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The Problems With Mandatory Arbitration Of Securities Claims

Written By:
Samuel M. Ward and Michael A. Toomey
Barrack, Rodos & Bacine

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A brief remark from SEC Commissioner Michael Piwowar during a July 17, 2017, Q&A has caused great concern among investors that the U.S. Securities and Exchange Commission might soon allow companies to introduce mandatory arbitration clauses into their corporate charters.[1] If allowed, required arbitration would have a fundamental, adverse effect on the ability of investors to protect themselves against wrongdoing by corporations and their directors and officers. If mandatory arbitration were to be widely adopted, investors could be prohibited from asserting claims in federal court under the federal securities laws, which would effectively result in the loss of the very protections that these laws were designed to provide.


Samuel M. Ward

The Piwowar remark cannot be lightly dismissed. In a recent article on the issue, Alison Frankel of Reuters asked what the implications of this SEC change of heart might be:

> I talked to six securities law professors on Tuesday about the implications of mandatory shareholder arbitration provisions. Most said a pro-arbitration Supreme Court would likely uphold the legality of such provisions. And though Jill Fisch of the University of Pennsylvania suggested that state legislators might try to act to prohibit corporations from requiring shareholders to arbitrate disputes, much as Delaware lawmakers squelched loser-pays provisions in 2015, Michigan's Pritchard said the Federal Arbitration Act would probably pre-empt a state law disfavoring arbitration.[2]

The recent history of U.S. Supreme Court cases on arbitration has indeed been unfriendly for litigants trying to defeat arbitration agreements. Beginning with its decision in *Shearson/American Express v. McMahon*[3] and continuing to today, the Supreme Court has consistently upheld arbitration agreements even when the other party had no real choice.[4] But mandatory arbitration would profoundly limit investor rights, emboldening the small minority of companies and executives who engage in fraudulent conduct while foreclosing many investors from seeking recompense for that fraud.


Michael Toomey

Forcing investors to pursue binding arbitration, individually or on behalf of a class, ignores Congress' intent in enacting the Private Securities Litigation Reform Act, which has governed federal securities litigation since 1995. It also ignores the fact that the class action mechanism is uniquely suited to addressing allegations of securities fraud. Finally, it ignores a fundamental weakness in arbitrations: addressing disputes where there is a substantial imbalance between the parties regarding information underlying the claims.

The Problems with Mandatory Arbitration of Federal Securities Law Claims

Typically in a commercial dispute, each party is an active participant in the transaction underlying the claim. Thus, the parties to the dispute begin on a relatively even informational playing field; both sides know the facts and, more importantly, have equal access to evidence (documents and witnesses). In contrast, in securities actions, plaintiffs are at a distinct disadvantage, as their role in the transaction does not typically extend beyond purchasing the securities at issue; plaintiffs have limited or no access to evidence beyond that in the public sphere.

In addition to this natural disadvantage that investors suffer in pursuing securities actions, the PSLRA adds additional hurdles to investor plaintiffs, including more difficult pleading requirements. If investors survive this onerous standard, however, and the case is not dismissed, investors can then obtain discovery of the company's internal documents (including memos, emails, spreadsheets, transcripts from related proceedings, communications with business customers, partners and auditors, to name a few examples) and take depositions under oath of persons with particular knowledge of the facts and issues involved in the case. The discovery tools in federal court are needed because the alleged wrongdoers control virtually all the evidence relevant to the claims.

Unfortunately, the Commercial Arbitration Rules and Mediation Rules of the American Arbitration Association, the largest arbitration forum in the United States, are structured in a way that prevents plaintiffs from conducting discovery in this way. Under these rules, discovery is limited; the arbitrator's management of the exchange and production of information is undertaken "with a view to achieving an efficient and economical resolution of the dispute …."[5] Indeed, even the rules specific to "large, complex commercial disputes" provide for depositions only "in exceptional cases."[6] Thus, while investigations may be conducted in the context of an arbitration, they will not likely turn up internal company documents or provide the investor with access to company witnesses whose testimony would be essential to prove the claims. As a result, investors who pursue arbitration will be left at a distinct disadvantage, barred for the most part from obtaining the types of meaningful discovery that is necessary to prove fraud and that is available in class action litigation to plaintiffs who are able to meet the PSLRA's heightened pleading standard.

Permitting classwide arbitration would not solve this problem. Investors would face the same uneven playing field as with individual arbitration. Moreover, actually achieving a resolution through classwide arbitration poses several unique challenges. For example, in *Oxford Health Plans v. Sutter*, the Supreme Court held that defendants cannot be compelled to engage in classwide arbitration absent their agreement.[7] Thus, were a corporate charter to provide for arbitration but be silent as to classwide arbitration, a defendant corporation may challenge any effort to compel classwide arbitration, instead demanding arbitration on an individual basis. There would also be serious questions concerning whether the arbitration tribunal could obtain jurisdiction over potential noncorporate defendants. Similarly, it is unclear how issues of personal jurisdiction over absent class members would be resolved in a putative classwide arbitration.

In contrast, securities class actions litigated in federal court provide all parties — the plaintiff, all potential defendants and absent class members — with the certainty that a judgment can be enforced on behalf of (or against) class members, coupled with the ability for absent class members, on proper notice, to opt out of the litigation.

Absent classwide arbitration, requiring investors to arbitrate securities claims would also prove to be uneconomical for all but the most significantly injured investors, and would likely create significant duplication of effort on the part of both investors and defendants while raising the prospect of inconsistent results, as multiple parties seek to arbitrate claims that are now litigated on a classwide basis.

Piwowar's Suggestion Contravenes the Intent of Congress in Passing the PSLRA

In enacting the PSLRA, Congress expressed its intent to guarantee investors the ability to litigate securities claims classwide in court. As reflected in the legislative history, the PSLRA's purpose was to "encourage the most capable representatives of the plaintiff class to participate in class action litigation" and "increase the likelihood that parties with significant holdings in issuers, whose interests are more strongly aligned with the class of shareholders, will participate in the litigation."[8] Congress expected that "increasing the role of institutional investors in class actions will ultimately benefit shareholders and assist courts by improving the quality of representation in securities class actions."[9] Following enactment of the PSLRA, institutional investors stepped up to the plate and have served as lead plaintiffs in 91 of the 100 largest securities class action settlements, all of which involved actions that were filed following passage of the PSLRA.[10] The results achieved by these institutional investors are nothing short of stellar. Indeed, these 91 settlements collectively recovered approximately $60 billion for investors.[11]

The challenges posed by forced arbitration are indicative of the effectiveness of the class action device in addressing securities fraud claims. Class members share the same injuries, arising from the same conduct giving rise to the claim. The inconsistencies in causation and damages often raised in nonsecurities class actions are all but absent in securities class actions. Moreover, securities class actions provide the ability to aggregate the claims of investors who, while damaged, may not have suffered damages substantial enough to support individual litigation (or arbitration). Thus, securities class actions represent the ideal application of the class action device, as reflected in Congress' enactment of the PSLRA. In contrast, forced arbitration of securities fraud claims would be inefficient and inconsistent with the intent of Congress in passing the PSLRA, and would provide substantial advantage to companies and their executives who defraud investors. The imposition of forced arbitration would substantially erode investor rights and weaken our capital markets.

In sum, Piwowar's words have cast doubt on the ability of investors to fight back against corporate fraud in an open, public setting that has yielded excellent results since enactment of the PSLRA. They threaten the right of investors to a jury trial. They similarly would enshroud the prosecution of claims of corporate fraud in a veil of secrecy, in contrast to securities fraud actions in court that are adjudicated in a public trial, and often following summary judgment motions and responses that make public evidence that may have been produced under a confidentiality designation. What's more, they threaten yet another fundamental legal right: the right to appeal.

> "The reputed informality and the relative speediness of an arbitration procedure are achieved by severely limited discovery, imposing few evidentiary rules, giving the arbitrator almost unbridled discretion to make decisions without basing them on established principles of law or making written findings to support the arbitrator's conclusions, and providing virtually no right of appeal in the case of error in the arbitrator's decision."[12]

What Can Be Done to Protect Investors' Rights?

So what can stop this infringement of shareholder rights? The best course would be for investors, institutional and otherwise, to make their views known in any SEC rule-making procedure that allowing corporations to require arbitration of claims brought under the federal securities law would not only contravene the intent of Congress, as enacted in the PSLRA, but would also significantly impair the rights of investors and further encourage instances of corporate fraud and deception. But there may be other methods of preventing it.

A recent article in the D&O Diary noted that mandatory arbitration provisions in a company's bylaws or charter could also be defeated by an act of Congress.[13] Given Congress' current composition, however, that's unlikely. It is far more likely that state legislatures would try to intervene to prohibit arbitration bylaw or charter provisions. Indeed, in 2015, Delaware amended its corporate law to prevent Delaware corporations from including mandatory arbitration clauses in their charters or bylaws, at least to the extent such clauses would inhibit "internal corporate claims" from being brought in Delaware courts.[14]

But most claims under the federal securities laws do not involve internal corporate claims. As a result, states wishing to prohibit their domestic corporations from mandating arbitration of investor claims would need to enact broader anti-arbitration provisions. How would the courts respond to those state laws? We know that the Supreme Court has been very hard on states that resist compelled arbitration, consistently holding that the Federal Arbitration Act "preempts any state rule discriminating on its face against arbitration — for example, a 'law prohibit[ing] outright the arbitration of a particular type of claim.'"[15] Nonetheless, this may be a unique situation.

Bylaws and charters are not like the everyday commercial contracts that include mandatory arbitration agreements. These are the documents that "plainly relate to the 'business of the corporation[s],' the 'conduct of [their] affairs,' and regulate the 'rights or powers of [their] stockholders,'"[16] which are nearly exclusively governed by the law of the state of incorporation. "The [U.S.] Supreme Court consistently has reiterated that corporate law, including governance and shareholder rights, is a field traditionally left to the states."[17] "It … is an accepted part of the business landscape in this country for states to create corporations, to prescribe their powers, and to define the rights that are acquired by purchasing their shares. A state has an interest in promoting stable relationships among parties involved in the corporations it charters, as well as in ensuring that investors in such corporations have an effective voice in corporate affairs."[18] Indeed, we are unaware of any situation in which the federal government has dictated what can and cannot be in a particular state's bylaws and charters. Thus, Piwowar's remarks appear to be an attempt to invade the states' jurisdiction.

Moreover, the FAA applies to arbitration provisions only in contracts.[19] So a threshold FAA question is whether a corporate charter is a contract. While Delaware jurisprudence likens the corporate charter and bylaws to a contract,[20] it is not clear that federal courts would consider these governance documents to be the type of "contracts" that the FAA was intended to regulate. Professor Ann Lipton of Tulane University Law School argues compellingly that the FAA should apply only to contracts between arm's-length counterparties, a far cry from charters and bylaws, which govern the relationship between stockholders and their fiduciaries.[21] Lipton also points out that it is far from clear that the mandatory arbitration provisions in charters or bylaws should control the forum for federal securities claims or other types of claims that do not involve a corporation's internal affairs.[22]

So given this situation, where there is an invasion of the states' rights to police their corporations and the prospect that these clauses might be an attempt to immunize corporations from securities class actions, where would the Supreme Court come down? That's less than clear, despite the strong jurisprudence favoring arbitration.

Justice Clarence Thomas has consistently stated (in dissent) that the FAA does not apply to state courts because "[t]o the extent that federal statutes are ambiguous, we do not read them to displace state law. Rather, we must be 'absolutely certain' that Congress intended such displacement before we give preemptive effect to a federal statute."[23] What's more, Justice Elena Kagan, joined by Justices Stephen Breyer and Ruth Bader Ginsburg, has stated (also in dissent) that an arbitration clause should not immunize defendants from "potentially meritorious federal claims."[24] Justice Sonia Sotomayor took no part in the decision in which Justice Kagan dissented, but these four justices have dissented together in other arbitration cases regarding class action waivers.[25] Thus, this situation may be one in which both the conservative and liberal wings of the court would find common cause against Piwowar's recommendation.

While speculating about what the Supreme Court might do in a case is always risky, this may offer a unique situation where the Supreme Court would finally limit its expansive view of the FAA and stop the march toward corporation-mandated arbitration and thus prevent corporations from using mandatory arbitration clauses in their charters to inhibit stockholders from bringing meritorious securities class actions in court.

Samuel M. Ward, a partner in the San Diego office of Barrack Rodos & Bacine, regularly participates in the prosecution of securities class actions. Michael A. Toomey, an associate in the firm's New York office, concentrates his practice on actions involving corporate governance as well as on securities class actions.

ENDNOTES:

[1] https://www.c-span.org/video/?431364-1/michael-piwowar-remarks-businesses-regulation-economy (see 1:04:01 mark where Piwowar said, "For shareholder lawsuits, companies can come to us to ask for relief to put in mandatory arbitration into their charters.")

[2] A. Frankel, Shareholder alert: SEC Commissioner floats class-action-killing proposal, Reuters (July 18, 2017), http://www.reuters.com/article/us-otc-arbitration-idUSKBN1A326T.

[3] 482 U.S. 220 (1987).

[4] For example, in many consumer contracts, such as those for cellular phone or cable television service, contracts are not negotiable and providers have universally adopted mandatory arbitration provisions, leaving consumers with no recourse other than to forego the service at issue. *See, e.g. AT&T Mobility v. Concepcion*, 563 U.S. 333 (2011) (reversing a Ninth Circuit decision in which the appellate court voided a mandatory arbitration provision in a contract for cellular telephone service upon a determination that it was a contract of adhesion).

[5] Commercial Arbitration Rules and Mediation Rules of the American Arbitration Association at R-22(a) (amended Oct. 1, 2013), https://www.adr.org/sites/default/files/Commercial%20Rules.pdf.

[6] Id. at L-3(f).

[7] 133 S. Ct. 2064 (2013).

[8] H.R. Rep. No. 104-369 at 32.

[9] Id. at 34.

[10] Securities Class Action Services, The Top 100 U.S. Settlements of All Time (2017), https://www.issgovernance.com/file/publications/SCAS-Top-100-US-Settlements-31Dec2016.pdf.

[11] Id.

[12] 21 Williston on Contracts, Fundamental Due Process § 57:91 (4th ed.).

[13] Kevin LaCroix, Up Next: Mandatory Securities Claim Arbitration Provisions? July 19, 2017, http://www.dandodiary.com/2017/07/articles/securities-litigation/next-mandatory-securities-claim-arbitration-provisions/#more-14247.

[14] Del. Code Ann. tit. 8, § 115; R. Franklin Balotti & Jesse A. Finklestein, The Delaware Law of

Corporations and Business Organizations, § 115 FORUM SELECTION PROVISIONS, 2016 WL 17159.

[15] *Kindred Nursing Centers Ltd. P'ship v. Clark*, 137 S. Ct. 1421, 1426, 197 L. Ed. 2d 806 (2017) (*citing Am. Exp. Co. v. Italian Colors Rest.*, 133 S. Ct. 2304, 2314, 186 L. Ed. 2d 417 (2013)).

[16] *Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934, 939 (Del. Ch. 2013).

[17] *Freedman v. Redstone*, 753 F.3d 416, 430 (3d Cir. 2014).

[18] *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 91 (1987).

[19] 9 U.S.C. § 2.

[20] *Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934, 939 (Del. Ch. 2013) ("our Supreme Court has long noted that bylaws, together with the certificate of incorporation and the broader DGCL, form part of a flexible contract between corporations and stockholders"); *Airgas Inc. v. Air Prods. & Chems. Inc.*, 8 A.3d 1182, 1188 (Del. 2010) ("[c]orporate charters and bylaws are contracts among a corporation's shareholders ..."); *STAAR Surgical Co. v. Waggoner*, 588 A.2d 1130, 1136 (Del. 1991) ("a corporate charter is both a contract between the State and the corporation, and the corporation and its shareholders"); *Centaur P'rs, IV v. Nat'l Intergroup Inc.*, 582 A.2d 923, 928 (Del. 1990) ("[c]orporate charters and by-laws are contracts among the shareholders of a corporation ...")

[21] Ann M. Lipton, Manufactured Consent: The Problem of Arbitration Clauses in Corporate Charters and Bylaws, 104 Geo. L.J. 583, 616 (2016) ("[T]he terms of the corporate contract are imposed by the directors and the state itself as a substitute for shareholders' voluntary consent .... The FAA, and the contractual doctrine on which it rests, start from the presumption that contracts to arbitrate represent the choices of autonomous persons who are better positioned than the state to bargain for their interests.").

[22] Id. at 598 ("there is no reason to believe that corporate governance documents, regulated by the law of the state of incorporation, can dictate mechanisms for bringing claims that do not concern corporate internal affairs, such as claims alleging fraud in connection with a securities sale").

[23] *Allied-Bruce Terminix Companies Inc. v. Dobson*, 513 U.S. 265, 292 (1995) (Thomas, J. dissenting) (citations omitted).

[24] *Am. Exp. Co. v. Italian Colors Rest.*, 133 S. Ct. 2304, 2313 (2013) (Kagan, J. dissenting).

[25] *AT&T Mobility LLC v. Concepcion*, 563 U.S. 333, 357 (2011) (Breyer, J. dissenting).