STOCKHOLDER ADOPTION OF MANDATORY INDIVIDUAL ARBITRATION FOR STOCKHOLDER DISPUTES

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INTRODUCTION

Federal Rule of Civil Procedure 23 and the Private Securities Litigation Reform Act of 1995 (PSLRA)[1] together govern securities class actions. These regimes provide that a class representative may bring a claim against a corporation on behalf of all investors who owned a security at a time when there was an alleged misstatement or failure to disclose a material fact that caused loss. By default all potential members of a class—all investors who owned the security during the relevant time (before the misstatement or omission was corrected)—are included in the class unless they take the affirmative step of opting out. Inertia, therefore, works to expand the class.

1. Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 and 18 U.S.C.). One of the stated purposes of the PSLRA was to provide greater discipline by creating a more stringent check on bringing stockholder suits. For example, the Act mandated that changes in an issuer's stock price, without further investigation of culpability, was an insufficient basis on which to bring a claim. H.R. Rep. No. 104-369, at 31 (1995) (Conf. Rep.).

Allowing stockholders to vote to adopt mandatory individual arbitration gives them a choice whether to accept the uncertain benefits and high costs of securities class actions. Securities class actions have two principal rationales: compensation and deterrence.[2] The case for compensation is weak and generally rejected by commentators. Long-term stockholders end up suing themselves while recoveries are offset by plaintiff attorneys' fees amounting to 25–35% of the settlement[3] and defense costs in the same range.[4] At the same time, choosing which short-term stockholders recover and which pay is decidedly random, given that shares are held on average for just slightly longer than one year.[5] Further, securities class actions generally do not provide redress to smaller stockholders. Indeed, smaller investors often do not bother to collect their settlements because they are so small—we have all experienced throwing class action notices in a wastebasket. Courts left with unclaimed funds often give them to the parties that filed claims in a second round of pro-rata distribution and even sometimes to charity.

The case for deterrence is ambiguous at best. First, private securities class actions supplement the United States' robust system of public civil and criminal enforcement through the actions of the Department of Justice (DOJ), the Securities and Exchange Commission (SEC), and state attorneys general and securities enforcement officials.[6] Second, the settlements and

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2. John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation*, 106 COLUM. L. REV. 1534, 1538 (2006). Proponents also argue that private attorneys seeking substantial fees will do a better job of constructing the case. Evidence does not support that claim, however, as many private securities class actions follow or copy the enforcement actions of the Securities and Exchange Commission (SEC) and the Department of Justice (DOJ). *See infra* note 52.

3. Coffee, *supra* note 2, at 1546, 1558.

4. *See* Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' and Officers' Liability Insurer*, 95 GEO. L.J. 1795, 1815 n.95 (2007).

5. The annualized share turnover rate was about 86% at the end of 2011. *See Facts & Figures*, NYSE TECHNOLOGIES, *available at* http://www.nyxdata.com/factbook.

6. Of course, courts serve as an important check on the adequacy of public enforcement. For example, several judges recently hesitated to approve settlements between the SEC and issuers when the judges deemed those settlements inadequate. *See, e.g.*, Zachary A. Goldfarb, *Judge balks at SEC's settlement with Citigroup*, WASH. POST, Aug. 17, 2010, at A11; Dan Fitzpatrick et al., *Rakoff Backs BofA Accord, Unhappily*, WALL ST. J., Feb. 22, 2010, http://online.wsj.com/article/NA_WSJ_PUB:SB10001424052748704454304575081373576395894.html.

judgments primarily impact stockholders, not management. Managers seeking short-term profits from stock performance are unlikely to be deterred by the later possibility of class actions whose impact will fall on all stockholders. Third, the major deterrence from management misdeeds comes from the disclosure of wrongdoing rather than the bringing of class actions: after disclosing wrongdoing, a firm can be expected to lose about 40% of its value, most of it due to a reputational penalty rather than losses from anticipated litigation, which are estimated to account for less than 9% of the decline in value,[7] and almost all of the responsible parties quit or are fired.[8]

Securities class actions are also a serious problem for the attractiveness of the U.S. public capital markets. The prevalence and cost of such suits drive capital abroad or into the private markets, as the Committee on Capital Markets Regulation (the Committee) documented,[9] and reduce venture capital investment because of the increased liability risk of going public (and getting the multiples that go with such exit). In 2012, investors filed 152 federal class actions alleging securities fraud[10] and courts approved 93 settlements with an aggregate payout of $3.3 billion.[11] In the past, these settlements have risen to as much as $19 billion in a single year.[12] Because stockholder class actions

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7. Jonathan M. Karpoff et al., *The Cost to Firms of Cooking the Books*, 43 J. FIN. & QUANT. ANALYSIS 581, 582 (2008).

8. *See* Jonathan M. Karpoff et al., *The Consequences to Managers for Financial Misrepresentation*, 88 J. FIN. ECON. 193 (2008). Mark L. Humphery-Jenner argues that stockholder class actions "are a catalyst to promote disciplinary takeovers, CEO turnover and pay-cuts, and harm CEOs' future job-prospects," but does not address the likelihood that these disciplinary effects come from the disclosure of wrongdoing (and the accompanying expectation of a subsequent SEC or DOJ action) rather than the class action itself. Mark L. Humphery-Jenner, *Internal and External Discipline Following Securities Class Actions*, 21 J. FIN. INTERMEDIATION 151 (2012).

9. *See* COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT 71 (2006) [hereinafter CCMR INTERIM REPORT].

10. *See* CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS: 2012 YEAR IN REVIEW 1 (2012) [hereinafter CORNERSTONE FILINGS 2012].

11. RENZO COMOLLI ET AL., NERA ECONOMIC CONSULTING, RECENT TRENDS IN SECURITIES CLASS ACTION LITIGATION: 2012 FULL-YEAR REVIEW 23, 31 (2012), *available at* http://www.nera.com/67_7992.htm [hereinafter NERA FULL-YEAR REVIEW 2012].

12. *See* ELLEN M. RYAN & LAURA E. SIMMONS, CORNERSTONE RESEARCH, SECURITIES CLASS ACTION SETTLEMENTS: 2011 REVIEW AND ANALYSIS 1 (2011) [hereinafter CORNERSTONE SETTLEMENTS 2011]. Note that some settlements approved in 2010 relate to suits filed before 2010. Totals are calculated in 2010 dollar equivalents.

are almost uniquely American, it is not hard to see how these suits dampen the competitiveness of the U.S. capital markets.

Arbitration, by contrast, is a means of resolving stockholder disputes that does not present the same concerns of high cost and uncertain benefit inherent in securities class actions. Arbitration is a common means of dispute resolution in other securities laws disputes, for instance, between broker-dealers and their customers.[13] By its nature, mandatory individual arbitration requires more engaged stockholders, which may result in larger settlements for those that are so engaged.

Nonetheless, arbitration has many vocal opponents. These opponents question whether a majority of stockholders in a corporation can bind the minority through a by-law provision like the one we propose; they claim arbitration is unfair; and finally, they assert that mandatory arbitration would deprive individual plaintiffs of their right to litigate. In response to these arguments, as discussed below, Delaware law is clear that a majority of stockholders have the right to bind a minority and that an arbitration requirement is permitted in a corporation's by-laws. This conclusion arguably has been reinforced by the recent Supreme Court's decision in *AT&T Mobility LLC v. Concepcion*,[14] which makes clear that mandatory individual arbitration provisions are enforceable in the consumer contract context.[15] Furthermore, there are strong counterarguments to the claim that arbitration is inherently unfair. Finally, regarding the argument that arbitration denies individual stockholders their rights, it is these same individuals that are likely to throw their class action settlement paperwork in the wastebasket—they have very little to gain from participation. In light of the enormous potential benefits of an arbitration regime for stockholders as a whole, it seems unwise to give excessive deference to a lost "right" for stockholders who, as evidenced by their failure to collect settlement proceeds, clearly do not value the opportunity to participate in the class.

Note that these figures include the somewhat extraordinary years of 2005 through 2007, when WorldCom, Enron, and Tyco all settled for unprecedented amounts.

13. Barbara Black, *Arbitration of Investors' Claims Against Issuers: An Idea Whose Time Has Come?*, 75 LAW & CONTEMP. PROBS. 107 (2012).

14. 131 S. Ct. 1740 (2011).

15. *Id.* at 1748.

Part I of this Article discusses in detail the shortcomings of the modern class action system, including its uncertain benefits (in terms of compensation and deterrence) as well as its indisputable high costs. Part II then presents the benefits of the mandatory individual arbitration stockholder proposal and why it is likely to be upheld if challenged in court, as well as certain procedural protections contained in our proposal. We also present an alternative to arbitration, our Opt-In Proposal, and discuss its shortcomings and why we believe arbitration is a preferable approach. Finally, our stockholder resolution, supporting statement and model by-law amendment are attached in two Appendices.

I. THE SHORTCOMINGS OF CLASS ACTIONS

A. *The Uncertain Benefits of Securities Class Actions*

1. *Compensation of Plaintiffs*

There is a broad consensus that securities class actions are a poor method of compensating stockholders for losses due to securities fraud.[16] Since the passage of the PSLRA in late 1995, there have been only twenty securities class action trials, as compared to a total of over 3900 filings. Almost all suits, if not dismissed, settle. In fact, less than 0.5% of securities class action filings result in a verdict.[17] When securities class actions do settle, they settle for a very small percentage of the damages claimed. According to one study, the median class action in 2011 settled for only 2.1% of "estimated damages" (a calculation method typically used by plaintiffs to estimate claim values in securities class actions) or 7.0% of "disclosure dollar loss" damages (a more conservative calculation of damages based on decline in market capitalization during the class pe-

16. Coffee, *supra* note 2, at 1535–36 ("[T]he fundamental problem: As presently constituted, securities class actions produce wealth transfers among shareholders that neither compensate nor deter."); James D. Cox et al., *There Are Plaintiffs and…There Are Plaintiffs: An Empirical Analysis of Securities Class Action Settlements*, 61 VAND. L. REV. 355 (2008) (collecting several organizations' criticisms of securities class actions).

17. NERA FULL-YEAR REVIEW 2012, *supra* note 11, at 39.

riod).[18] The median and average securities class action settlements in 2012 were $12 million and $36 million, respectively.[19] From this amount, plaintiffs' attorneys customarily receive between 25% and 35%.[20] Plaintiffs' attorneys have an incentive to encourage their clients to settle cases for much less than an amount that would compensate them for their losses, in order to avoid the cost and risk of a trial.

In all securities class actions, a significant part of the funds recovered, either at trial or through a settlement, is not distributed to members of the class. This may occur because class members cannot be located, because they fail to submit claims as required by the court's orders, or because the costs of distributing a small amount of funds would exceed the value of the claim.[21] An examination of seventy-five random securities class action settlement distributions between 2001 and 2008 revealed that holders of only 40–60% of the potentially eligible shares submitted a claim for a distribution.[22] That a large percentage of funds is not claimed speaks volumes about the current class action system. Although plaintiffs' attorneys must make reasonable efforts to notify potential class members of a settlement, some members will never be reached. The identification of qualifying plaintiffs is even more difficult today than it once was, as computerized trading has resulted in a myriad of trades in which positions are held for just a few minutes.[23] Further, for small investors the amounts at stake are often so small that those who are reached do not even bother to file for a recovery.[24]

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18. CORNERSTONE SETTLEMENTS 2011, *supra* note 12, at 7, 8.

19. NERA FULL-YEAR REVIEW 2012, *supra* note 11, at 27, 28.

20. ELAINE BUCKBERG ET AL., NERA ECONOMIC CONSULTING, RECENT TRENDS IN SHAREHOLDER CLASS ACTION LITIGATION: ARE WORLDCOM AND ENRON THE NEW STANDARD? 7 (2005) [hereinafter NERA REPORT 2005], http://www.nera.com/extImage/Recent_Trends_07.2005.pdf.

21. Kevin M. Forde, *What Can a Court Do with Leftover Class Action Funds? Almost Anything!*, 35 JUDGE'S J., no. 3, 1996, at 19.

22. FRANCIS E. MCGOVERN, MEASURING PARTICIPATION RATES IN PRIVATE SECURITIES LITIGATION SETTLEMENT DISTRIBUTIONS i (Apr. 15, 2011) (written for the Committee on Capital Markets Regulation; on file with authors).

23. *Id*. at 15.

24. *See* Cundiff v. Verizon California, Inc., 84 Cal. Rptr. 3d 377, 379 (Cal. Ct. App. 2008) (deciding a dispute over "$414,593.81 in settlement checks that either were not cashed or were returned by the post office as undeliverable"); Tiffaney

As discussed below, individual arbitration would result in more engaged stockholders, which may lead to larger settlements on an individual basis. Under our proposed stockholder resolution, stockholder compensation may be substantially higher in light of the requirement that the corporation cover arbitration costs for all nonfrivolous claims as well as attorneys' fees for claims on which the plaintiffs prevail.

In addition, modern portfolio management results in class action recoveries often being circular. Recoveries are "largely paid by diversified shareholders to diversified shareholders and thus represen[t] a pocket-shifting wealth transfer that compensates no one in any meaningful sense and [yet] incurs substantial wasteful transaction costs in the process."[25] Class actions generally result in institutional stockholders effectively suing themselves, paying high defense costs and giving plaintiffs' attorneys a large percentage of the settlement amount. All stockholders pay for something they did not take an active part in and could not control. Whether an investor happens to have bought or sold shares during a class period is largely a matter of chance, and while the diversified investor may receive a distribution in one case, she is just as likely to be on the other side of the equation in the next one.[26] What could therefore be a neutral proposition for diversified investors becomes a clear net negative once the heavy transaction costs of attorneys' fees and other litigation expenses are taken into account.[27]

Congress has provided a better method for investors to be compensated. The SEC has traditionally used disgorgement of profits as a powerful enforcement tool in administrative pro-

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Allen, *Anticipating Claims Filing Rates in Class Action Settlements*, CLASS ACTION PERSPS., Nov. 2008, at 2, *available at* http://www.rustconsulting.com/Portals/0/pdf/Monograph_ClaimsFilingRates.pdf ("A typical securities settlement may conclude with between 20 and 35 percent of class members having filed claims."); Shay Lavie, *Reverse Sampling: Holding Lotteries to Allocate the Proceeds of Small-Claims Class Actions*, 79 GEO. WASH. L. REV. 1065, 1067 (2011) ("[F]or many class members, it is not economically viable to redeem their meager awards. The result is unclaimed compensatory damages commonly in the range of millions of dollars.").

25. CCMR INTERIM REPORT, *supra* note 9, at 79.

26. *See* Coffee, *supra* note 2, at 1558; *see also* Amanda Rose & Richard Squire, *Intraportfolio Litigation*, 105 NW. U. L. REV. 1679, 1679 (2011).

27. Coffee, *supra* note 2, at 1558.

ceedings[28] and, since *SEC v. Texas Gulf Sulphur Co.*,[29] in judicial proceedings as well. Any funds recovered in these actions generally went to the U.S. Treasury. However, the Sarbanes-Oxley Act of 2002 (SOX)[30] created a "Fair Fund" for investors, through which defrauded investors may be compensated.[31] If the SEC recovers money from an action it brings, then it may contribute the proceeds to a pool from which victims of the fraud are compensated. One commentator has characterized the SEC's role in the process as one of "public class counsel"[32] because, as the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)[33] reiterated, the Fair Fund pool provides for "relief of victims" and is to be "established for the benefit of the victims" of fraud.[34] As opposed to private class actions, the funds in the SEC's pool may come from disgorgements from the actual individuals responsible for the fraud (which increases their deterrent value) rather than from the current stockholders. Another major difference is that no attorneys' fees are withheld from the amount of relief given to stockholders.

The SEC has made significant use of the Fair Fund to compensate defrauded investors with the proceeds of civil penalties and disgorgement.[35] In fiscal years 2010 and 2011, the SEC returned a total of over $3.6 billion in disgorgement and penalties to injured investors.[36] We believe this is a better compensatory tool than class actions. Of course, the largest advantage to recovering stockholders is that no attorneys' fees are withheld from the recovery. The SEC's incentives are thus better aligned

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28. *See, e.g.*, SEC v. Titan Corp., Exchange Act Release No. 19,107, 84 SEC Docket 3413 (Mar. 1, 2005); SEC v. ABB Ltd., Exchange Act Release No. 18,775, 83 SEC Docket 849 (July 6, 2004).

29. 446 F.2d 1301, 1307–08 (2d Cir. 1971).

30. Pub. L. No. 107-204, 116 Stat. 745, 784 (codified at 15 U.S.C. § 7246).

31. 15 U.S.C. § 7246(a) (2010).

32. Verity Winship, *Fair Funds and the SEC's Compensation of Injured Investors*, 60 FLA. L. REV. 1103, 1103 (2008).

33. Pub. L. no. 111-203. 124 Stat. 1376 (2010).

34. 15 U.S.C. § 7246(a) (as modified by the Dodd-Frank Wall Street Reform and Consumer Protection Act § 929B (2010)).

35. Barbara Black, *Should the SEC be a Collection Agency for Defrauded Investors?*, 63 BUS. LAW. 317, 318 (2008).

36. U.S. SEC. & EXCH. COMM'N, FY 2011 PERFORMANCE AND ACCOUNTABILITY REPORT 2 (2011).

with those of stockholders, in contrast to the incentives of plaintiffs' attorneys to obtain a quick settlement.

Further, the SEC has several procedural advantages over private plaintiffs: it need not establish reliance or loss causation in securities fraud cases;[37] it may pursue actions against aiders and abettors;[38] and it is not subject to the limits on extraterritorial application of the antifraud provisions of the securities laws.[39] In this respect, it can bring cases private plaintiffs cannot. Additionally, the SEC is well positioned to identify meritorious cases. For example, in fiscal year 2011 (FY2011), 18.5% of SEC investigations were opened due to issues identified during the course of SEC examinations, analysis of data, disclosure review, or other activities.[40]

When the SEC first began its use of the Fair Fund authority in 2002, it did not have the necessary in-house expertise to establish Fair Fund pools and to distribute their proceeds efficiently. Outside consultants were hired to develop economic formulas for the distribution of settlement proceeds. Collection and distribution of the funds was a lengthy process. The SEC has since established a group with the mission and expertise to establish and equitably distribute the funds from the Fair Fund pools. As a result, the SEC now either receives payment or initiates collection within six months of a monetary penalty being imposed in over 90% of cases and is actively working to speed the distribution of these funds.[41] However, there is still much room for improvement. Between FY2007 and FY2011 the SEC was able to collect only between 50–70% of the ordered disgorgement and penalties.[42] The SEC should be given additional resources both to improve collection and also to bring more of these suits in the first instance to compensate stockholders. In

37. *See* Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 342–46 (2005); Oscar Private Equity Invs. v. Allegiance Telecomm., Inc., 487 F.3d 261, 264 (5th Cir. 2007); Black, *supra* note 35, at 335.

38. *See* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 158 (2008); Black, *supra* note 35, at 335; Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 104, 109 Stat. 737 (codified as amended in scattered sections of 15 and 18 U.S.C.).

39. Dodd-Frank Act § 929P(b) (codified at 15 U.S.C. § 77(v)(c) (2010)).

40. U.S. SEC. & EXCH. COMM'N, *supra* note 36, at 65.

41. *Id.* at 62.

42. *Id.* at 66.

the meantime, the SEC should focus its limited resources on improving its recovery methods, rather than on protecting the inherently flawed securities class action regime by allowing corporations to exclude arbitration proposals from a stockholder vote, as discussed below.

2. Deterrence

Apart from compensating stockholders, some argue that securities class actions may be justified as deterring bad behavior. In reality, however, it is individuals who perpetrate fraud, but corporations—and in turn stockholders—who pay the cost of securities litigation. Individual directors and officers rarely pay securities class action settlements or damages of any amount themselves.[43] Although directors and officers are often named in suits, corporations or their insurance companies will likely be the entities to pay out on a settlement, with the corporations funding the insurance coverage for directors and officers.[44] Indeed, evidence shows that insurance covers settlement amounts in 96% of securities class actions.[45] A study of securities class action settlements between the years 2000 and 2009 revealed that corporate officers personally contributed to only 5% of the settlements, while outside directors personally contributed to less than 1% of the settlements.[46] Besides not being directly responsible for damages, one study found that directors do not generally suffer a loss of reputation following securities class actions either, other than in cases involving relatively large settlements or

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43. "[O]ut-of-pocket payments by outside directors are rare. Companies and their directors are frequently sued under the securities laws and state corporate law, and settlements are common. But the actual payments are nearly always made by the companies involved—either directly or pursuant to directors' rights to indemnification—or by a D&O insurer, a major shareholder, or another third party." Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1059–60 (2006). The few cases where directors or officers do personally pay a portion of the recovery are typically cases where the entity is insolvent, or the D&O insurance is in some manner inadequate. Coffee, *supra* note 2, at 1550.

44. WorldCom and Enron are notable exceptions to this trend. *See* Michael Klausner et al., *Outside Directors' Liability: Have WorldCom and Enron Changed the Rules?*, STAN. LAW., Winter 2005, at 36.

45. James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 512 (1997).

46. Michael Klausner & Jason Hegland, *How Protective is D&O Insurance in Securities Class Actions?—Part I*, 23 PROF. LIABILITY UNDERWRITING SOC. J., Feb. 2010, at 1, 3.

in cases where the SEC is involved.[47] Furthermore, courts do not supervise how defendants apportion liability in a settlement among themselves, so long as it is fair to the plaintiffs. For example, in *In re Cendant Corp. Litigation*, thirteen Cendant directors had been named as defendants but the corporation paid the entire $2.85 billion settlement itself.[48]

Deterrence of wrongdoing mainly comes from the impact of disclosure of wrongdoing. On average, firms lose about 40% of their market value when news of misconduct is reported. This is not due to anticipation of a lawsuit (only 8.8% of this decline in market value appears related to anticipated litigation costs)—rather, most of the loss is due to damaged reputation.[49] So it is the damage to reputation from the disclosure—not the lawsuit itself—that causes the vast majority of losses. In addition, over 90% of the parties responsible for the wrongdoing lose their jobs, and a majority are explicitly fired.[50] These potential consequences are more powerful engines of deterrence as they directly impact those responsible for the wrongdoing.

It further appears that neither stockholders nor their attorneys do much to uncover fraud—rather, this is done mainly by whistleblowers and the media.[51] Private class actions accompany about half of the securities enforcement actions brought by the SEC or the DOJ.[52] The role of whistleblowers as a deterrent to fraud has been further strengthened by Dodd-Frank, which provides that whistleblowers can recover between 10–30% of monetary sanctions recovered by the Commodity Futures Trading Commission or the SEC.[53]

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47. Eric Helland, *Reputational Penalties and the Merits of Class-Action Securities Litigation*, 49 J. L. & ECON. 365, 366 (2006).

48. Coffee, *supra* note 2, at 1568.

49. Karpoff et al., *supra* note 7; *see also* John Armour et al., Regulatory Sanctions and Reputational Damage in Financial Markets (Sept. 16, 2010) (unpublished manuscript) *available at* http://ssrn.com/abstract=1678028 (U.K. study showing that when misconduct has harmed stockholders, reputational loss is approximately ten times the cost of government fines and restitution).

50. Karpoff et al., *supra* note 8.

51. Alexander Dyck et al., *Who Blows the Whistle on Corporate Fraud?*, 65 J. FIN. 2213, 2214 (2010).

52. John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 275 (2007).

53. Dodd-Frank Act § 748 (codified at 7 U.S.C. § 23 (2010)); *id.* § 922 (codified at 15 U.S.C. § 78u-6 (2010)).

Another important source of deterrence is the very strong public enforcement regime in the United States. The SEC and other government agencies, including the DOJ and state attorneys general, who pursue individuals and corporations who violate the securities laws, consider factors other than the largest and speediest potential payouts in bringing such actions. The SEC, for example, carefully considers whether to pursue the corporation (and therefore the stockholders) or just the officers and directors in an individual capacity, recognizing that stockholders bear the brunt of recoveries against corporations. It has publicly articulated the two principal factors it considers in making this decision: "The presence or absence of a direct benefit to the corporation as a result of the violation," and "[t]he degree to which the penalty will recompense or further harm the injured shareholders."[54] It also considers several other factors, including "[t]he need to deter the particular type of offense" and "[t]he degree of difficulty in detecting the particular type of offense."[55] Plaintiffs' attorneys, on the other hand, always pursue the deep pockets of the corporation and therefore, indirectly, its stockholders. They also are incentivized to bring actions where they can achieve a significant settlement, whatever the merits. Indeed, the larger the potential settlement, the higher the attorneys' fees and, therefore, the greater the incentive to pursue those cases. The possibility of financial penalties, loss of reputation, or even jail time for executives provides a real deterrence to corporate malfeasance, particularly now that the SEC has started to bring cases against individuals even for negligent violations.[56]

Choi and Pritchard find that the stock drop *preceding* a standalone SEC investigation (where there is no class action) is

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54. Press Release, U.S. Sec. & Exch. Comm'n, Statement of the Securities & Exchange Commission Concerning Financial Penalties (Jan. 4, 2006), *available at* http://www.sec.gov/news/press/2006-4.htm.

55. *Id.*

56. *See* Kara Scannell, *SEC shifts focus to unintentional fraud*, FIN. TIMES, June 27, 2011, *available at* http://www.ft.com/intl/cms/s/0/ee706612-a0e6-11e0-adae-00144feabdc0.html ("'The securities laws make it unlawful to mislead investors, regardless of whether [it's] done negligently or intentionally,' said Robert Khuzami, the SEC's enforcement chief"); *see also, e.g.*, Complaint, SEC v. Steffelin, 11-CV-___ (S.D.N.Y.), *available at* http://www.sec.gov/litigation/complaints/2011/comp-pr2011-131-steffelin.pdf.

2.09%, as compared to a much bigger 21.90% stock drop preceding a standalone class action.[57] This does not indicate that class actions are brought in cases of more serious violations, as the authors claim, but only ones in which there are large stock drops, permitting the plaintiffs' attorneys to claim larger damages and attorneys' fees. The SEC, on the other hand, pursues cases based on the merits, not the potential damage recovery. Further, the amount of stock drop, although damaging to the company, does not deter wrongdoing by individuals; it just results in the loss of shareholder value. The authors further find that the stock drop following the announcement of a SEC investigation is 1.80% compared with 2.23% drop following the announcement of a class action.[58] This small difference in market impact may reflect shareholder anticipation of larger losses as a result of a class action, though the differential in average settlements resulting from class action ($15 million) is also relatively small when compared to average settlements of the SEC proceeding alone ($13 million).[59] In any event, the 2.23% further stock drop following announcement of a class action is dwarfed by the 21.90% stock drop on announcement of the violation, confirming our view the deterrence comes mainly from the impact of disclosure of the wrongdoing.

In 2009, the SEC articulated its "renew[ed] . . . commitment to protecting investors."[60] It "restructured the Enforcement Division[,] . . . sought more than twice as many temporary restraining orders and asset freezes[, and] issued well over [twice] as many formal orders of investigation" compared to the previous year.[61] In 2011, it filed "735 enforcement actions, an 8.6 percent increase from 2010," and obtained orders for al-

57. Stephen J. Choi & Adam C. Pritchard, *SEC Investigations and Securities Class Actions: An Empirical Comparison* 12 (Univ. of Mich. Law & Econ. Research Paper Series, Paper No. 12-022, 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2109739.

58. *Id.* at 13.

59. *See id.* at 22.

60. U.S. SEC. & EXCH. COMM'N, 2009 PERFORMANCE & ACCOUNTABILITY REPORT 2 (2009).

61. Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n, Speech at SEC Speaks: Looking Ahead and Moving Forward (Feb. 5, 2010), *available at* http://www.sec.gov/news/speech/2010/spch020510mls.htm.

most $2 billion in penalties and disgorgements.[62] It has had several recent high-profile settlements, including in cases against Bank of America and Goldman Sachs.[63] The Dodd-Frank Act further strengthens the SEC's enforcement powers,[64] and the agency appears primed to seize its new powers and enhance its enforcement operations.[65] Dodd-Frank also strengthens protections for whistleblowers,[66] who play a significant role in uncovering fraud.[67]

The SEC enhances its enforcement impact by working with federal and state officials and self-regulatory organizations (SROs). In FY2011 the SEC referred 586 investigations to SROs or other state, federal, and foreign authorities for enforcement.[68] For example, the Director of the Division of Enforcement at the SEC remarked, "Working with the New York State Attorney General, we pursued placement agents and others for allegedly extracting kickbacks from investment management firms seeking to manage the assets of New York's largest pension fund, the New York State Common Retirement Fund."[69] In addition, state attorneys general themselves are a powerful force in securities law enforcement.[70] The New York Attorney

62. U.S. SEC. & EXCH. COMM'N, *supra* note 36, at 2. Note that these statistics do not include the substantial number of actions brought by state authorities and other federal bodies, DOJ, and the Financial Industry Regulatory Authority (FINRA).

63. *See* SEC v. Bank of America Corp., Exchange Act Release No. 21,407, Civ. Nos. 09-6829, 10-0215 (S.D.N.Y.) (Feb. 4, 2010); SEC v. Goldman Sachs & Co., Exchange Act Release No. 21592, Civ. No. 10-3229 (S.D.N.Y.) (July 15, 2010).

64. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929P, 124 Stat. 1376 (2010).

65. *See* Jean Eaglesham & Brooke Masters, *SEC: No longer a doormat*, FIN. TIMES, Aug. 26, 2010, *available at* http://www.ft.com/cms/s/0/1d2fd850-b14d-11df-b899-00144feabdc0.html.

66. *See* Dodd-Frank Act § 922.

67. *See* Dyck et al, *supra* note 51.

68. U.S. SEC. & EXCH. COMM'N, *supra* note 36, at 64.

69. Robert Khuzami, Dir., Div. of Enforcement, U.S. Sec. & Exch. Comm'n, Speech by SEC Staff: Remarks Before the New York City Bar: My First 100 Days as Director of Enforcement (Aug. 5, 2009), *available at* http://www.sec.gov/news/speech/2009/spch080509rk.htm.

70. John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 713–14 (2009) ("[S]tate regulators now have become important players in major financial scandals, often preceding the SEC in detection and enforcement."); *see also* Melanie Gray et al., *Striking the Right Balance*: *Public Versus Private Enforcement Laws—What Will We Learn From This Financial Meltdown?*, 60 SYRACUSE L. REV. 449, 449 (2010).

General has particularly broad authority thanks to the Martin Act,[71] which gives the Attorney General broader powers of discovery and authority to order restitution than the SEC has.[72]

It is difficult to determine with precision the ideal mix of public and private enforcement, but there is a deep concern that private enforcement of securities laws skews incentives and might result in too great an incidence of unmeritorious private suits.[73] This is a good reason for allowing stockholders, the potential beneficiaries of compensation as well as of deterrence, the opportunity to consider the benefits and burdens of the current class action system and to choose to replace the existing securities class action procedures with mandatory individual arbitration if they believe the current system is not optimal.

B. The High Costs of Securities Class Actions

Securities class actions impose significant costs on corporations, regardless of their merit and regardless of whether they actually deter individual wrongdoers. From 2000 through 2012, the total value of all securities class action settlements was approximately $68.1 billion.[74] According to one study, the annual payouts in past years have been as much as $19 billion.[75] These costs do not include defense costs, increased director and officer insurance premiums, or the decline in stock price from litigation uncertainty, all of which further adversely impact stockholders. According to one scholar, defense costs alone are often in the range of 25% to 35% of the settlement amount, and can rise to 50% to 100% of the settlement.[76]

The prevalence of securities litigation is a major concern of foreign corporations considering listing in the United States or

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71. N.Y. Gen. Bus. Law art. 23-A, §§ 352–53.

72. *See* Miriam H. Baer, *Choosing Punishment*, 92 B.U. L. Rev. 577, 624–25 (2012).

73. *See, e.g.*, Amanda M. Rose, *The Multienforcer Approach to Securities Fraud Deterrence: A Critical Analysis*, 158 U. PA. L. REV. 2173, 2176, 2201 (2010) (arguing that a single public enforcement agency would be more effective and efficient than the current mix of enforcement from federal and state officials and private class actions).

74. NERA FULL-YEAR REVIEW 2012, *supra* note 11, at 31.

75. CORNERSTONE SETTLEMENTS 2011, *supra* note 12, at 1. Totals are calculated in 2011 dollar equivalents. Note that these figures include the somewhat extraordinary years of 2005 through 2007, when WorldCom, Enron and Tyco all settled for unprecedented amounts. In 2010, total settlements amounted to $3.1 billion.

76. Baker & Griffith, *supra* note 4, at 1815 n.95.

private corporations going public, and places U.S. public capital markets at a disadvantage.[77] Since 1996, over 40% of the corporations listed on major stock exchanges in the United States have been the target of a securities class action.[78] In recent years, securities class actions have become an almost automatic response to corporate transactions, with 94% of public takeovers attracting a class action in 2011.[79] Even those corporations that may never face a securities class action pay substantial sums to mitigate this possibility. For example, insurance costs for a Fortune 500 company are more than six times higher in the United States than in Europe[80] and the cost of directors and officers insurance premiums in the United States is 129% what it is in Europe, potentially setting high expense burdens for U.S. issuers compared to international competitors.[81] Additionally, a settlement may exceed the coverage limits. As of 2006, the maximum coverage available for public companies was $300 million.[82] Thus, for large settlements, the company and its stockholders must bear the cost of settlement. This risk causes firms to "hold significantly more cash"[83] and to be conservative in debt contracting.[84] Securities class action defendants face deteriorating profitability and operational efficiency compared to peer firms, even three years after settlement, and have a higher risk of bankruptcy.[85]

In 2010, the United States Supreme Court in *Morrison v. National Australia Bank* held that Section 10(b) of the Exchange Act does not provide a cause of action for Australian plaintiffs who

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77. 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, 619 (2010).

78. *Id.* at 615–16.

79. MATTHEW D. CAIN & STEVEN M. DAVIDOFF, TAKEOVER LITIGATION IN 2011 (2012), http://ssrn.com/abstract=1998482.

80. CCMR INTERIM REPORT, *supra* note 9, at 78.

81. E-mail from Thomas J. Scherer, SVP & General Counsel, AIG Property Casualty, to author (January 17, 2013, 15:03 EST) (on file with author).

82. Baker & Griffith, *supra* note 4, at 1806.

83. Matteo Arena & Brandon Julio, Litigation Risk and Corporate Cash Holdings 1 (July 2010) (unpublished manuscript), *available at* http://www.fma.org/NY/Papers/LitigationAndCash12-10-09.pdf.

84. *Cf.* Anne Beatty et al., *Conservatism and Debt*, 45 J. ACCT. & ECON. 154 (2008).

85. Lynn Bai et al., *Lying and Getting Caught: An Empirical Study of the Effect of Securities Class Action Settlements on Targeted Firms*, 158 U. PA. L. REV. 1877, 1896–1904 (2010).

purchased securities of a foreign corporation on foreign exchanges because the securities were listed *only* on foreign exchanges and "all aspects of the purchases . . . occurred outside the United States."[86] As a result of this decision and the line of lower court cases that have broadly applied *Morrison*, corporations that offer securities outside the United States will have significant protection from U.S. securities class action litigation, so long as those securities are not listed on a U.S. exchange. Although U.S. courts are still in the process of defining what constitutes a sale "outside the United States" where that sale does not occur on a foreign securities exchange,[87] the future application of the *Morrison* decision can be expected to further contribute to the disparity between the cost of U.S. and foreign capital markets. Note that the SEC, in its study on the cross-border scope of private suits under Section 10(b) of the Exchange Act called for by Section 929Y of the Dodd-Frank Act, put forward several potential options for Congress to consider should Congress wish to override the Supreme Court's decision in *Morrison.*[88] However, it notably failed to make any specific recommendation of a course of action, which may make Congressional action less likely.[89]

Although recent Supreme Court decisions have made it more difficult to establish SEC Rule 10b-5 claims,[90] recent statistics

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86. 130 S. Ct. 2869, 2888 (2010).

87. *See, e.g.,* Absolute Activist Master Fund Ltd. v. Ficeto, 677 F.3d 60, 66–67 (2d Cir. 2012) (either the agreement to purchase or sell securities or the transfer of title to the securities must occur in the United States).

88. U.S. SEC. & EXCH. COMM'N, STUDY ON THE CROSS-BORDER SCOPE OF THE PRIVATE RIGHT OF ACTION UNDER SECTION 10(B) OF THE SECURITIES EXCHANGE ACT OF 1934 1–4 (2012).

89. *Id.* at 69 ("This Study has attempted to identify the relevant policy considerations that Congress might want to consider.").

90. *See, e.g.*, Janus Capital Grp., Inc. v. First Derivative Traders, 131 S. Ct. 2296, 2298 (2011); *Morrison*, 130 S. Ct. 2869; Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 153 (2008); Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314 (2007). As discussed above, *Morrison* provides protection from U.S. securities laws for issuers where "all aspects of the purchases . . . occurred outside the United States." *Morrison*, 130 S. Ct. at 2888. *Tellabs* established heightened pleading standards for 10b-5 claims. *Tellabs*, 551 U.S. at 328. *Stoneridge* rejected "scheme liability" for third parties, insulating them from 10b-5 claims. *Stoneridge*, 552 U.S. at 159–60. *Janus Capital*, which restricted liability to those who actually "make" the material misstatement or omission, further limited 10b-5 actions against those other than the issuer itself. *Janus Capital*, 131 S. Ct. at 2305. *But see* Erica P. John Fund, Inc. v. Halliburton Co., 131 S. Ct. 2179, 2183

suggest that the collective impact, if any, of these decisions will be minor. Since 2007, plaintiff attorneys filed 223, 167, 176, 188, and 152 securities class actions, an average of 181 filings per year, which almost exactly matches the historical average from 1996, the first year following the passage of the PLSRA, through 2011.[91]

The Committee on Capital Markets Regulation found that securities class actions are a major contributor to driving capital abroad and to reducing venture capital investment because of the increased liability risk of going public.[92] Several leading reports have echoed the cry that securities class actions are a major contributor to making the U.S. capital markets less competitive and less attractive. A report commissioned by Mayor Michael R. Bloomberg and Senator Charles E. Schumer, prepared by McKinsey & Company, and endorsed by then-Governor Eliot Spitzer, highlighted securities class actions as a major contributor to the high "cost of doing business in the U.S. financial services industry."[93] Survey data confirm this: 85% of senior executives surveyed in connection with the report "indicated that London was preferable" in terms of litigiousness, "and not a single one chose New York."[94] A 2008 report from the U.S. Chamber of Commerce and a 2007 report from the Financial Services Forum both reached a similar conclusion.[95] In recent years, U.S. capital markets have also begun to lose U.S. companies to foreign exchanges. In 2011, 8.5% of U.S. companies that went public did so abroad,[96] whereas a foreign I.P.O.

(2011), which held that securities fraud plaintiffs do not need to prove loss causation in order to obtain class certification, and may result in more, rather than fewer, securities class actions being filed.

91. *See* CORNERSTONE FILINGS 2012, *supra* note 10, at 4.

92. *See* CCMR INTERIM REPORT, *supra* note 9, at 71.

93. SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP 74–78 (2007), *available at* http://www.abanet.org/buslaw/committees/CL116000pub/materials/library/NY_Schumer-Bloomberg_REPORT_FINAL.pdf.

94. *Id.* at 75.

95. CTR. FOR CAPITAL MKTS. COMPETITIVENESS, U.S. CHAMBER OF COMMERCE, STRENGTHENING U.S. CAPITAL MARKETS: A CHALLENGE FOR ALL AMERICANS 13 (2008), *available at* http://www.capitalmarketssummit.com/files/2010/11/2008_Report.pdf; FIN. SERVS. FORUM, 2007 GLOBAL CAPITAL MARKETS SURVEY 6 (2007), *available at* http://crapo.senate.gov/documents/FINAL2007ForumIPOStudy.pdf.

96. COMM. ON CAPITAL MKTS. REGULATION, COMPETITIVENESS MEASURES, (2013), *available at* http://www.capmktsreg.org/competitiveness/category-I.html.

of a U.S. company was almost unheard of ten years ago. This trend is an alarming vote of no confidence in our markets.

In addition to being costly to corporate stockholders, the modern securities class action system, with its high rewards for plaintiffs' attorneys, provides incentives for these attorneys to engage in abusive practices and illegal activities. Prior to the passage of the PSLRA and its lead plaintiff provision, further discussed below, it was a common practice for professional plaintiffs, supported illegally by plaintiffs' law firms,[97] to own small pools of shares in large corporations, thereby enabling them to bring class action suits in return for kickbacks from attorney firms.[98] A suit did not have to be meritorious to be profitable; it simply had to result in a substantial settlement.

The PSLRA was intended to reduce the incidence of "strike suits," so-called because they are sometimes perceived as a form of legal blackmail, forcing the corporation to settle on a meritless claim and pay the lawyers a large fee rather than risk the future of the corporation with a massive judgment at the hands of an unpredictable jury.[99] The PSLRA also sought to prevent so-called "sweetheart deals," whereby plaintiff attorneys sell out their clients by "trading a relatively low recovery for a relatively high fee award"[100] in cases that are actually meritorious. These sweetheart deals benefit both defendants and plaintiffs' attorneys at the expense of the stockholders, as defendants and plaintiffs' attorneys avoid the risk and expense of a trial and defendants receive a binding settlement for far less than an action may be worth.[101] These abusive practices

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97. *See, e.g.*, the 2006 indictment on conspiracy charges of Milberg Weiss and two of its named partners for paying illegal kickbacks to individuals who served as plaintiffs in suits brought by Milberg Weiss. Press Release, U.S. Attorney C.D. Cal., Milberg Weiss Law Firm, Two Senior Partners Indicted in Secret Kickback Scheme Involving Named Plaintiffs in Class-Action Lawsuits (May 18, 2006), *available at* http://online.wsj.com/public/resources/documents/milbergpress05182006.pdf.

98. Russell Kamerman, Note, *Securities Class Action Abuse: Protecting Small Plaintiffs' Big Money*, 29 CARDOZO L. REV. 853, 858–59 (2007).

99. Charlotte S. Alexander, *Would an Opt In Requirement Stop Class Action Strike Suits and Sweetheart Deals? Evidence from the Fair Labor Standards Act* 3 (2010) (unpublished manuscript), *available at* http://works.bepress.com/charlotte_alexander/1.

100. *Id.*

101. John Bronsteen, *Class Action Settlements: An Opt-In Proposal*, 2005 U. ILL. L. REV. 903, 904, 914 (2005).

have been successful for plaintiffs' law firms because of "the effective absence of the client."[102]

The central provision of the PSLRA addressing these concerns is the lead plaintiff provision, which "creates a rebuttable presumption that the investor with the largest financial interest in a securities fraud class action should be appointed the lead plaintiff for the suit."[103] This provision was designed to encourage class representatives who, having the most at stake, would actively monitor the litigation, as well as counsel, whose interests may differ from those of their clients, thereby reducing the abuses of modern class actions.[104] The provision has been somewhat effective. Institutional investors, typically insurance companies, banks, pension funds, mutual funds, endowments, and foundations, served as lead plaintiffs in nearly 64% of settlements in 2012,[105] and studies have concluded that institutional lead plaintiffs generate larger settlements than individual lead plaintiffs.[106]

Despite these reforms, abuses have continued since the passage of the PSLRA. For example, attorneys have engaged in so-called "pay-to-play" practices in which plaintiffs' law firms make large payments to the campaign funds of state officials; in return, the attorneys are appointed counsel for suits brought by state pension funds.[107] Some of the most dramatic examples of recent abuses have been exposed through the prosecution of plaintiffs' law firms. For instance, in recent years, several partners and lead plaintiffs of the leading class action law firm Milberg Weiss were indicted and convicted on conspiracy charges related to an alleged $250 million kickback scheme for lead plaintiffs in stock-

102. John C. Coffee, Jr., *Rescuing the Private Attorney General: Why the Model of Lawyer as Bounty Hunter is Not Working*, 42 MD. L. REV. 215, 233 (1983).

103. James D. Cox et al., *Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 COLUM. L. REV. 1587, 1588 (2006).

104. *Id.*

105. NERA FULL-YEAR REVIEW 2012, *supra* note 11, at 37.

106. Cox et al., *supra* note 103, at 1636. The data showed that institutions increase settlements by 0.04% for every 1% increase in provable losses, which is small but statistically significant. *Id.*

107. *See, e.g.*, Mark Maremont et al., *Trial Lawyers Contribute, Shareholder Suits Follow*, WALL ST. J., Feb. 3, 2010, *available at* http://online.wsj.com/article/SB10001424052748703837004575013633550087098.html.

holder class actions.[108] Named partner Melvyn Weiss received a thirty-month prison sentence.[109] The law firm itself paid a fine of $75 million to avoid criminal charges.[110] Because the law firm was paying the plaintiffs, its ability to provide oversight or control over its lawyers was clearly compromised.

Despite the low recoveries, questionable deterrence, and high cost of securities class actions, stockholders rarely opt out. In particular, institutional investors, which own and control approximately 68% of shares,[111] fear having to justify leaving a case once they are in—they could be said to be leaving money on the table. Even if an institutional investor stands to lose money overall—the losses it incurs as the stockholder of defendant corporations likely exceed the damages it recovers as a member of plaintiff classes—once a class action is brought, the investor is always better off collecting some money rather than none. This helps explain why the median opt-out percentage in three major studies of a wide range of class actions, including securities class actions, was 0.15%.[112] Plaintiffs that do opt out are often those with the largest stake in the litigation, and those that would therefore like to take a more proactive approach and seek a better settlement than the 2–3% of plaintiff-style damages normally received.[113] Given the small amount of money they stand to recover from a suit, smaller investors typically do not opt out because they are indifferent.

The viability of a securities class action is based significantly on inertia rather than choice, because plaintiffs who do not respond to opt-out notices are automatically included in the class.[114] The low opt-out rate works to the advantage of plain-

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108. *New York attorney sentenced in kickback scheme*, N.Y. TIMES, Nov. 1, 2008, *available at* http://www.nytimes.com/2008/02/11/business/worldbusiness/11iht-kickbacks.5.9951917.html; Press Release, U.S. Attorney C.D. Cal., *supra* note 97.

109. *Class-Action King Weiss Sentenced*, FORBES, Jun. 2, 2008, http://www.forbes.com/2008/06/02/weiss-milberg-sentencing-cx_pm_0602autofacescan04.html.

110. Jonathan D. Glater, *Big Penalty Set for Law Firm, but Not a Trial*, N.Y. TIMES, Jun. 17, 2008, http://www.nytimes.com/2008/06/17/business/17legal.html?ref=milbergweissbershad.

111. Jonathan Lewellen, *Institutional Investors and the Limits of Arbitrage*, 102 J. FIN. ECON. 62, 62 (2011).

112. Alexander, *supra* note 99, at 8.

113. *Id.* at 9; *see also* CORNERSTONE SETTLEMENTS 2011, *supra* note 12, at 7.

114. Alexander, *supra* note 99, at 9. Although a plaintiff needs to respond to a notice to collect, the class may be formed through inaction.

tiffs' attorneys, who are able to represent a large class comprised of many plaintiffs, particularly smaller investors, with very little interest in the case or its handling. Under mandatory individual arbitration, by contrast, lawyers could not benefit by indifference; stockholders would each have to bring their own claims in individual arbitration. Our proposal will therefore give stockholders the ability to eschew class actions in favor of a more efficient means of settling securities-based disputes with the corporation in which they are, or were, stockholders.

II. THE CASE FOR MANDATORY INDIVIDUAL ARBITRATION

A. Benefits of Arbitration

Burdened by the high costs of securities class actions, which provide inadequate compensation and ineffective deterrence, stockholders should be given the opportunity to adopt mandatory individual arbitration in a corporation's by-laws. Stockholders could make a proposal to include in their corporation's proxy statement a vote to amend the corporation's by-laws by including an arbitration provision governing issuer-stockholder disputes under the U.S. securities laws. The amendment would require that arbitrations be brought on an individual, rather than a class-wide, basis to avoid the potentially catastrophic settlements that afflict corporate defendants and their stockholders in traditional class actions.

Arbitration is the norm in several other securities law disputes, such as those between customers and broker-dealers,[115] and its benefits make it attractive for issuer-stockholder disputes too.[116] Individual arbitration poses advantages over securities class actions in terms of speed of resolution, engagement

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115. Black, *supra* note 13, at 1.

116. Arbitration between issuers and stockholders is already reasonably established outside the United States. The SEC appears willing, presumably on comity principles, to allow these foreign issuers to maintain their arbitration provisions upon becoming Exchange Act-reporting companies. As of December 31, 2007, there were approximately forty foreign private issuers with Exchange Act reporting obligations, most notably Royal Dutch Shell, whose corporate documents contained arbitration provisions to which the SEC has not objected. *See* 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, 393–94 (2007).

of stockholders, and thus potential size of settlement, overall costs (including attorneys' fees), and expertise in judgment. Wronged stockholders will receive quicker payment—although the average federal securities class action takes more than four years to settle, studies on arbitration have found it is two to three times faster than similar litigation.[117] In addition, the individual nature of the arbitration necessarily will result in more engaged stockholders, which in turn may lead to larger settlements on an individual basis. Whereas under a class action regime, a plaintiffs' attorney commanding a large class would be satisfied with the average settlement of 7% of "disclosure dollar loss" damages, individuals and their lawyers engaged in arbitrations would likely push for higher compensation.[118] As attorneys would be representing an individual rather than a class, they will have an incentive to seek a higher damages percentage, given the lower aggregate dollar *ad damnum*.

Regarding costs, arbitration will result in savings to the corporation and, ultimately, its stockholders.[119] From the corporation's perspective, mandatory individual arbitration will result in fewer strike suits and less incentive to settle where there has been no wrongdoing. The lower costs of individual arbitration, including lower attorneys' fees, would provide savings to the corporation and, by extension, to the corporation's stockholders. In the event that numerous arbitrations are brought against a corporation related to a single set of circumstances, a corpora-

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117. Deborah Masucci, *Securities Arbitration—A Success Story: What Does the Future Hold?*, 31 WAKE FOREST L. REV. 183, 188–89 (1996); Paul Weitzel, *The End of Shareholder Litigation? Allowing Shareholders to Customize Enforcement through Arbitration Provisions in Charters and Bylaws*, BYU L. REV. (forthcoming) (manuscript at 25–26), *available at* http://ssrn.com/abstract=1963498.

118. *See* CORNERSTONE SETTLEMENTS 2011, *supra* note 12, at 8.

119. *See, e.g.*, Warren E. Burger, *Using Arbitration to Achieve Justice*, ARB. J., Dec. 1985, at 3, 6 ("[I]n terms of cost, time, and human wear and tear, arbitration is vastly better than conventional litigation for many kinds of cases."); Dwight Golann, *Developments in Consumer Financial Services Litigation*, 43 BUS. LAW. 1081, 1091 (1988) (arguing that arbitration offers the possibility of a faster and cheaper process by allowing the parties "only limited discovery, scheduling of hearings by agreement, no transcript, decisions without detailed findings of fact or ruling of law, and very limited rights of appeal"); Roger S. Haydock, *Civil Justice and Dispute Resolution in the Twenty-First Century: Mediation and Arbitration Now and for the Future*, 27 WM. MITCHELL L. REV. 745, 759 (2000) ("Arbitration filing fees and hearing fees, and elective attorney fees, are much less than the total of litigation costs and expenses and mandatory attorney fees.").

tion could consider a form of mass stockholder settlement to avoid defending multiple arbitrations simultaneously. In addition, the comparative brevity of an individual arbitration will reduce the amount of time that management's attention is diverted from running the corporation. Finally, the ability to select arbitrators with relevant expertise may result in more sensible decisions for corporations and stockholders.[120] In contrast, the lack of prior experience on the part of judges hearing securities class action disputes is striking. Between 1996 and 2011, 160 judges ruled on summary judgment motions for securities class actions, 83% of whom were issuing such a ruling for the first time in their careers.[121]

Individual arbitration may hold additional benefit for an institutional investor, particularly when the potential damages to that investor are meaningful and thus worth pursuing as an individual claimant. The institution would be able to decide whether to bring its own claim, and will be able (and incentivized) to control the arbitration of that claim. This contrasts with securities class actions, where the investor (unless a lead plaintiff) likely has little, if any, control over the progress of the suit. Individual arbitration is also preferable to class action arbitration, where the investor needs to decide whether to be part of a class action and must monitor such actions as they proceed. Under either class approach, the investor also faces the challenges of a labyrinthine mass settlement process.

Attached as appendicies are our proposed stockholder resolution, supporting statement, and model by-law amendment.[122] Our model amendment contains a number of provisions that address potential criticisms of arbitration, which are discussed below, including, for example, provisions for selecting a mutually agreeable forum, a requirement that the corporation cover

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120. *See, e.g.*, Anthony DeToro, *Waiver of the Right to Compel Arbitration of Investor-Broker Disputes*, 21 CUMB. L. REV. 615, 619 (1991) ("[P]arties often benefit from the arbitrators' specialized knowledge . . . ."); 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, 1119 (1999) (noting that "specialized arbitrators also may be preferable to judges[;] [a]n arbitrator who is an accountant is likely to know what motivates accountants better than a judge without an accounting background.").

121. Weitzel, *supra* note 117, at 26.

122. *See infra* apps. 1–2.

arbitration costs for all non-frivolous claims as well as attorneys' fees for claims on which the plaintiffs prevail, and a five-year sunset provision.

B. Responses to Critics of Arbitration

Of course, arbitration is not without its detractors, who raise a number of points including, foremost, a concern that the majority of stockholders in a corporation would not be able to bind the minority through a by-law amendment. These detractors also claim that arbitration is "unfair," and that it takes away an investor's right to litigate. We address each of these points, as well as the arguments for why a by-law amendment requiring mandatory individual arbitration would likely be upheld if challenged in court, below.

1. Majority Can Bind Minority and Future Stockholders through By-law Amendment

Once adopted, the mandatory individual arbitration provision would bind both present and future stockholders consistent with corporate law. The power to bind minority and future stockholders is already bestowed upon majority stockholders. For example, stockholders may amend a corporation's by-laws to change future voting and quorum requirements, or to provide holders of a certain percentage of shares the right to call a special meeting.[123] Furthermore, in a publicly traded company, minority stockholders who disagree with a vote by the majority are free to express their disagreement by selling their shares.

The Supreme Court's recent decision in *AT&T Mobility LLC v. Concepcion*,[124] discussed in more detail below, makes clear that mandatory individual arbitration provisions are enforceable, albeit in the consumer contract context. Although the decision does not suggest any intent to limit its applicability to the consumer contract arena, the Federal Arbitration Act (FAA), as an initial matter, requires a written agreement or contract between parties that includes an agreement to arbitrate. Although there is little case law that considers what con-

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123. *See, e.g.*, William K. Sjostrom, Jr. & Young Sang Kim, *Majority Voting for the Election of Directors*, 40 CONN. L. REV. 459, 464, 471–73 (2007).

124. 131 S. Ct. 1740 (2011).

stitutes a contract under the FAA, it can be expected that courts will follow applicable state law. For example, Delaware courts view a corporation's by-laws as a contract memorializing an agreement between a corporation and its stockholders, setting down rules and procedures that bind each party.[125]

Delaware corporate law grants stockholders the power to adopt, amend, or repeal by-laws. Under Section 109(b) of the Delaware General Corporation Law (DGCL), the by-laws of a Delaware corporation "may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees."[126] This broad language allows corporations and their stockholders great flexibility in the way they organize their relationship. In fact, by-laws are viewed as contracts between a corporation and its stockholders.[127] They "set down rules and procedures that bind a corporation's board and its shareholders."[128] The "procedural, process-oriented nature of bylaws"[129] makes them appropriate for procedural modifications to the corporation-stockholder relationship, such as through the mandatory individual arbitration proposal. Although claims by stockholders against the corporation to which this proposed by-law amendment would relate arise under the federal securities laws, they necessarily are an incident of stock ownership[130] and accordingly should be considered within the purview of the matters described under Section 109(b) that can be addressed by a corporate by-law.

In 2004, then Vice Chancellor (now Chancellor) Strine adopted a broad approach to what a corporation may properly include in

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125. CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 234 (Del. 2008). In this way, by-laws are no different than a limited partnership agreement such as the one governing The Carlyle Group. *See* text accompanying *infra* note 171. Each set of by-laws forms a binding contract between the entity and its equityholders.

126. 8 DEL. C. tit. 8 § 109(b) (2012).

127. *See* Kidsco Inc. v. Dinsmore, 674 A.2d 483, 492 (Del. Ch. 1995).

128. *CA*, 953 A.2d at 234.

129. *Id.* at 235.

130. There is a nexus between stock ownership and such claims, which distinguishes these claims from a tort or contract claim arising out of a product or service relationship between the plaintiff and the corporation.

its by-laws in *Jones Apparel Group v. Maxwell Shoe Co.*[131] In his decision, Strine stated, "Delaware's corporate statute is widely regarded as the most flexible in the nation because it leaves the parties to the corporate contract (managers and stockholders) with great leeway to structure their relations."[132] So long as a corporate provision does not "transgress . . . a mandatory rule of [Delaware] corporate code or common law," parties are free to agree to their preferred form of private ordering.[133] Courts will perform a "careful, context-specific review"[134] of any provision alleged to transgress Delaware law, avoiding "sweeping rule[s]" that restrict private ordering.[135] Accordingly, under the broad statutory language of Section 109(b) of the DGCL and the flexible approach to corporate governance accepted by the courts, a corporation's by-laws are an appropriate place for a mandatory individual arbitration provision.[136]

2. *Individual-Only Arbitration is Permitted by Federal Arbitration Act*

When the 2006 Interim Report of the Committee on Capital Markets Regulation was published, the law was still unclear as to the enforceability of arbitration clauses containing a class action waiver. This understandably made corporations and stockholders reluctant to consider incorporating such provisions into their corporate documents. Recent legal developments, however, have created an ideal backdrop against which our proposal could be implemented, therefore allowing a corporation's stockholders to adopt a mandatory individual arbitration provision.

131. 883 A.2d 837 (Del. Ch. 2004).

132. *Id.* at 845.

133. *Id.* at 846.

134. *Id.* at 848.

135. *Id.* at 852.

136. Note that a recent suit against a corporation's directors, discussed in more detail below, raised an analogous issue of enforceability of a forum selection clause in a company's by-laws. *See* Galaviz v. Berg, 763 F. Supp. 2d 1170 (N.D. Cal. 2011). While the Northern District of California found the provision unenforceable, the court's decision was based on the manner in which the provision had been introduced (unilaterally by the directors). The court stated that were a majority of stockholders to have approved an amendment, the case for enforcement would be much stronger. *Id.* at 1175.

The Supreme Court's recent decision in *AT&T Mobility LLC v. Concepcion*,[137] in which the Court struck down a California law prohibiting class action waivers in arbitration clauses, has provided much-needed clarity in this area. In its decision, the Court emphasized the "national policy favoring arbitration"[138] embodied in the FAA, which promotes the twin goals of "enforcement of private agreements and encouragement of efficient and speedy dispute resolution."[139] The Court went on to recognize individual arbitration's efficiency advantages over not only class action litigation but also over class action arbitration also, noting that while individual arbitration dispositions on the merits were reached in an average of six months, not a single one of the 283 class action arbitrations opened by the American Arbitration Association since 2009 had yet resulted in a final award on the merits.[140] In addition, "the median time from filing to settlement, withdrawal or dismissal—not judgment on the merits—was 583 days, and the mean was 630 days."[141] Class arbitration also increases risks to defendants because an adverse decision could result in an enormous liability, much like in class action litigation.[142] This extreme risk dynamic results in the *in terrorem* settlement of even questionable claims, exactly as in securities class action litigation.[143]

Indeed, class arbitration has been criticized for being less efficient than individual arbitration, mainly due to the need for judicial involvement and supervision.[144] Class arbitration requires courts to play an active role not only due to logistical

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137. 131 S. Ct. 1740 (2011).

138. *Id.* at 1749 (quoting Buckeye Check Cashing, Inc. v. Cardegna, 546 U.S. 440, 443 (2006)).

139. *Id.* at 1749 (quoting Dean Witter Reynolds v. Byrd, 470 U.S. 213, 221 (1985)).

140. *Id.* at 1751.

141. *Id.*

142. *Id.* at 1752.

143. *See id.*

144. Elizabeth P. Allor, Keating v. Superior Court*: Oppressive Arbitration Clauses in Adhesion Contracts*, 71 CALIF. L. REV. 1239, 1253 (1983) ("[W]hen conducted on a classwide basis, arbitration is unlikely to remain inexpensive and efficient. It will increase the burden on the judge and divide authority between the judge and the arbitrator. . . . [T]he division of authority over the proceedings between the judge and the arbitrator would entail many procedural complications.").

difficulties such as who chooses the arbitrator,[145] but also because of due process concerns.[146] In this respect, it has been argued that "judicial discretion must exist in the classwide arbitration setting if courts are to protect the absent class members' due process rights."[147] Specifically, critics argue that judges supervising classwide arbitration "must be heavily involved in certification, including relevant discovery, supervision of notice, ongoing monitoring of the adequacy of class representation, providing notice of and approving any settlement, and postjudgment determinations of the scope of class relief."[148] Such inevitable continuing judicial supervision makes class arbitration inefficient and renders the process "the worst of both systems."[149] Judicial critics of classwide arbitration, such as Justice Richardson of the California Supreme Court, have described classwide arbitration as "fundamentally contrary to the purpose of arbitration and to the public policy encouraging arbitration."[150] In short, critics argue, classwide arbitration imposes the costs of class action litigation while undermining the benefits of arbitration.

3. Mandatory Individual Arbitration of Securities Claims is Not Unfair

Although the Supreme Court has upheld mandatory individual arbitration provisions as a matter of law, corporations and stockholders must also consider the issue of fairness. Some critics have cited arbitration and other forms of alternative dispute resolution as having an industry bias,[151] inconvenient fo-

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145. *See* Jean R. Sternlight, *As Mandatory Binding Arbitration Meets the Class Action, Will the Class Action Survive?*, 42 WM. & MARY L. REV. 1, 49 (2000); Farah Z. Usmani, *Inequities in the Resolution of Securities Disputes: Individual or Class Action; Arbitration or Litigation* 7 FORDHAM J. CORP. & FIN. L. 193, 229 (2001).

146. *See generally* Carole J. Buckner, *Due Process in Class Arbitration*, 58 FLA. L. REV. 185 (2006).

147. Daniel R. Waltcher, *Classwide Arbitration and 10b-5 Claims in the Wake of* Shearson/American Express, Inc. v. McMahon, 74 CORNELL L. REV. 380, 402 (1989).

148. Sternlight, *supra* note 145, at 50–51 (citations omitted).

149. Maureen A. Weston, *Universes Colliding: The Constitutional Implications of Arbitral Class Actions*, 47 WM. & MARY L. REV. 1711, 1741 (2006).

150. *Id.* (quoting Keating v. Superior Court, 645 P.2d 1192, 1217 (Cal. 1982) (Richardson, J., dissenting in part)).

151. Roger J. Perlstadt, *Comment: Timing of Institutional Bias Challenges to Arbitration*, 69 U. CHI. L. REV. 1983, 1985 (2002).

rum,[152] inadequate rights of appeal and judicial review,[153] failing to push the law forward in a public and precedential manner,[154] and for being offered in contracts of adhesion, presented on a "take it or leave it" basis.[155] These criticisms do not derail this proposal because they can either be easily avoided or they do not apply to the unique case of stockholder disputes.

An industry bias and a potentially inconvenient forum can easily be avoided through neutral arbitrator selection processes and through the existence of an easily accessible forum. Arbitration provisions can specify who the arbitrators will be and where the arbitration will be conducted, or provide mechanisms for the parties to identify a mutually agreeable venue, as is the case in our proposal. The critiques concerning appeals and the development of the law are unconvincing in the context of stockholder securities actions, which are now almost universally settled out of court and therefore create no binding precedents. Mandatory individual arbitration would not make things worse.

Adhesion contracts raise concerns of unequal bargaining power and fairness. Our stockholder proposal avoids the fairness concerns present in consumer contracts of adhesion or board adoption of a provision in the corporation's by-laws because our proposal would be put forward and adopted by the stockholders themselves, avoiding the possibility of unequal bargaining power. Unlike the consumer context in which the consumer can only obtain a service by agreeing to arbitration, here the stockholders are entirely free to accept or reject the proposal. To be successful, our proposal would have to be championed by stockholders, rather than by management. It is a bottom-up, rather than a top-down, approach. Our proposal also contains a sunset provision requiring reapproval of the by-law five years from the date of its adoption. This provides

152. *See Brower v. Gateway 2000, Inc.*, 676 N.Y.S.2d 569, 574 (App. Div. 1988) (claiming that arbitration forum was inconvenient).

153. *See* David M. Kinnecome, *Where Procedure Meets Substance: Are Arbitral Procedures a Method of Weakening the Substantive Protections Afforded by Employment Rights Statutes?*, 79 B.U. L. REV. 745, 770–72 (1999).

154. Edward Brunet, *Questioning the Quality of Alternate Dispute Resolution*, 62 TUL. L. REV. 1, 16–19 (1987).

155. AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740, 1750 (2011); *see also* David S. Schwartz, *Enforcing Small Print To Protect Big Business: Employee and Consumer Rights Claims in an Age of Compelled Arbitration*, 1997 WIS. L. REV. 33, 55–60 (1997).

stockholders with a chance to reconsider their position based on actual experience.

In *Galaviz v. Berg*,[156] a court recently rejected the enforceability of a forum selection clause contained in a by-law amendment passed by the corporation's directors. It explained, "the bylaw was adopted by the very individuals who are named as defendants, and after the alleged wrongdoing took place, there is no element of mutual consent to the forum choice at all."[157] The court added, "Certainly were a majority of shareholders to approve such a charter amendment, the arguments for [enforcing] the venue provision . . . would be much stronger, even in the case of a plaintiff shareholder who had personally voted against the amendment."[158] By contrast, it can hardly be said to be unfair if the stockholders vote, in advance of any dispute, to use a specific dispute resolution mechanism.

4. Mandatory Arbitration Denies Stockholders a Right to Litigate

Opponents of arbitration may argue that individual stockholders who become subject to mandatory arbitration would lose the ability to have their day in court. This could be true, particularly as individuals may not have the personal resources to retain lawyers and initiate an arbitration proceeding, notwithstanding that our proposal provides for the corporation to bear all costs of a nonfrivolous arbitration as well as legal costs of a stockholder who is successful on the merits. Individual stockholders may also not have the incentive to bring an arbitration action, as their individual damages may not be significant enough to warrant the expense. Securities class actions or even class action arbitrations offer certain economies of scale that make it possible for individual stockholders to appear in court where they otherwise might not. However, even if all these circumstances are taken as a given, it is important to remember that these individuals are the same ones who have very little to gain in a securities class action or arbitration.[159]

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156. 763 F. Supp. 2d 1170 (N.D. Cal. 2011).

157. *Id.* at 1171.

158. *Id.* at 1175.

159. *See* Martin H. Redish et al., *Cy Pres Relief and the Pathologies of the Modern Class Action: A Normative and Empirical Analysis*, 62 FLA. L. REV. 617, 618 (2010)

They are the same investors who will likely throw their securities class action notices in the wastebasket.[160] In light of the benefits arbitration provides, this criticism should not hold much weight.

5. Mandatory Individual Arbitration Does Not Violate the Securities Laws

The Committee first introduced the idea of issuer-stockholder arbitration in its 2006 Interim Report. In that report, the Committee referenced the Supreme Court cases of *Shearson/American Express, Inc. v. McMahon*[161] and *Rodriguez de Quijas v. Shearson/American Express, Inc.*,[162] which held that a pre-dispute agreement to submit to arbitration claims based on substantive rights under the Securities Exchange Act of 1934 (*McMahon*) or the Securities Act of 1933 (*Rodriguez*) does not violate the anti-waiver-of-rights provisions of either statute. The arbitration provisions in question did not waive the rights granted by the Securities Act or the Exchange Act, but rather set out how to enforce those rights. As the Second Circuit later noted in *Roby v. Corporation of Lloyd's*, "By agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial, forum."[163] Following those decisions, the vast majority of broker-dealers have incorporated arbitration provisions into their account management contracts,

("[E]ven when individual class members have received notification of their rights to compensation from a general fund, their claims will often be so small that their size fails to justify the effort and expense of pursuing those claims on an individual basis.").

160. *See* RUBENSTEIN ET AL., NEWBERG ON CLASS ACTIONS § 10:14 (4th ed. 2002) (noting that "[t]here is virtually a statistical certainty that not all class members who receive actual notice will file statements or proofs of claim," at least in part because "the amount of individual recovery may be too modest by itself or relative to the burdens of retrieving and reviewing one's records to supply necessary claim information as an economic matter").

161. 482 U.S. 220 (1987).

162. 490 U.S. 477 (1989).

163. 996 F.2d 1353, 1362 (2d Cir. 1993) (citing Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 628 (1985)).

and arbitration is now the primary method of dispute resolution for broker-customer disputes.[164]

Although disputes between brokers and their customers are different from disputes between corporations and their stockholders, the Supreme Court's recent decision in *CompuCredit Corp. v. Greenwood*[165] clarifies that the legal reasoning of *McMahon* and *Rodriguez* applies to our arbitration proposal. *CompuCredit* held that a general non-waiver provision in a federal statute is insufficient to act as a bar to arbitration agreements in the absence of a "congressional command" that the Federal Arbitration Act (FAA) shall not apply.[166] As the Securities Act and Exchange Act are each silent on whether claims can proceed in an arbitrable forum, just as the Credit Repair Organization Act was in *CompuCredit*, "the FAA requires the arbitration agreement to be enforced according to its terms."[167]

Despite this strong support from the Supreme Court in favor of arbitration, the SEC recently granted no-action relief to two corporations seeking to exclude stockholder proposals of binding by-law amendments providing for mandatory individual arbitration under certain circumstances, stating that there was "some basis" for the view that the proposals would violate the

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164. Black, *supra* note 13, at 1. In February 2013, a FINRA Hearing Panel concluded that mandatory arbitration provisions contained in Charles Schwab's customer agreements violated FINRA rules; however, the panel held that the FINRA rules requiring members to preserve judicial class actions as an alternative to arbitration were unenforceable because they "represent[ed] the kind of 'hostility' to arbitration that the Supreme Court has repeatedly found inappropriate and unenforceable under the FAA." Dep't of Enforcement v. Charles Schwab & Co., FINRA Disciplinary Proceeding No. 2011029760201, 9–10 (Feb. 21, 2013), *available at* http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p210893.pdf (citing AT&T Mobility LLC v. Concepcion, 132 S. Ct. 665 (2012); Rodriguez De Quijas v. Shearson/American Express, Inc., 490 U.S. 477 (1989); Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987)).

165. 132 S. Ct. 665 (2012).

166. *Id.* at 671.

167. *Id.* at 673. Congress, in Section 921 of the Dodd-Frank Act, authorized the SEC to adopt rules limiting or prohibiting pre-dispute arbitration provisions in broker-dealer contracts if it finds that such rules would be in the public interest. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 921, 124 Stat. 1376 (2010). This authorization to potentially limit arbitration, however, does not rise to the level of a "congressional command" prohibiting arbitration under the Securities Act or the Exchange Act. Rather, it leaves the decision up to the discretion of the SEC, which has not yet taken any action with regard to this provision.

federal securities laws.[168] Two stockholders, investors in both Pfizer, Inc. and Gannet Co., Inc., submitted proposals for inclusion in the companies' 2012 proxy materials. Their proposals provided for mandatory individual arbitration of all stockholder claims under $3 million.[169] Both corporations sought to exclude the proposals. Although this response might be surprising in light of arbitration's potential benefits to the corporations, it is likely Pfizer and Gannett did not want to be the first movers or "test cases" for the arbitration proposals. They would prefer not to face legal uncertainty and the potential cost and distraction of defending the arbitration provisions, should they have been eventually adopted.

Regarding the $3 million cap in the Pfizer and Gannet stockholder proposals, we see no reason to place a cap on the size of a claim that can be arbitrated. In fact, the higher the claim, the greater the potential benefit from mandatory individual arbitration. Mandatory individual arbitration for all stockholders regardless of the size of their claims enables a corporation and its stockholders to avoid the class action regime altogether.

Though the SEC, as is customary, did not elaborate on the reasons behind its decision, each of the letters argued that the arbitration proposal would, if adopted, violate the anti-waiver provision of the Exchange Act. We disagree. As discussed above, the Supreme Court's decisions in *McMahon* and *CompuCredit*, which held that arbitration agreements do not violate general statutory anti-waiver provisions, make the legality of arbitration under the federal securities laws abundantly clear. If the SEC were to instead follow the direction of the Supreme Court and publicly clarify that mandatory arbitration provisions are acceptable, we believe these provisions would be embraced by companies where they are introduced by shareholders.

In addition, the SEC has twice considered issuer-stockholder arbitration provisions in an IPO issuer's constituent instruments in connection with reviewing the issuer's IPO registration statement, and in both instances refused to declare the reg-

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168. *See* Pfizer Inc., SEC No-Action Letter (Feb. 22, 2012); Gannett Co., Inc., SEC No-Action Letter (Feb. 22, 2012).

169. Pfizer Inc., *supra* note 168; Gannett Co., Inc., *supra* note 168.

istration statement effective.[170] The first such instance was in 1990, while the second instance involved The Carlyle Group's recent attempt to include a similar arbitration provision in its amended and restated limited partnership agreement in connection with its IPO.[171] In both cases, the SEC refused to clear the filing, although it did not provide any public statement of the reasoning behind its decisions.[172] The SEC's actions in granting no-action relief to corporations seeking to prevent stockholder arbitration proposals and in refusing to declare registration statements effective so long as they contain an arbitration provision are reminiscent of the "judicial hostility towards arbitration that prompted the FAA."[173] Congress, through the FAA, and the Supreme Court, through its consistent decisions in favor of the FAA's broad pro-arbitration policy, have spoken clearly on both the legality of arbitration and on its fairness.[174]

In our view, the SEC inappropriately inserted itself in a policy discussion that has already been decided by Congress and the Supreme Court, when its mission requires only that it ensure that the arbitration provisions in question are adequately disclosed to prospective investors. Further, though we believe the SEC should not interfere with a company's decision to include an arbitration provision in its IPO documents, we note that our arbitration proposal would be introduced by stockholders themselves, through a by-law amendment, rather than

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170. *See* Carl W. Schneider, *Arbitration in Corporate Governance Documents: An Idea the SEC Refuses to Accelerate*, 4 INSIGHTS 21, 28 n.10 (1990); Hal S. Scott & Leslie N. Silverman, *The Alternative to Shareholder Class Actions*, WALL ST. J., Apr. 1, 2012, http://online.wsj.com/article/SB10001424052702303816504577312373860495762.html; Miles Weiss et al., *Carlyle Drops Class-Action Lawsuit Ban as Opposition Mounts*, BLOOMBERG, Feb. 3, 2012, http://www.bloomberg.com/news/2012-02-03/carlyle-drops-class-action-lawsuit-ban.html.

171. In this regard, our stockholder proposal is preferable to the inclusion of an arbitration provision in the constituent instruments of an issuer when it is going public, where prospective investors must weigh mandatory arbitration as one of many factors in deciding whether or not to purchase the issuer's equity securities. So long as an arbitration provision is adequately disclosed, however, we believe the SEC should be obliged to let the issuer's initial public offering proceed as there is plainly no public policy against mandatory arbitration of issuer-stockholder disputes.

172. Weiss et al., *supra* note 170.

173. AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740, 1747 (2011).

174. *See* Scott & Silverman, *supra* note 170.

by management through a provision in a corporate charter. We believe a stockholder vote in support of an arbitration provision (as opposed to a purchase decision in the IPO context) further bolsters our arguments against interference by the SEC.

6. *The Need for Adequate Notice and Other Procedural Protections*

In enforcing arbitration provisions, courts have suggested that all parties having notice of the provision is one of the factors militating in favor of enforcement.[175] Professor Myriam Gilles pointed out in a 2005 article that courts have recognized "binding arbitration clauses that obligate a plaintiff-consumer to arbitrate claims against a defendant-manufacturer, where the clause was contained inside (or on) a box that she bought at a third party retailer."[176] If that type of notice is acceptable, then the notice provided by a stockholder vote should also be sufficient. But corporations could go further in providing notice. Corporations could and should describe the arbitration provisions in their bylaws and their effect on present and future stockholders in their Exchange Act filings. Corporations should also describe these provisions on their website, as they do in response to other SEC and stock exchange requirements that impose disclosure obligations for certain corporate governance practices.

The Supreme Court in *Concepcion*, though it did not rely on these facts for its decision, noted that the AT&T mandatory individual arbitration contract that it upheld provided several protections for customers.[177] Although these protections are most necessary in a consumer contract of adhesion such as the one at issue in *Concepcion*, our mandatory individual arbitration provision also includes procedural protections to ensure an adequate remedy is available to stockholders.[178] First, our

175. *See, e.g.*, Skirchak v. Dynamics Research Corp., 508 F.3d 49, 60 (1st Cir. 2007) (holding class action waiver of claims under FLSA unenforceable due to lack of adequate notice); Dale v. Comcast Corp., 498 F.3d 1216, 1218 (11th Cir. 2007) (holding no-class-action arbitration clause unenforceable due, in part, to lack of adequate notice).

176. Myriam Gilles, *Opting Out of Liability: The Forthcoming, Near-Total Demise of the Modern Class Action*, 104 MICH. L. REV. 373, 423 (2005) (emphasis omitted).

177. 131 S. Ct. at 1745.

178. The Second Circuit, in *In re American Express Merchants' Litigation*, 667 F.3d 204 (2d Cir. 2012), *reh'g en banc denied*, 681 F.3d 139 (2d Cir. 2012), *cert. granted*, 133

proposal calls for the arbitration to be governed by the American Arbitration Association's (AAA) Commercial Arbitration Rules, as supplemented by the Securities Arbitration Supplementary Procedures (AAA Rules). The AAA provides the standard set of rules and procedures for many different types of arbitration, including the consumer contract in *Concepcion*. Organizing the arbitration under the AAA Rules provides clarity and certainty to both the corporation and its stockholders. Second, our proposal provides for a panel of three arbitrators in large cases, providing each side the opportunity to choose its preferred arbitrator. The AAA Rules provide for cases to be heard by arbitrators drawn from the National Panel of Securities Arbitrators, which assures that arbitrators with relevant expertise will hear cases. This should result in more sensible decisions for corporations and stockholders. Third, the arbitration venue under our proposal is to be mutually agreed upon by the parties, allowing stockholders a say in where the arbitration takes place. Fourth, the corporation will cover all costs of the arbitration in nonfrivolous claims as well as the payment of attorneys' fees in the event the stockholder is successful. This approach limits stockholder barriers to arbitration and should ensure that attorneys are willing to take on valid stockholder claims. Finally, our proposal's five-year sunset provision provides stockholders with a chance to reconsider their position based on actual experience.

S. Ct. 594 (2012), recently struck an arbitration provision in a merchant credit card agreement, finding that the plaintiffs had successfully proved that enforcement of the arbitration provision would make enforcement of their rights under the Sherman Act economically unfeasible given the expenses involved. We believe the decision may very well be overturned, as it appears to be contrary to the Supreme Court's recent line of arbitration decisions. In particular, the Second Circuit itself acknowledged that the Sherman Act contains no "congressional command" against arbitration as required by *CompuCredit Corporation v. Greenwood*, 132 S. Ct. 665 (2012), and relied instead on dicta in the older Supreme Court cases of *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614 (1985) and *Green Tree Financial Corp.-Alabama v. Randolph*, 531 U.S. 79 (2000) to justify its decision. Regardless of the eventual outcome of *In re American Express*, we believe the procedural protections contained in our arbitration proposal are sufficient to provide a remedy to stockholders for any violation of their rights under federal law.

C. An Alternative

We have also considered an alternative approach whereby stockholders would agree to a by-law amendment that would require, in the case of a proposed securities class action, contrary to Federal Rule of Civil Procedure 23, that the class be composed only of those stockholders who opt into the class rather than include all eligible class participants other than those who opt out of the class (Opt-In Proposal). We believe the Opt-In Proposal would result in smaller class sizes, as individual investors who have little to gain and potentially more to lose from participating in such a suit would simply not join the class, thus reducing the class size. The reduction in overall class size could produce lower damages, which in turn would make the case less appealing to securities class action lawyers and thus would deter meritless class actions brought mainly for their settlement value.

However, in discussing our Opt-In Proposal with both corporations and institutional investors, several significant objections were raised. First, opponents argued that institutional investors likely would not change their behavior under the Opt-In Proposal. Rather, they likely will always opt in to such a class action: Although all institutional investors would be better off without the class action, if the suit is going forward anyway, any single institutional investor would prefer to recover something rather than nothing. For companies with significant institutional ownership, the fact that institutional investors would all be expected to opt in would mean that the class size likely would not decrease dramatically. Furthermore, even if the class size decreased, plaintiffs' lawyers might not make a corresponding reduction in the settlement amounts they seek.

In addition to the collective action problem just discussed, two other objections were raised to the Opt-In Proposal: institutional investors could incur increased due diligence costs as they determine whether to opt in to a suit, rather than whether to opt out; and finally, as retail investors would be the group most likely affected by the Opt-In Proposal, there could be a negative public perception of this approach even though it does not impact these investors' rights (as they could always choose to opt in). Regarding the due diligence objection, we believe institutional investors should be conducting due diligence regardless of whether they are in an opt-in or opt-out

regime; this ensures meaningful participation by stockholders who believe there is merit to a particular suit. Secondly, in response to the critique about potential public perception regarding impact on retail investors, we reiterate that it is these retail investors who suffer most from class actions—they often stand to gain only pennies as a result of any settlement, and frequently will not bother to fill out the paperwork necessary to collect their recovery amounts.

We believe our arbitration proposal to be superior to the Opt-In Proposal. Arbitration does not give rise to the collective action problem described above. Most importantly, however, mandatory individual arbitration will eliminate, rather than merely reduce, securities class actions and their attendant costs and burdens. Finally, arbitration provides a forum for dispute resolution far preferable to the courts.

CONCLUSION

The case law supports the conclusion that the courts would uphold a by-law amendment that requires individual arbitration in place of securities class actions. Securities class actions are a flawed regime that stockholders should have the opportunity to replace: they provide little meaningful compensation to institutional or individual stockholders, and instead primarily benefit plaintiffs' attorneys who recover up to 35% of a settlement value in contingency fees; they do little to deter wrongdoing, as the actual wrongdoers are rarely held personally responsible for losses; and finally, they have a major negative impact on the competitiveness of the U.S. capital markets. As we have set forth above, under our proposal, stockholders would propose an amendment to a corporation's by-laws that, if approved by a stockholder vote, would require individual arbitration in the event of stockholder disputes involving the U.S. securities laws. Our proposal also provides for the corporation covering all costs of the arbitration in nonfrivolous claims and the payment of attorneys' fees in the event the stockholder is successful.

The SEC should hold an open hearing on the issue of mandatory arbitration provisions, rather than continuing to oppose, without explanation, companies' and stockholders' efforts to opt for the arbitration regime.

APPENDIX 1: DRAFT STOCKHOLDER RESOLUTION

Stockholder Resolution

Resolved that the by-laws of [XYZ Corporation] be amended to provide that:

"A stockholder must arbitrate as an individual (not on a class basis), under the Commercial Arbitration Rules of the American Arbitration Association, as supplemented by the Securities Arbitration Supplementary Procedures, any dispute between the stockholder and the Corporation or its affiliates involving the U.S. federal securities laws (including any rules, regulations or case law under the U.S. federal securities laws) insofar as such dispute is based on events or circumstances arising on or after the date this by-law is adopted.

The Corporation will bear all costs of the arbitration in non-frivolous claims, which shall occur in a mutually agreed-upon U.S. location. In the event the stockholder receives an arbitration award, the Corporation will reimburse the stockholder's reasonable attorneys' fees.

This by-law may be amended or repealed at any time by a vote of a majority of the shares outstanding.

This by-law will expire and cease to be effective five years from the date of its adoption unless extended by a vote of a majority of the shares outstanding."

Supporting Statement

Securities class actions are uniquely American, and have a major negative impact on the competitiveness of the U.S. capital markets. From 2000 through 2011, the total value of all securities class action settlements was approximately $64.4 billion. Academic commentators are almost unanimous in concluding that class actions result in little meaningful compensation. Diversified institutional stockholders, who are both plaintiffs and investors in the defendant corporations, end up suing themselves and lose up to 35% of their recoveries on the turn to contingency fees of plaintiff attorneys. Smaller investors recover so little that they often do not bother to claim their recoveries.

Nor are securities class actions an effective deterrent of wrongdoing. Class action settlements primarily affect stockholders, not management. The major deterrence of fraud occurs

from the damage to reputation reflected in stock drop losses incurred upon the disclosure of wrongdoing, which is mainly uncovered by whistleblowers and the media, and through SEC and state enforcement actions.

A better approach is to give stockholders a meaningful choice: Stockholders can decide to require individual arbitration in lieu of class actions. The Supreme Court in its recent decision in *AT&T Mobility LLC v. Concepcion* strongly endorsed individual arbitration, emphasizing its advantages over class actions. Individual arbitration offers speedier resolution with relative informality—timely and less costly results—benefiting both stockholders and corporations.

APPENDIX 2: BY-LAW AMENDMENT

[X]. Arbitration

(A) All disputes between a stockholder in that stockholder's capacity as such and the Corporation and/or its directors and/or its officers shall be exclusively and finally settled by arbitration under the Commercial Rules of the American Arbitration Association (AAA), as supplemented by the Securities Arbitration Supplementary Procedures (the Arbitration Rules), as amended from time to time.

(B) Disputes between a stockholder in that stockholder's capacity as such and the Corporation and/or its directors and/or its officers and/or its controlling persons may not be brought as a class, and such disputes may not be consolidated or joined.

(C) The tribunal shall consist of one arbitrator (if the claim is $100,000 or less) or three arbitrators (if the claim exceeds $100,000), in each case to be appointed in accordance with the Arbitration Rules.

(D) The place of arbitration shall be a mutually agreed-upon U.S. location (or, in the event the parties are unable to agree, a location selected by the arbitrator(s)).

(E) Notwithstanding the result of any arbitration, the Corporation shall pay the fees of the AAA relating to the arbitration and the fees of the arbitrator or arbitrators relating to the arbitration, unless the claim is determined by the arbitrator(s) to be frivolous. The Corporation also shall pay reasonable costs of counsel of the stockholder party, as well as its own counsel costs, if the stockholder party is successful.

(F) The language of the arbitration shall be English.

(G) This article [X] also contains or evidences an express submission to arbitration by each stockholder, the Corporation, its directors, its officers and its controlling persons and such submissions shall be treated as a written arbitration agreement.

(H) Each person to whom this article [X] applies hereby waives, to the fullest extent permitted by law: (i) any right under the laws of any jurisdiction to apply to any court of law or other judicial authority to determine any preliminary point of law; and/or (ii) any right it may otherwise have under the laws of any jurisdiction to appeal or otherwise challenge the award, ruling or decision of the tribunal.

(I) The governing law of any arbitration commenced pursuant to this article [X], including any submission to arbitration and the written arbitration agreement contained in or evidenced by this article [X], shall be the substantive law of [state of incorporation].

(J) The Corporation shall be entitled to enforce article [X] for its own benefit, and that of its directors, subsidiaries, officers and controlling persons.

(K) Damages alone may not be an adequate remedy for any breach of this article [X], so that in the event of a breach or anticipated breach, the remedies of injunction and/or an order for specific performance would in appropriate circumstances be available.

(L) This article [X] may be amended or repealed only by the vote of the holders of the majority of shares of the Corporation voting on such amendment or repeal, and may not be amended or repealed by the board of directors of the Corporation.

(M) This article [X] shall expire and cease to have any effect on the date five years from the date of this article's adoption, unless the holders of the majority of shares of the Corporation voting on such extension vote to extend the duration of this article.

(N) References in this article [X] to:

> (i) "Corporation" shall be read to include each and any of the Corporation's subsidiaries from time to time;
>
> (ii) "Director" shall be read to include each and any director of the Corporation from time to time in his or her capacity as such or as employee of the

Corporation and shall include any former director of the Corporation; and

(iii) "Officer" shall be read to include each and any officer of the Corporation from time to time in his or her capacity as such or as employee of the Corporation and shall include any former officer of the Corporation.