rebut any of the business judgment rule's presumptions, which are that "in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).

6. Plaintiffs had challenged the board's decision to: (i) hire the CEO based on his assurance that a consultant with whom he was in an intimate relationship would be removed from the company's account, (ii) discipline rather than terminate the Global Head of HR following a sexual harassment incident, and (iii) terminate the CEO without cause rather than with cause after learning that he had engaged in an inappropriate relationship with an employee.

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