ARBITRATION OF INVESTORS' CLAIMS AGAINST ISSUERS: AN IDEA WHOSE TIME HAS COME?

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I
INTRODUCTION

Arbitration of investors' claims against issuers is "an idea whose time has come" for over twenty years, ever since the U.S. Supreme Court, in *Shearson/American Express, Inc. v. McMahon*[1] and *Rodriguez de Quijas v. Shearson/American Express, Inc.*,[2] overturned long-standing precedent and held that arbitration provisions contained in brokerage customers' agreements were enforceable with respect to federal securities claims. After these decisions, as arbitration before the self-regulatory organization (SRO) forums became the customary method of resolving disputes between individual investors and brokerage firms, some academics and practitioners suggested the use of mandatory arbitration to resolve investors' claims against publicly traded issuers. Proposals were floated to include in an issuer's governance documents a provision that would require arbitration of investors' claims against the issuer.[3] A second round of proposals was advanced in the post-PSLRA (Private Securities Litigation Reform Act of 1995) deregulatory climate.[4] All proponents

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1. 482 U.S. 220 (1987).

2. 490 U.S. 477 (1989).

3. *See, e.g.*, John C. Coffee, Jr., *No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOK. L. REV. 919, 953–70 (1988); Carl W. Schneider, *Arbitration in Corporate Governance Documents: An Idea the SEC Refuses to Accelerate*, INSIGHTS: CORP. & SEC. L. ADVISOR, May 1990, at 21; G. Richard Shell, *Arbitration and Corporate Governance*, 67 N.C. L. REV. 517 (1989).

4. *See, e.g.*, COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 109–12 (2006), *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf; Cyril Moscow, *Arbitration Bylaws to Bar Shareholder Class Actions*, INSIGHTS: CORP. & SEC. L. ADVISOR, Apr. 2006, at 8; MICHAEL R. BLOOMBERG & CHARLES E. SCHUMER, SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP 102–03, (2007), *available at* http://www.nyc.gov/html/om/pdf/ ny_report_final.pdf; Joseph W. Bartlett, *Tort Reform in the Securities Sector*, J. PRIVATE EQUITY, Winter 2008, at 99, 101–12; U.S. CHAMBER INST. FOR LEGAL REFORM, SECURITIES CLASS ACTION LITIGATION: THE PROBLEM, ITS

emphasized the traditional benefits of arbitration, namely, a faster, less expensive, and more flexible process in which arbitrators possessing expertise in the subject matter resolve the parties' dispute. Many also advocated for arbitration as an antidote to perceived abuses of federal securities class actions.[5]

To date, however, publicly traded domestic issuers and their counsel have not seriously pursued these proposals, probably because of several legal obstacles to implementation. First, there is doubt about the legality and enforceability under state corporate law of an arbitration provision contained in an issuer's governance documents.[6] Second, there is also doubt whether an issuer's governance documents are commercial contracts within the meaning of Federal Arbitration Act (FAA) § 2.[7] Third, the Securities and Exchange Commission (SEC) has never repudiated its staff position that an arbitration provision in a publicly traded issuer's governance documents would violate the anti-waiver provisions of the Securities Act of 1933[8] and the Securities Exchange Act of 1934.[9]

Recently, however, these legal obstacles may be eroding. First, while there continues to be uncertainty about the legality and enforceability of arbitration provisions contained in corporate governance documents, a recent Delaware Chancery Court opinion suggests that certificates of incorporation of publicly traded Delaware corporations could include arbitration clauses that would bind shareholders at least with respect to state fiduciary duty claims.[10] Second, it is possible that even if Delaware courts held such arbitration provisions unenforceable, other courts could conclude that they were enforceable under the FAA, which would preempt the state law.[11] Third, the SEC may find it difficult to maintain its opposition to arbitration provisions in governance documents in light of the fact that a number of foreign private issuers whose securities are traded in the United States have such provisions in their governance documents.[12]

Apart from these legal obstacles, publicly traded issuers may not have previously perceived significant advantages to arbitration. Indeed, with respect to high-stakes "bet-the-company" disputes, such as securities class actions,

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IMPACT, AND THE PATH TO REFORM 42 (July 2008), *available at* http://www.instituteforlegalreform.com/get_ilr_doc.php?docId=1213; Bradley J. Bondi, *Facilitating Economic Recovery and Sustainable Growth Through Reform of the Securities Class-Action System: Exploring Arbitration as an Alternative to Litigation*, 33 HARV. J.L. & PUB. POL'Y 607 (2010); Steven A. Ramirez, *Arbitration and Reform in Private Securities Litigation: Dealing with the Meritorious as Well as the Frivolous*, 40 WM. & MARY L. REV. 1055 (1999).

5. All those in note 4 except Professor Ramirez, who advocated arbitration because of the obstacles created by the PSLRA.

6. *See infra* Part II.A.

7. *See infra* Part II.B.

8. 15 U.S.C. § 77n (2006).

9. *Id.* § 78cc. *See infra* Part II.C.

10. *See infra* notes 31–40 and accompanying text.

11. *See infra* notes 43–44 and accompanying text.

12. *See infra* notes 72–80 and accompanying text.

litigation may be preferable.[13] First, the very narrow grounds for judicial review of arbitration awards may make the risk of an aberrational award unacceptably high.[14] Second, specifically with respect to federal securities claims, because the PSLRA imposes significant obstacles on plaintiffs, it was hard to see how relocating securities class actions from a court to a more flexible, less law-oriented arbitration forum would provide any advantages to corporate defendants. Finally, issuers could expect that adoption of an arbitration provision would expose them to criticism from investor advocates and negative publicity.[15] Taking into account all these factors, an issuer and its counsel were, at least until recently, likely to conclude that the costs of attempting to adopt an arbitration provision outweighed any likely benefits. Accordingly, few publicly traded domestic issuers took the bold step of adopting arbitration provisions in their governance documents.

The Supreme Court's recent opinion in *AT&T Mobility LLC v. Concepcion*,[16] however, makes inclusion of an arbitration provision in a publicly traded issuer's governance documents a proposal worthy of serious consideration. In that opinion, a majority of the Justices upheld a provision in a consumer contract that disallowed class arbitration because the FAA preempted California precedent striking down class arbitration waivers as unconscionable.[17] In light of *Concepcion*, issuers may be able to achieve an advantage through the adoption of an arbitration provision in their governance documents that they were not able to achieve through the PSLRA and the Securities Litigation Uniform Standards Act.[18] They could finally achieve the demise of securities class claims!

13. See *infra* Part III.

14. 9 U.S.C. § 10(a) sets forth narrow grounds for vacating awards based on arbitrator misconduct. It is not clear whether the judicially created ground of "manifest disregard of the law" survives *Hall Street Associates v. Mattel, Inc.*, 552 U.S. 576 (2008).

15. *McMahon* was generally viewed as an anti-investor decision, and investors' advocates urged Congress to enact legislation to overturn the result. *See, e.g.*, *McMahon Decision Should be Overturned to Protect Investors, House Panel Told*, SEC. REG. & L. REP. (BNA), Apr. 1, 1988, *available at* Westlaw, 20 SRLR 492. That negative perception continues, as the press frequently expresses negative views on customer arbitration. *See* Jill Gross & Barbara Black, *When Perception Changes Reality: An Empirical Study of Investors' Views of the Fairness of Securities Arbitration*, 2 J. DISP. RESOL. 349, 397 (2008).

16. 131 S. Ct. 1740 (2011).

17. *See infra* Part IV.

18. The Securities Litigation Uniform Standards Act of 1998 (SLUSA), Pub L. No. 105-353, 112 Stat. 3227, amends Securities Exchange Act § 28(f), 15 U.S.C. § 78bb, to confer on federal courts exclusive jurisdiction over most securities class actions, because of the congressional concern that plaintiffs' attorneys could avoid the PSLRA obstacles by bringing class actions in state courts. Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 82 (2006).

II
LEGAL OBSTACLES ARE ERODING

A. Legality and Enforceability Under State Corporate Law

There is considerable uncertainty under state corporate law[19] about the legality and enforceability of arbitration provisions contained in a publicly traded issuer's governance documents.[20] While modern corporation statutes allow great flexibility and private ordering, the discretion of corporate managers and shareholders to limit shareholders' powers cannot "achieve a result forbidden by settled rules of public policy."[21] For that reason it is unlikely that, absent legislative authorization, corporations could amend their certificates of incorporation to eliminate directors' fiduciary obligations.[22] As another example, a 1926 Delaware Supreme Court opinion struck down a charter provision that gave a board of directors the power to deny a stockholder the right to inspect books and records.[23] Unfortunately, there is very little recent case law addressing when this amorphous "public policy" standard has been violated.

Further, even if an arbitration provision adopted by all shareholders was deemed legal under state law, there is a serious question of fairness about taking away rights from current shareholders who did not assent to the provision. While it is true that modern corporate law, with its emphasis on flexibility and adaptability, allows substantial alteration—even elimination—of shareholders' rights without their consent, the power of shareholders holding a majority of the vote to alter corporate governance and stock ownership rules is not absolute. Thus, for example, majority shareholders cannot adopt an amendment to eliminate the board of directors, because that would deprive minority shareholders of the protections afforded by a board of directors with fiduciary responsibilities to the corporation.[24] Similarly, although restrictions on transferability can be found in corporate governance documents, they are not

19. I previously reviewed the legal arguments in Barbara Black, *Eliminating Securities Fraud Class Actions Under the Radar*, 2009 COLUM. BUS. L. REV. 802, 838–42 (2009).

20. Arbitration of shareholders' disputes in closely held corporations has long been generally accepted, but in those instances the arbitration clause is typically found in a shareholders' agreement. *See id.* at 843.

21. Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 118 (Del. 1952).

22. There is a contrary position. *See, e.g.*, Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 28–30, 67–68 (1990) (discussing fiduciary duties as "simply one of many drafting alternatives," a default that can be altered or abandoned in the corporate contract without statutory permission). For a more general advocacy of the contractual nature of corporations, see Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989).

23. State *ex rel.* Cochran v. Penn-Beaver Oil Co., 143 A. 257, 259–60 (Del. 1926).

24. In Delaware a statutorily defined "close corporation" may provide for management by the shareholders if all the incorporators or shareholders agree to it and existence of the provision is conspicuously noted on the stock certificate. DEL. CODE ANN. tit. 8, § 351 (2011). *See also* MODEL BUS. CORP. ACT § 7.32 (1984) (featuring a similar provision under which the agreement ceases to be effective when the corporation becomes public).

binding on current shareholders who do not assent to the restrictions.[25] Providing appraisal rights to shareholders if they dissent from the adoption of an arbitration provision may help to alleviate fairness concerns.

Finally, assuming that an arbitration provision does not violate public policy and current shareholders who dissent from the provision are treated fairly, there is the question whether the provision is enforceable as to subsequent stockowners. Courts routinely state that charter provisions are binding on all shareholders, including subsequent purchasers, in the context of customary corporate governance provisions[26] and provisions relating to the terms of the shares.[27] But again, this principle is not without limits. Some changes so fundamentally alter the corporate governance structure or the shareholders' property rights that they are limited to closely held corporations or require special protections for subsequent shareholders.[28] Arbitration proponents assert that notice on the corporation's web site and in its SEC filings would be sufficient to bind future owners,[29] and because plaintiffs in securities fraud actions will likely rely on the fraud-on-the-market (FOTM) presumption,[30] it would be inconsistent for them to argue that a public notice cannot bind them. Nevertheless, the issue remains unsettled.

The foregoing summary is not intended to answer definitively whether arbitration provisions in governance documents of publicly traded issuers are legal and enforceable under state corporate law. Rather, I suggest that because of the considerable uncertainty as to these issues, publicly traded issuers and their counsel have been hesitant to put forward an arbitration provision for shareholder vote.

A recent Delaware Chancery Court opinion, *In re Revlon Inc. Shareholders Litigation*,[31] however, changes the equation and suggests that certificates of incorporation of publicly traded Delaware corporations could include an arbitration clause that would bind shareholders at least with respect to state

25. DEL. CODE ANN. tit. 8, § 202(b) (2011).

26. *See, e.g.*, Goldboss v. Reimann, 55 F. Supp. 811, 819 (S.D.N.Y. 1943); Mason v. Mallard Tel. Co., 240 N.W. 671, 674 (Iowa 1932).

27. *See, e.g.*, *In re* Appraisal of Ford Holdings, Inc. Preferred Stock, 698 A.2d 973, 977 (Del. Ch. 1997) (stating that terms of preferred shares can limit holders' right to seek judicial appraisal).

28. DEL. CODE ANN. tit. 8, § 351 (eliminating the board of directors is available only to statutorily defined close corporations, all shareholders must approve the amendment, and there must be conspicuous notice of the provision on the stock certificate); *id.* § 151 (restrictions on the transferability of shares are binding on subsequent shareholders if there is conspicuous notice on the stock certificate or, in the case of uncertificated shares, it is contained in the required notice).

29. *See, e.g.*, Bartlett, *supra* note 4, at 105.

30. In *Basic, Inc. v. Levinson*, 485 U.S. 225 (1988), the U.S. Supreme Court adopted the fraud-on-the-market presumption of reliance, which is based on the theory that the price of securities traded in an efficient market should reflect all publicly available information. As a result, plaintiffs do not have to establish individual reliance on fraudulent statements.

31. 990 A.2d 940 (Del. Ch. 2010); *see also* Douzinas v. Am. Bureau of Shipping, Inc., 888 A.2d 1146, 1149 (Del. Ch. 2006) (dictum suggesting that a provision in a certificate of incorporation could require arbitration of derivative claims).

fiduciary duty claims.[32] In *Revlon*, Vice Chancellor Laster granted a motion to replace the original lead counsel because of counsel's failure to advocate on behalf of the class and lack of candor with the tribunal.[33] Acknowledging that greater oversight by the Delaware Chancery could lead to plaintiffs' counsel filing in other jurisdictions, the Vice Chancellor stated: "If they do, and if boards of directors and shareholders believe that a particular forum would provide an efficient and value-promoting locus for dispute resolution, then corporations are free to respond with charter provisions selecting an exclusive forum for intra-entity disputes."[34] Nevertheless, Vice Chancellor Laster indicated limits on this power: "I can envision that the Delaware courts would retain some measure of inherent residual authority so that entities created under the authority of Delaware law could not wholly exempt themselves from Delaware oversight. The issues implicated by an exclusive forum selection provision must await resolution in an appropriate case."[35]

After *Revlon*, a few Delaware corporations have amended their governance documents to provide that Delaware is the exclusive forum for intra-corporate litigation.[36] Although a California federal district court held that a bylaw adopted by the Oracle board of directors specifying Delaware as the exclusive forum was not enforceable at least with respect to those who were shareholders prior to its adoption, the court acknowledged that, "were a majority of shareholders to approve such a charter amendment, the arguments for treating the venue provision like those in commercial contracts would be much stronger, even in the case of a plaintiff shareholder who had personally voted against the amendment."[37]

The U.S. Supreme Court has described predispute arbitration agreements as a form of forum selection clause.[38] Accordingly, *Revlon* may provide encouragement to a publicly traded corporation that wishes to adopt an arbitration provision in its governance documents. The Delaware judiciary's reaction to an arbitration provision that would largely remove fiduciary obligation litigation from judicial oversight, however, may well be different from its reaction to a clause specifying Delaware as the sole forum for fiduciary

32. *Revlon*, 990 A.2d at 960–61.

33. *Revlon* is an instance of greater judicial scrutiny of those plaintiffs' attorneys whom the Delaware judiciary has dubbed "frequent filers."

34. *Id.* at 959.

35. *Id.* at 960 n.8.

36. *See* Joseph A. Grundfest, *Choice of Forum Provisions in Intra-Corporate Litigation: Mandatory and Elective Approaches (The 2010 Pileggi Lecture)* (Rock Ctr. for Corporate Governance at Stanford Univ., Working Paper No. 91, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1690561 (finding that forum selection clauses in the governance documents of publicly traded corporations are "exceedingly rare," although there has been a sharp increase since the *Revlon* decision).

37. Galaviz v. Berg, 763 F. Supp. 2d 1170, 1175 (N.D. Cal. 2011).

38. *See, e.g.*, Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 255 n.11 (1987); *see also* 14 Penn Plaza LLC v. Pyett, 556 U.S. 247 (2009) (requiring arbitration of ADEA claims is not a waiver of the statutory claims).

obligation litigation. Mandatory arbitration tests the extent to which Delaware corporations can "exempt themselves from Delaware oversight"[39] and may be a "bridge too far" for the judiciary.[40] If that should prove to be the case, then the courts, and ultimately the U.S. Supreme Court, would have to address whether the arbitration provision was contained in a "contract evidencing a transaction involving commerce" under FAA § 2,[41] so that the Delaware judiciary's refusal to enforce it would be impermissible anti-arbitration animus.[42] We turn next to this question.

B. What Constitutes a Commercial Contract Under FAA § 2

The FAA's primary purpose is "ensuring that private arbitration agreements are enforced according to their terms";[43] to that end, the FAA preempts state law that exhibits anti-arbitration bias.[44] If a publicly traded issuer's governance documents constitute a "contract evidencing a transaction involving commerce" under FAA § 2, then courts must enforce an arbitration provision in those documents notwithstanding contrary state law. The prerequisite for invoking this federal pro-arbitration policy, however, is an agreement to arbitrate[45] because "arbitration is strictly a matter of consent."[46] In *First Options of Chicago, Inc. v. Kaplan*, the Court stated that courts should apply state-law principles that govern the formation of contracts in deciding whether parties agreed to arbitrate.[47]

It is black letter law that the formation of a contract requires manifestation of mutual assent.[48] There has been considerable litigation over assent to

39. *Revlon*, 990 A.2d at 960 n.8.

40. However, Delaware permits Chancellors to serve as arbitrators. *See Delaware Court of Chancery Implements New Arbitration Procedures for Rapid Resolution of Business Disputes, Including Patent Disputes*, FISH & RICHARDSON P.C. (Feb. 18, 2010), http://www.fr.com/Delaware-Court-of-Chancery-Implements-New-Arbitration-Procedures-for-Rapid-Resolution-of-Business-Disputes-Including-Patent-Disputes-02-18-2010/. (Thanks to John Coyle for alerting me to this.)

41. 9 U.S.C. § 2 (2006).

42. *See* Doctor's Assocs. v. Casarotto, 517 U.S. 681, 685 (1996) ("[T]he proper inquiry here should focus . . . on this question: Would the application of [state law] undermine the goals and policies of the FAA.") (internal quotation marks omitted).

43. Volt Info. Scis., Inc. v. Bd. of Trs. of Leland Stanford Junior Univ., 489 U.S. 468, 478 (1989).

44. *See Doctor's Assocs.*, 517 U.S. at 681; AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740, 1753 (2011).

45. Granite Rock Co. v. Int'l Bhd. of Teamsters, 130 S. Ct. 2847, 2858–60 (2011); First Options of Chi. v. Kaplan, 514 U.S. 938, 943 (1995).

46. *Granite Rock*, 130 S. Ct. at 2857 n.6 (internal quotation marks omitted).

47. 514 U.S. at 994 (1995). *But cf.* John Wiley & Sons, Inc. v. Livingston, 376 U.S. 543, 550 (1964) (holding that federal labor law controlled because "a collective bargaining agreement is not an ordinary contract").

48. RESTATEMENT (SECOND) OF CONTRACTS §§ 3 (agreement defined), 18 (manifestation of mutual assent) (1979); *see also* Rodgers v. Erickson Air-Crane Co. LLC, No. C.A. 98C-07-014 WTQ, 2000 WL 1211157, at *6 (July 30, 1999) ("[M]utual assent is essential to the formation of . . . contracts") (quoting 11 RICHARD A. LORD, WILLISTON ON CONTRACTS § 4:1 (4th ed. 1990)); Lopez v. Charles Schwab & Co., 13 Cal. Rptr. 3d 544, 548 (Cal. Ct. App. 2004) ("An essential element of any contract is the consent of the parties, or mutual assent.") (quoting Donovan v. RRL Corp., 27 P.3d 702, 709 (Cal.

arbitration in cases where a document containing a purported agreement to arbitrate is made available (either physically or online) to an individual who then takes some action consistent with contract performance,[49] such as keeping the purchased goods,[50] continuing employment,[51] or downloading software.[52] While the opinions reach different answers that may depend on specific factual issues,[53] important factors are whether the individual received actual notice of the existence of the terms in sufficient time to renounce the transaction, and whether he took action that could constitute acceptance.[54] It is not clear whether notice in a corporation's SEC filings and on its corporate web site would be sufficient notice, and whether continuing to hold securities would be sufficient action, to manifest assent.[55] It is possible for publicly traded issuers to deliver to shareholders a copy of the governance document containing an arbitration provision by including it, for example, in the annual proxy statement, and it can be argued that shareholders who continued to hold their shares after receiving the notice would be bound. The countervailing argument, that merely continuing to hold shares is not the manifestation of assent required under contract law, is also supportable.[56]

State corporate law frequently refers to a corporation's governance documents as a contract with the state[57] and with the shareholders.[58] An issue rarely addressed in the case law is whether this judicial notion of a contract in the context of resolving corporate governance issues should be deemed the equivalent of a commercial contract under FAA § 2. Arbitration of shareholders' disputes in closely held corporations has long been generally

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49. *See* STEPHEN J. WARE, ALTERNATIVE DISPUTE RESOLUTION § 2.22(b) (2d ed. 2007) (describing recurrent fact patterns and citing cases).

50. *E.g.*, Hill v. Gateway 2000, Inc., 105 F.3d 1147 (7th Cir. 1997).

51. *E.g.*, Hardin v. First Cash Fin. Servs., Inc., 465 F.3d 470 (10th Cir. 2006).

52. *E.g.*, Specht v. Netscape Commc'ns. Corp., 306 F.3d 17 (2d Cir. 2002).

53. The sufficiency of notice also depends on the extent to which the document resembles a traditional contract. *See, e.g.*, Metters v. Ralphs Grocery Co., 74 Cal. Rptr. 3d 210, 214 (Cal. Ct. App. 2008) (finding no agreement to arbitrate because the form did not look like a contract).

54. *Specht*, 306 F.3d at 29. *Compare* Hines v. Overstock.com, Inc., 668 F. Supp. 2d 362, 367 (E.D.N.Y. 2009) (determining that the plaintiff's use of the website was not assent because of the insufficient notice of terms), *with* Major v. McCallister, 302 S.W.3d 227, 231 (Mo. Ct. App. 2009) (concluding that the plaintiff's use of the website was assent because of the visibility of terms).

55. Support for the argument that notice on the corporation's website is sufficient can be found in the auction cases where, because of the special nature of auctions, the law imposes a greater responsibility on bidders to ascertain the terms of the sale. *See* Hessel v. Christie's Inc., 399 F. Supp. 2d 506, 516 (S.D.N.Y. 2005). I discuss these cases in Black, *supra* note 19, at 849–50.

56. *See* Schnabel v. Trilegiant Corp., No. 3:10-CV-957 JCH, 2011 WL 797505, at *6 (D. Conn. Feb. 24, 2011) (holding that subscriber's failure to cancel after viewing an email did not manifest assent to its arbitration provision); Bratek v. L&L Fin. Holdings, No. 10-246 (MLC), 2010 WL 1930598, at *5 (D.N.J. May 12, 2010) (holding that arbitration provision on a warrant was not enforceable because investor never manifested assent to be bound).

57. The metaphor goes back at least to *Trustees of Dartmouth College v. Woodward*, 17 U.S. 518 (1819).

58. *See, e.g.*, STAAR Surgical Co. v. Waggoner, 588 A.2d 1130, 1136 (Del. 1991).

accepted,[59] but the arbitration clause is typically found in an actual agreement entered into by all the shareholders.[60] A recent Third Circuit opinion, applying Pennsylvania law, refused to enforce an arbitration provision contained in the bylaws of a professional corporation (a law firm) against a lawyer–shareholder in the absence of evidence that she assented to it.[61] The plaintiff specifically averred that she was never provided a copy of the bylaws, was never informed of the existence of the arbitration provision in the bylaws, and never signed any document that referred to the arbitration provision. To counter this, the law firm argued that as a director, she had constructive notice of the terms of the bylaws. After the Pennsylvania Supreme Court declined to address the "tension between corporate law principles and arbitration contract principles,"[62] the Third Circuit determined that because the plaintiff did not receive a copy of the bylaws containing the arbitration provision, she could not have agreed to arbitrate. Note that the Third Circuit stated that there cannot be assent to arbitration without receipt of the arbitration agreement; it did not state that receipt of the arbitration provision, without more, would constitute the requisite manifestation of assent.[63] If an affirmative act of acceptance is required, a shareholders' vote on the management proxy card would possibly suffice, although there remains the issue of whether non-assenting shareholders would be bound.[64]

The uncertainty under both state corporate and contract law could lead to different outcomes in different jurisdictions, possibly culminating in a showdown between the current Supreme Court, which is generally considered "pro-business," and the Delaware judiciary, which is widely praised for its business acumen. Moreover, even if the arbitration provision is determined to be legal and enforceable under corporate or contract law, the legal battle may not be over for a publicly traded issuer wishing to adopt such a provision. Federal courts may determine that the arbitration provision is invalid with respect to federal securities claims because it violates the anti-waiver provisions of the federal securities laws. We turn next to this issue.

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59. *See, e.g.*, Data Mountain Solutions, Inc. v. Giordano, 680 F. Supp. 2d 110 (D.D.C. 2010); *see generally* Shell, *supra* note 3, at 528–33.

60. In addition, it may be included in the governance documents. *See* Shell, *supra* note 3 at 528, n.80.

61. Kirleis v. Dickie, McCamey & Chilcote, P.C., 560 F.3d 156 (3d Cir. 2009). Perhaps she would have been better off in arbitration, because the court subsequently granted the firm's motion for summary judgment. Kirleis v. Dickie, McCamey & Chilcote, P.C., No. 06cv1495, 2009 WL 3602008 (W.D. Pa. Oct. 28, 2009).

62. *Kirleis*, 560 F.3d at 158.

63. *See* Bratek v. L&L Fin. Holdings, No. 10-246 (MLC), 2010 WL 1930598, at *5 (D.N.J. May 12, 2010) (holding that an arbitration provision on a warrant was not enforceable because investor never manifested assent to be bound).

64. The court in *Galaviz v. Berg*, 763 F. Supp. 2d 1170 (N.D. Cal. 2011), discussed *supra* note 37 and accompanying text, also recognized the tension between corporate and contract law principles when it found no mutual assent, at least with respect to preexisting shareholders, when a forum selection bylaw was adopted by directors, but stated that the argument for treating it like a commercial contract would be stronger if it had been adopted by a majority vote of the shareholders.

C. SEC Staff's Position on Arbitration Provisions in Governance Documents

Securities Act § 14[65] and Securities Exchange Act § 29(a)[66] (the anti-waiver provisions) invalidate "any condition, stipulation, or provision binding any person to waive compliance with" the federal securities statutes and their rules.[67] In 1990, when a corporation that was planning its initial public offering (IPO) sought to include an arbitration provision in its governance documents, the SEC staff objected to its inclusion.[68] In its view,

> it would be contrary to the public interest to require investors who want to participate in the nation's equity markets to waive access to a judicial forum for vindication of federal or state law rights, where such a waiver is made through a corporate charter rather than through an individual investor's decision.[69]

Although there are differences between customer–broker and purchaser–issuer claims that provide a basis for distinguishing *McMahon–Rodriguez*, it is not likely that those differences would persuade courts that the latter type of claims could not be brought in arbitration (assuming that the requisite agreement was present).[70] Whatever the ultimate resolution of that legal issue, however, the SEC staff's position presented a significant practical obstacle. An issuer that wanted to include an arbitration provision in its governance documents would have to work around the practical difficulties caused by the agency's disapproval and suffer the consequences of incurring the SEC staff's disapproval.

There are signs that times have changed since 1990. Although the SEC has never publicly modified its staff position that arbitration clauses in corporate documents of publicly traded issuers are contrary to federal public policy, there were published reports in 2007 that the SEC, under the leadership of Chairman Christopher Cox, considered changing its policy.[71] Moreover, some foreign private issuers whose securities trade in U.S. markets require arbitration of investors' claims in their corporate governance documents[72] or American

65. 15 U.S.C. § 77n (2006).

66. 15 U.S.C. § 78cc.

67. For the legislative history and leading cases analyzing these provisions, see Black, *supra* note 19, at 824–28.

68. Both the attorney who represented the issuer and the attorney who was at the time Assistant General Counsel, Office of the General Counsel, at the SEC wrote accounts of this incident, advocating for their respective positions. *See* Thomas L. Riesenberg, *Arbitration and Corporate Governance: A Reply to Carl Schneider*, INSIGHTS: CORP. & SEC. L. ADVISOR, Aug. 1990, at 2; Schneider, *supra* note 3.

69. Riesenberg, *supra* note 68, at 2.

70. The argument is essentially that purchaser–issuer claims involve more complex legal issues than a customer–broker dispute; yet the Supreme Court has approved of the arbitration of complex antitrust and RICO claims. *See* Black, *supra* note 19, at 828–32. I went on to argue that an arbitration provision with a class action waiver would violate the anti-waiver provisions. *Id.* at 832–35. I address this *infra* Part V.

71. *See* Nicholas Rummel, *SEC and Congress Gang up on Arbitration*, FIN. WEEK, July 23, 2007, *available at* http://www.financialweek.com/apps/pbcs.dll/article?AID=/20070723/REG/70720028/1002/; Kara Scannell, *SEC Explores Opening Door to Arbitration*, WALL ST. J., Apr. 16, 2007, at A1.

72. *See, e.g.*, ROYAL DUTCH SHELL PLC, ARTICLES OF ASSOCIATION (May 18, 2010), *available at* http://www.static.shell.com/static/investor/downloads/rds/corporate_governance/rds_articles_of_

Depositary Receipt [or Share] (ADR) agreements.[73] The best known is Royal Dutch Shell (RDS), incorporated under the laws of England and Wales, with its official residence in the Netherlands, whose ADRs are traded on the New York Stock Exchange (NYSE). Its articles of association require that all shareholder disputes, including disputes arising under U.S. securities laws,[74] be resolved in The Hague under the Rules of Arbitration of the International Chamber of Commerce.[75] Indeed, a few securities and breach of fiduciary duty class claims involving publicly traded domestic and foreign private issuers have been filed in the American Arbitration Association (AAA) forum.[76] In a matter that received considerable publicity, Harvard University, the owner of ADRs representing preferred shares of Surgut, a public oil and gas company organized under the laws of the Russian Federation, brought a purported class arbitration seeking money damages and declaratory relief for Surgut's alleged failure to pay the full amount of mandated dividends.[77] An AAA arbitration panel (by a two-to-one vote, the arbitrator appointed by Surgut dissenting) construed the arbitration clause to permit class arbitration, and a federal district court confirmed the award.[78] After an appeal to the Second Circuit was stayed, Harvard and Surgut stipulated to the voluntary dismissal of the arbitration.[79]

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association_18052010.doc.; *see also* Christos Ravanides, *Arbitration Clauses in Public Company Charters: An Expansion of the ADR Elysian Fields or a Descent into Hades?*, 18 AM. REV. INT'L ARB. 371, 389 (2007) (finding arbitration options or requirements in the charters, bylaws, or regional laws governing forty companies trading in the United States).

73. *See, e.g.*, JSC Surgutneftegaz v. President & Fellows of Harvard Coll., 167 F. App'x 266, 267 (2d Cir. 2006).

74. Royal Dutch Shell plc, Annual Report (Form 20-F), at 85 (Mar. 9, 2011), *available at* http://www.sec.gov/Archives/edgar/data/1306965/000095012311025398/u09838e20vf.htm.

75. ROYAL DUTCH SHELL PLC, ARTICLES OF ASSOCIATION §§ 138–40 (May 18, 2010), *available at* http://www.static.shell.com/static/investor/downloads/rds/corporate_governance/rds_articles_of_association_18052010.doc.

76. The pleadings and any awards issued are available in its public database, available at http://www.adr.org/sp.asp?id=25562. A review of the AAA class arbitration database conducted in Fall 2010 identified six cases involving investment disputes and another four involving business disputes. Most originated as judicial actions in which defendants were successful in requiring arbitration in the AAA forum on the basis of an arbitration clause contained in an agreement. In four cases in which defendants challenged class arbitration, arbitration panels construed arbitration clauses that were silent on the question of class arbitration as permitting class arbitration. (*Stolt-Nielsen S.A. v. AnimalFeeds Int'l Corp.*, 130 S. Ct. 1758 (2010), discussed *infra* notes 107–120 and accompanying text, will likely have an impact on this issue.) Derivative claims are not included in the AAA database; therefore, it could not be determined if any have been filed. A few courts have ordered the arbitration of derivative claims brought by public shareholders of securities brokerage firms, but it is not clear that any of these arbitrations took place. *See, e.g.*, *In re* Salomon Inc. S'holders Derivative Litig., No. 91 Civ. 5500 (RPP), 1994 WL 533595, at *12 (S.D.N.Y. Sept. 30, 1994) (NYSE refused to accept claim); Frederick v. First Union Secs., Inc., 122 Cal. Rptr. 2d 774, 779 (Cal. Ct. App. 2002) (NYSE refused to accept; court thought that NASD might accept).

77. Demand for Class Arbitration, President and Fellows of Harvard Coll. v. JSC Surgutneftegaz, American Arbitration Association, AAA No. 11 168 T 01654 04, June 29, 2004, *available at* http://www.adr.org/si.asp?id=3544.

78. JSC Surgutneftegaz v. President and Fellows of Harvard Coll., No. 04 Civ. 6069(RMB), 2007 WL 3019234, at *2 (S.D.N.Y. Oct. 11, 2007).

79. Stipulation of Voluntary Dismissal and Order of Approval, President and Fellows of Harvard Coll. v. JSC Surgutneftegaz, American Arbitration Association, AAA No. 11 168 T 01654 04, *available*

Whatever the SEC's current position on arbitration provisions in governance documents, if the agency permits securities of foreign private issuers that have arbitration provisions in their governance documents to trade in the U.S. markets, it will be hard-pressed to justify its continued opposition to the use of such provisions by U.S. issuers. If there was a trend in this direction, however, it appears to have stalled. A review of approximately seventy issuers with operations in China that conducted IPOs in 2010 found only one that explicitly stated that its articles of association required arbitration of disputes involving the articles of association or the applicable business company laws.[80] Of twenty-two foreign private issuers that conducted IPOs in 2011, as of October 28, 2011, none stated that it required arbitration. A number of issuers explicitly stated that their corporate governance documents did not require arbitration, which suggests that the SEC staff may have asked.

As Part II makes clear, a publicly traded issuer contemplating inclusion of an arbitration provision in its governance documents would have to take into account the attendant legal uncertainties. These obstacles, however, are not necessarily insurmountable in the face of a determined campaign by a motivated issuer and its counsel. It is likely that publicly traded issuers have not seriously pursued any of the proposals that have been circulated over the past twenty years because they were not persuaded that there would be significant benefits to outweigh the considerable costs. Part III examines the arbitration and litigation options from the perspective of a corporate defendant to show why, at least until recently, litigation, and not arbitration, has been the preferred option.

III

COMPARING ARBITRATION AND LITIGATION: HIGH-STAKES CLAIMS

From the perspective of a publicly traded issuer contemplating amendment of its governance documents to require arbitration of investors' claims, the cost-benefit analysis of arbitration versus litigation is complex.[81] Adopting an arbitration provision would certainly entail significant initial costs. Because litigation is the default rule and arbitration in this context is not customary, transaction costs would be incurred in drafting the arbitration provision, amending the corporate governance documents, and in all likelihood litigating challenges to the provision, at least until the issues of legality and enforceability were resolved. Adopting an arbitration clause may also cost a corporate defendant in terms of reputation and bad publicity, given a strong belief among many investors and their advocates that arbitration is unfair and biased toward

at http://www.adr.org/si.asp?id=5748.

80. Data on file with author.

81. *See generally* Christopher R. Drahozal & Stephen J. Ware, *Why Do Businesses Use (or Not Use) Arbitration Clauses?*, 25 OHIO ST. J. ON DISP. RESOL. 433, 447–49 (2010) (reviewing factors outside the context of securities fraud and derivative claims).

businesses that are "repeat players."[82] The corporation may also experience a negative reaction from the SEC staff that could affect subsequent dealings with the agency. After the initial costs, arbitration entails some expenditures for the arbitration panel and forum that are not incurred in litigation.[83] In the context of securities class actions and derivative claims, however, where other costs (principally lawyers' and experts' fees) are high, these costs may not be a significant factor in the equation.[84] Nevertheless, arbitration would have to offer businesses meaningful advantages to warrant the additional costs of implementation.

What are the potential advantages of arbitration? According to Professors Christopher Drahozal and Stephen Ware, parties will pay the additional costs associated with arbitration when they expect it will provide them with a better process or a better outcome.[85] Potential benefits include (1) faster and less expensive proceedings, (2) decreased risk of aberrational jury verdicts, (3) more accurate outcomes because of arbitrator expertise or the application of trade rules, and (4) better protection of confidential information.[86] Others stress the parties' control over the process.[87] Businesses often prefer arbitration in disputes that involve routine, small-stakes contracts,[88] transnational contracts,[89] and situations where parties wish to maintain an ongoing relationship.[90] Conversely, Professors Drahozal and Ware identify certain categories of cases where parties prefer litigation over arbitration. The most important for our purpose is high-stakes "bet-the-company" litigation, where the limited grounds for judicial review of arbitration awards may make the risk of an aberrational award unacceptably high.[91]

Commercial arbitration providers concur with the academic perspective. Organizations that have as their mission the promotion of dispute-resolution alternatives to litigation compile comparisons of arbitration and litigation.[92]

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82. *See, e.g.*, David S. Schwartz, *Mandatory Arbitration and Fairness*, 84 NOTRE DAME L. REV. 1247, 1309–12 (2009) (discussing bias of arbitrators and arbitral forums towards defendants, particularly in the employment context); Jean R. Sternlight, *Creeping Mandatory Arbitration: Is It Just?*, 57 STAN. L. REV. 1631, 1650–51 (2005).

83. Drahozal & Ware, *supra* note 81, at 447–49.

84. CTR. FOR PUB. RES., ADR IN SECURITIES DISPUTES: MODEL ADR PROCEDURES 19 (1991).

85. Drahozal & Ware, *supra* note 81, at 451.

86. *Id*. at 451–52.

87. DAVID B. LIPSKY & RONALD L. SEEBER, THE APPROPRIATE RESOLUTION OF CORPORATE DISPUTES 17 (1998).

88. Such as securities broker–customer disputes. Black, *supra* note 19, at 828–36.

89. "Arbitration is the dispute resolution mechanism of choice in international commerce." Christopher R. Drahozal, *Contracting Out of National Law: An Empirical Look at the New Law Merchant*, 80 NOTRE DAME L. REV. 523, 523 (2005). Arbitration is seen as neutral forum, and awards are enforceable in foreign jurisdictions. *Id.*

90. Drahozal & Ware, *supra* note 81, at 452.

91. *Id.* at 454–56.

92. *E.g.*, INT'L INST. FOR CONFLICT PREVENTION & RESOLUTION, ADR SUITABILITY GUIDE (FEATURING MEDIATION ANALYSIS SCREEN) (2003), *available at* http://www.cpradr.org/Portals/0/Resources/ADR%20Tools/Tools/cpr%20suitability%20guide.pdf [hereinafter *ADR Suitability*

While they describe a number of advantages that arbitration has over litigation,[93] they also describe the significant negative factor of arbitration in high-stakes litigation that should curb any corporate defendants' enthusiasm for it, namely: "award is final & binding; limited grounds to vacate or modify award."[94] Securities class actions and derivative claims are paradigm cases of high-stakes disputes where corporate defendants fear an aberrational result imposing significant liability; hence meaningful judicial review is important.[95]

In addition, corporate defendants will likely prefer litigation over arbitration because, specifically with respect to federal securities claims, the PSLRA imposes procedural obstacles on plaintiffs[96] in order to achieve the statute's twin goals of "curb[ing] frivolous, lawyer-driven litigation, while preserving investors' ability to recover on meritorious claims."[97] Because arbitration is a more flexible, less law-oriented forum, arbitration panels may not apply these legal procedures rigorously. Accordingly, corporate defendants are not likely to find arbitration advantageous.

But what if publicly traded issuers could eliminate at least some high-stakes dispute resolution? That would certainly change the cost-benefit analysis. We turn now to the recent Supreme Court jurisprudence on class arbitration.

IV
CLASS ARBITRATION IN THE U.S. SUPREME COURT AND THE GAME CHANGER—*AT&T MOBILITY LLC V. CONCEPCION*

Since its 2005 opinion, *Green Tree Financial Corp. v. Bazzle*,[98] the Supreme Court has effected a complete reversal in its position on high-stakes arbitration, culminating in its 2011 opinion in *AT&T Mobility LLC v. Concepcion*,[99] the game changer that allows class action waivers in consumer arbitration.

In *Bazzle* a divided Court considered whether an arbitration clause in consumer-lending contracts that was silent on the issue of class arbitration could be interpreted to permit it. Justice Breyer, in an opinion joined by three other Justices,[100] stated that this was a state-law issue of contract interpretation that,

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Guide].

93. Advantages of arbitration that would be attractive to corporate defendants include the limited discovery production, the confidentiality of proceedings, and the parties' ability to select arbitrators, often with special expertise. *Id.* at 30.

94. *Id.* at 30, 32.

95. *See* Brief of the Chamber of Commerce of the United States of America as Amicus Curiae in Support of Petitioners at 16–17, Stolt-Nielsen S.A. v. Animalfeeds Int'l Corp., 130 S. Ct. 1758 (2010) (No. 08-1198).

96. *See* DONNA M. NAGY, RICHARD W. PAINTER & MARGARET V. SACHS, SECURITIES LITIGATION AND ENFORCEMENT 9–10 (2d ed. 2008).

97. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 322 (2007).

98. 539 U.S. 444 (2003).

99. 131 S. Ct. 1740 (2011).

100. Justice Stevens would have affirmed the judgment below, seeing no need to remand, but because that would have meant that there was no controlling judgment of the Court, he concurred in the judgment. *Bazzle*, 539 U.S. at 454 (Stevens, J., concurring in the judgment).

under the FAA, is decided by the arbitrator. In contrast, the dissenting Justices interpreted the contract term giving the commercial lender the right to select an arbitrator for each dispute as precluding class arbitrations.[101]

Courts[102] and commentators[103] interpreted *Bazzle* as authorizing arbitrators to permit class arbitrations so long as the arbitration agreement did not expressly prohibit it. In response to *Bazzle*, the AAA developed and implemented a set of rules to govern class arbitrations, which went into effect in October 2003.[104] As of September 2009, the AAA had administered 283 class actions under its class rules.[105] Although most were consumer- or employment-related claims, there was a small number that involved corporate or securities matters or other complex business disputes.[106]

Five years after *Bazzle*, the Supreme Court revisited the issue of the permissibility of class arbitration when the arbitration agreement is silent on the issue. In *Stolt-Nielsen S.A. v. AnimalFeeds International Corp.*,[107] a majority of the Justices held that the arbitrators exceeded their power under the FAA because they construed an arbitration clause in a shipping charter to permit class arbitration as a matter of public policy.[108] The parties stipulated that the arbitration clause was silent with respect to class arbitration and that "[a]ll the parties agree that when a contract is silent on an issue there's been no agreement that has been reached on that issue."[109] In reaching its decision, the arbitration panel relied in part on the fact that other arbitrators had, post-*Bazzle*, construed a variety of arbitration clauses to permit class arbitration, and that to rule otherwise "would leave 'no basis for a class action absent express agreement among all parties and the putative class members.'"[110]

In finding that the arbitration panel had exceeded its powers, Justice Alito, writing for the majority, made clear what he viewed as the essential hubris of the arbitration panel:

> Rather than inquiring whether the FAA, maritime law, or New York law contains a "default rule" under which an arbitration clause is construed as allowing class

101. *Id.* at 451 (majority opinion). Justice Thomas wrote a one-paragraph dissent reiterating his consistent position that the FAA did not apply to proceedings in state courts. *Id.* at 460 (Thomas, J., dissenting).

102. *E.g.*, Shroyer v. New Cingular Wireless Servs., Inc., 498 F.3d 976, 992 (9th Cir. 2007); Stolt-Nielsen S.A. v. AnimalFeeds Int'l Corp., 548 F.3d 85, 100 (2d Cir. 2008), *rev'd*, 139 S. Ct. 1758 (2010); Kinkel v. Cingular Wireless LLC, 857 N.E.2d 250, 262 (Ill. 2006).

103. *See, e.g.*, Carole J. Buckner, *Due Process in Class Arbitration*, 58 FLA. L. REV. 185, 187 (2006); Hans Smit, *Class Actions in Arbitration*, 14 AM. REV. INT'L ARB. 175, 176 (2003).

104. Brief of American Arbitration Association as Amicus Curiae in Support of Neither Party at 3–4, Stolt-Nielsen S.A. v. Animalfeeds Int'l Corp., 130 S. Ct. 1758 (2010) (No. 08-1198).

105. *Id.* at 22.

106. *See supra* note 76 and accompanying text.

107. 130 S. Ct. 1758 (2010).

108. The three dissenting Justices (Ginsburg, Stevens, and Breyer) argued that the issue was not ripe for judicial review because this was a "partial award" that ruled only that the arbitration clause permitted class arbitration. *Id.* at 1779 (Ginsburg, J., dissenting).

109. *Id.* at 1766 (majority opinion) (quotation marks omitted).

110. *Id.*

> arbitration in the absence of express consent, the panel proceeded as if it had the authority of a common-law court to develop what it viewed as the best rule to be applied in such a situation. Perceiving a post-*Bazzle* consensus among arbitrators that class arbitration is beneficial in "a wide variety of settings," the panel considered only whether there was any good reason not to follow that consensus in this case. . . . The conclusion is inescapable that the panel simply imposed its own conception of sound policy.[111]

The majority, moreover, did more than vacate the award; rather than remand to the arbitration panel, it went on to construe the arbitration clause as not permitting class arbitrations. Recognizing that this action appeared at variance with *Bazzle*, the majority took pains to narrow the import of that previous decision. Emphasizing repeatedly that the rationale of Justice Breyer's opinion did not constitute the views of a majority of Justices,[112] Justice Alito described *Bazzle*'s plurality opinion as addressing only one narrow question: that the arbitrators, and not the court, should decide whether a contract is "silent" on the question of class arbitration.[113] It did not, according to Justice Alito, address the standard for determining whether an arbitration agreement allows class arbitration.[114] In this discussion, Justice Alito raised the question whether the permissibility of class arbitrations is more than an issue of contract interpretation: "[D]oes the FAA entirely preclude class arbitration? Does the FAA permit class arbitration only under limited circumstances, such as when the contract expressly so provides? Or is this question left entirely to state law?"[115] Leaving these questions unanswered, the majority held that "an implicit agreement to authorize class-action arbitration . . . is not a term that the arbitrator may infer solely from the fact of the parties' agreement to arbitrate."[116]

In *Stolt-Nielsen*, the majority of the Court signaled that *Bazzle* should no longer be read to encourage class arbitrations.[117] In addition, in arriving at its

111. *Id.* at 1768–69.

112. Essentially, then, *Bazzle* established no precedent! *See* Thomas J. Stipanowich, Stipanowich on Stolt: Outcome Over Clarity (April 28, 2010), http://www.cpradr.org/Resources/ALLCPRArticles/tabid/265/ArticleType/ArticleView/ArticleID/587/Default.aspx ("It reminds me of the television show where a character woke up and discovered that the last couple of television seasons had all been a dream!").

113. *Stolt-Nielsen*, 130 S. Ct. at 1772 ("Unfortunately, the opinions in *Bazzle* appear to have baffled the parties in this case at the time of the arbitration proceeding. For one thing, the parties appear to have believed that the judgment in *Bazzle* requires an arbitrator, not a court, to decide whether a contract permits class arbitration. . . . In fact, however, only the plurality decided that question. But we need not revisit that question here because the parties' supplemental agreement expressly assigned this issue to the arbitration panel, and no party argues that this assignment was impermissible.").

114. *Id.* ("Unfortunately, however, both the parties and the arbitration panel seem to have misunderstood *Bazzle* in another respect, namely, that it established the standard to be applied by a decision maker in determining whether a contract may permissibly be interpreted to allow class arbitration.").

115. *Id.* at 1771.

116. *Id.* at 1775.

117. *See* SI Strong, *Opening More Doors Than It Closes*, 2010 LLOYD'S MAR. & COM. L.Q. 565, 568 (describing the opinion as signaling that the court may be cutting back its pro-arbitration precedent and as "extremely troubling").

conclusion that parties must agree specifically to class arbitration, the Court's majority opinion emphasized the fundamental differences between traditional arbitration and class arbitration. Thus, the majority reminded us, the typical arbitration is a relatively simple proceeding. Even when the subject matter of the dispute is complex, the task of the arbitrator is to resolve a single dispute that adjudicates the rights of a few identified parties who appear before the forum. In contrast, in a class arbitration, there is additional complexity because the arbitrator seeks to resolve many disputes that involve the adjudication of the rights of numerous parties, most of whom are absent from the proceeding. The Court made this point most explicitly when it compared and contrasted class arbitration and class-action litigation: "the commercial stakes of class-action arbitration are comparable to those of class-action litigation, . . . even though the scope of judicial review is much more limited . . . ."[118] In short, there should be certainty that parties have agreed to a method of dispute resolution that appears ill-suited to their needs.[119]

In addition, the Court highlighted two concerns that call into question the appropriateness of a private contractual justice system: the need to protect the interests of absent parties, and the importance of providing meaningful review of an arbitration award that has significant consequences for the parties, including absent class members.[120]

The Supreme Court returned to the differences between bilateral and class arbitration in *Concepcion*[121] and held that the FAA preempted California law that disallowed class action waivers in consumer arbitration agreements. Under California's *Discover Bank* rule, a waiver found in a consumer contract of adhesion, "in a setting in which disputes between the contracting parties predictably involve small amounts of damages," acts to exempt the responsible party from liability and is therefore unconscionable under California law.[122] Although the *Discover Bank* rule applied to the waivers of all class claims (judicial and arbitration), a majority of the Justices[123] found that it was "an obstacle to the accomplishment of the FAA's objectives":[124] "The overarching purpose of the FAA . . . is to ensure the enforcement of arbitration agreements according to their terms so as to facilitate streamlined proceedings. Requiring the availability of classwide arbitration interferes with fundamental attributes of

118. *Stolt-Nielsen*, 130 S. Ct. at 1776.

119. The *Stolt-Nielsen* majority emphasized that the agreement at issue involved arms-length bargaining among sophisticated parties, at least leaving open the possibility of distinguishing situations like *Concepcion* that involve consumer class arbitrations. *See id.* at 1775.

120. *Id.* at 1776.

121. AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740 (2011).

122. Discover Bank v. Superior Court, 113 P.3d 1100, 1110 (Cal. 2005).

123. Justice Thomas reluctantly joined the majority and wrote a concurring opinion founded on statutory interpretation of the FAA §§ 2, 4. *Concepcion*, 131 S. Ct. at 1753–56 (Thomas, J., concurring). Justice Breyer wrote a dissenting opinion, joined by Justices Ginsburg, Sotomayor, and Kagan. *Id.* at 1756 (Breyer, J., dissenting).

124. *Id.* at 1748 (majority opinion).

arbitration and thus creates a scheme inconsistent with the FAA."[125]

As did Justice Alito in *Stolt-Nielsen*, Justice Scalia enumerated the differences between bilateral and class arbitration to support his conclusion that "class arbitration, to the extent it is manufactured by *Discover Bank* rather than consensual, is inconsistent with the FAA."[126] In class arbitration, the traditional advantages of arbitration—informality, low cost, and speed—are lost because of the need for procedures to deal with class certification issues and protection of absent class members.[127] In particular, Justice Scalia emphasized the increased risks to defendants presented by class arbitration, where high stakes combined with minimal judicial review may work to pressure defendants into settling claims of questionable merit.[128] For these reasons, "[w]e find it hard to believe that defendants would bet the company with no effective means of review, and even harder to believe that Congress would have intended to allow state courts to force such a decision."[129]

Although *Concepcion* considered class action waivers in the context of consumer arbitration contracts, the majority's opinion does not suggest any inclination to limit its holding to that category of contract. Accordingly, *Concepcion* provides an incentive for publicly traded issuers that wish to eliminate securities class actions seriously to consider amending their governance documents to include an arbitration provision with a class action waiver.

V

LEGALITY OF CLASS ACTION WAIVERS IN SECURITIES CLASS ACTIONS

Suppose a publicly traded domestic issuer adopts an arbitration provision with a class action waiver. A class action waiver with respect to securities class actions raises two additional possible challenges to its validity: (1) it may be unenforceable because it is unconscionable under the FAA; and (2) it may be unenforceable, with respect to federal securities class claims, because it violates the anti-waiver provisions of the federal securities laws.[130] Before we examine the legal arguments, we need to consider the impact of a class action waiver on investors.[131]

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125. *Id.*

126. *Id.* at 1751.

127. *Id*.

128. *Id.* at 1752.

129. *Id.*

130. *See* supra notes 65–67 and accompanying text. State law may similarly restrict, on public policy grounds, limitations on liability. *See, e.g.*, Abry Partners V, L.P. v. F&W Acquisition LLC, 891 A.2d 1032, 1036 (Del. Ch. 2006) (holding that public policy does not permit a contractual provision to limit the remedy in the case of intentional misrepresentations).

131. An important issue is what the effect of an arbitration provision in the issuer's governance documents would have on potential third-party defendants, such as accountants and underwriters. *See* Thompson-CSF, S.A. v. Am. Arbitration Ass'n, 64 F.3d 773, 776–80 (2d Cir. 1995) (setting forth various contract and agency theories for requiring non-signatories to arbitrate).

Institutional investors would likely not experience a serious diminishment of their remedies, since they would be able to bring individual securities actions in the arbitration forum so long as their losses were large enough to make it cost-effective. Some institutional investors, in fact, have recently opted out of class actions to pursue their own remedies when they have a sufficient amount at stake.[132] Requiring them to bring their actions in a commercial arbitration forum (such as AAA) is not likely to present any difficulties that experienced litigators could not adjust to; as noted above, there have been federal securities claims filed in the AAA forum.[133]

For other investors, particularly small retail investors, however, it is a different story. Their claims will not be sufficiently large to make it economically feasible to bring individual arbitration claims. The costs of proving a federal securities fraud claim—including falsity, materiality, efficient market, scienter, causation, and damages[134]—are generally so large as to make pursuing individual claims infeasible for small retail investors. The only chance for compensation for their losses will be if the SEC, or another regulator, brings an enforcement action against the issuer, obtains a monetary recovery, and establishes a fund to compensate investors.[135] In instances where a regulator does not pursue actions against issuers, small investors will not be compensated for their losses. Will the lack of an available remedy cause courts to strike down a class arbitration waiver under the FAA or federal securities laws?

In its 2000 opinion, *Green Tree Financial Corp. v. Randolph*, the Supreme Court stated that "it may well be that the existence of large arbitration costs could preclude a litigant . . . from effectively vindicating her federal statutory rights in the arbitral forum."[136] The Second Circuit has been hostile toward class action waivers for this very reason. In its first opinion in *In re American Express Merchants' Litigation*,[137] the Second Circuit held that a class action waiver was unenforceable because it would effectively preclude individual plaintiffs from vindicating their statutory rights under federal antitrust law,[138] because of the high litigation costs and the small potential recovery.[139] The court agreed with

132. *See* John C. Coffee, Jr., *Accountability and Competition in Securities Class Actions: Why "Exit" Works Better than "Voice"*, 30 CARDOZO L. REV. 407, 426–29 (2008).

133. *See supra* notes 73–79. In fact the plaintiffs in *Harvard* voluntarily brought this as an arbitration; they could have gone to federal district court. Demand for Class Arbitration, President and Fellows of Harvard Coll. v. JSC Surgutneftegaz, American Arbitration Association, AAA No. 11 168 T 01654 04, June 29, 2004, at 13, *available at* http://www.adr.org/si.asp?id=3544.

134. *See* Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 341 (2005) (setting forth the elements of an action).

135. For a description of the SEC's authority to establish Fair Funds for investor compensation, see Barbara Black, *Should the SEC Be a Collection Agency for Defrauded Investors?*, 63 BUS. LAW. 371 (2008).

136. 531 U.S. 79, 90 (2000).

137. 554 F.3d 300, 312 (2d Cir. 2009), *vacated sub nom*, Am. Express Co. v. Italian Colors Rest., 130 S. Ct. 2401 (2010). For further discussion of this case, see Black, *supra* note 19, at 834–35.

138. 554 F.3d at 304.

139. *Id.* at 317 (quotation marks removed).

the plaintiffs that the class action waiver "flatly ensures that no small merchant may challenge American Express's tying arrangements,"[140] a troubling outcome because "private suits provide a significant supplement to the limited resources available to the Department of Justice for enforcing the antitrust laws and deterring violations."[141] Defendants sought certiorari before the Supreme Court, which granted the petition, vacated the decision, and remanded for reconsideration in light of *Stolt-Nielsen.*[142]

In its opinion on remand, which was decided prior to *Concepcion*, the Second Circuit affirmed its earlier decision,[143] essentially finding that *Stolt-Nielsen* was not relevant:

> While *Stolt-Nielsen* plainly rejects using public policy as a means for divining the parties' intent, nothing in *Stolt-Nielsen* bars a court from using public policy to find contractual language void. We agree with plaintiffs that "[t]o infer from *Stolt-Nielsen*'s narrow ruling on contractual construction that the Supreme Court meant to imply that an arbitration is valid and enforceable where, as a demonstrated factual matter, it prevents the effective vindication of federal rights would be to presume that the *Stolt-Nielsen* court meant to overrule or drastically limit its prior precedent."[144]

Some commentators hold out the hope that *American Express Merchants* can stand post-*Concepcion*.[145] It is possible to distinguish *Concepcion* on legal grounds, because the Supreme Court's majority ruled that the FAA preempts a state law invalidating class action waivers as unconscionable but did not address unconscionability as a question of substantive arbitration law. Moreover, *Concepcion* can be factually distinguished, because AT&T had, in fact, provided an attractive arbitration remedy for individual consumers so that they were not left without a remedy.[146] Nevertheless, the tenor of the majority's opinion in *Concepcion* does not suggest that those Justices would be amenable to narrowing its holding.

The argument that a waiver of a securities class action violates the anti-

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140. *Id.* at 319 (quotation marks removed).

141. *Id.*

142. *Am. Express Co.*, 130 S. Ct. 2401.

143. *In re* Am. Express Merchs. Litig., 634 F.3d 187, 200 (2d Cir. 2011).

144. *Id.* at 199 (quoting plaintiffs' brief); *see also* Chen-Oster v. Goldman, Sachs & Co., No. 10 Civ. 6950 (LBS) (JCF), 2011 WL 1795297, at *12–13 (S.D.N.Y. Apr. 28, 2011) (denying employer's motion to compel arbitration because a former employee's discrimination claims could not be vindicated in individual arbitration).

145. The Second Circuit reaffirmed its analysis post-*Concepcion*. *In re* Am. Express Merchs. Litig., No. 06-1871-cv, 2012 U.S. App. Lexis 1871 (2d Cir. Feb. 1, 2012). *See also* S.I. Strong, *Does Class Arbitration 'Change the Nature' of Arbitration?* Stolt-Nielsen*,* AT&T*, and a Return to First Principles*, 17 HARV. NEGOT. L. REV. (forthcoming 2012) (manuscript at 28, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1791928) (arguing that *Concepcion* "deals only with state-law preemption issues and leaves courts free to strike class action waivers on other grounds").

146. Any arbitration would be conducted in the county where the customer was billed, and, for small claims, customers could choose to conduct arbitration personally, telephonically, or just through submissions. AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740, 1744 (2011). AT&T would pay all costs for non-frivolous claims, could not seek reimbursement of its attorney fees, and was subject to punitive damages. *Id.* If an arbitration award was granted greater than AT&T's last written settlement offer, AT&T was required to pay a minimum recovery of $7500 plus double attorney's fees. *Id.*

waiver provisions of the federal securities laws because of the loss of the individual investors' private remedy is stronger. As the *McMahon* majority stated, Exchange Act § 29(a) is concerned with whether the agreement "'weakens [customers'] ability to recover under the Exchange Act.'"[147] It is well-established that § 29(a) does not permit provisions that weaken investors' ability to recover under the federal securities laws, no matter what form they take.[148] The high costs of pursuing federal securities claims means that, unless a class-wide remedy is available, there is, as a practical matter, no remedy for investors with small holdings. A class action waiver in this context is the equivalent of a waiver of investor protections prohibited by the anti-waiver provisions.

To counter this argument, opponents of the federal securities class action assert that class actions serve poorly the compensatory function, and, therefore, the individual investors would not lose anything of significance by waiving their rights to participate in a class.[149] Moreover, in *Stoneridge Investment Partners LLC v. Scientific-Atlanta, Inc.*,[150] the Court suggested that it agreed with business interests that the power of regulators to recover funds for the compensation of fraud victims provided an adequate opportunity for compensation. To the extent that courts doubt the compensatory function of class actions, the policy argument based on the anti-waiver provisions is less compelling.

There are implications beyond investor compensation if issuers prove successful in replacing securities class actions with individual arbitrations. It is worth remembering that there is a fundamental difference between arbitration and litigation. Arbitration is a contractual private system of justice, where the arbitrators are selected by the parties for the sole purpose of deciding the dispute before them. Their charge is to meet their contractual responsibilities to the parties.[151] Litigation, in contrast, takes place in a government forum, before government officials with a responsibility to look out for the public interest. Adjudications, unlike arbitrations, fulfill the functions of developing legal standards, deterring violations, and satisfying investors' right to know the laws

147. Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 230 (1987) (quoting Wilko v. Swan, 346 U.S. 427, 432 (1953)).

148. *See, e.g.*, Vacold LLC v. Cerami, 545 F.3d 114, 122 (2d Cir. 2008) (release in stock purchase agreement); AES Corp. v. Dow Chem. Co., 325 F.3d 174, 183 (3d Cir. 2003) (non-reliance clause in stock purchase agreement); McMahan & Co. v. Wherehouse Entm't, Inc., 65 F.3d 1044, 1051 (2d Cir. 1995) (no-action clause in indenture); Anglo-German Progressive Fund, Ltd. v. Concorde Grp., Inc., No. 09 Civ. 8708(PKC), 2010 WL 3911490, at *9 (S.D.N.Y. Sept. 14, 2010) (merger clause); Citibank v. Itochu Int'l, Inc., No. 01 Civ. 6007(GBD), 2003 WL 1797847, at *2 (S.D.N.Y. Apr. 4, 2003) (clause specifying indemnification as sole remedy); Special Transp. Servs., Inc. v. Balto, 325 F. Supp. 1185 (D. Minn. 1971) (clause providing for alternative remedy).

149. *See* John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay in Deterrence and its Implications*, 106 COLUM. L. REV. 1534, 1545 (stating that, "from a compensatory perspective, the conclusion seems inescapable that the securities class action performs poorly").

150. 552 U.S. 148, 166 (2008).

151. Stolt-Nielsen S.A. v. Animalfeeds Int'l Corp., 130 S. Ct. 1758, 1774–75 (2010).

are being enforced. Ironically, the best argument for the importance of the federal securities class action is the PSLRA, legislation that came about largely through the lobbying efforts of the business community. Business interests urged Congress to eliminate the FOTM presumption, without which securities fraud class actions would be difficult, if not impossible, to maintain.[152] Instead, the PSLRA sought to weed out frivolous suits through a variety of procedural and other measures.[153] In choosing to cure, but not eliminate, the securities class action, Congress determined that a class action remedy is necessary for investor protection, especially retail investors. In the PSLRA Congress thus confirmed the importance of the federal securities class action to the integrity of the U.S. capital markets.[154]

VI
CONCLUSION

As this article has explained, post-*Concepcion*, publicly traded domestic issuers have good reason to consider seriously the adoption of arbitration provisions, with class action waivers, in their governance documents. Although there is considerable uncertainty about the legality and enforceability of such a provision, an issuer may well consider the potential benefits worth fighting for.

Although the enforceability of an arbitration provision in governance documents raises interesting and complex legal questions, the overarching policy issue is the future of the securities class action. Respected academics have previously called for the SEC to take an active role in assessing the strengths and weaknesses of the federal securities class action.[155] There have been similar calls for reform of state securities class actions.[156] Before issuers undertake to adopt changes to their corporate governance documents to eliminate securities class actions, a re-examination of their costs and benefits is in order.

152. *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 664–67 (3d ed. 2003).

153. For a brief description of the key provisions, see NAGY ET AL., *supra* note 96, at 9–10.

154. *See* H.R. Rep. No. 104-369, at 26 (1995) (Conf. Rep.), *reprinted in* 2 U.S.C.C.A.N. 730, 731.

155. *See, e.g.*, Letter from Professor Donald C. Langevoort et al. to SEC Chairman Christopher Cox (Aug. 2, 2007), *available at* http://www.law.du.edu/images/uploads/corporate-governance/sec-governance-langevoort.pdf.

156. *See, e.g.*, Mark Lebovitch, Jerry Silk & Jeremy Friedman, *Making Order Out of Chaos: A Proposal to Improve Organization and Coordination in Multi-Jurisdictional Merger-Related Litigation*, BERNSTEIN LITOWITZ BERGER & GROSSMANN LLP, http://www.blbglaw.com/misc_files/MakingOrderoutofChaos (last visited Nov. 11, 2011).