The End of Shareholder Litigation? Allowing Shareholders to Customize Enforcement Through Arbitration Provisions in Charters and Bylaws

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Shareholder litigation has been heavily criticized for its inability to compensate harmed shareholders or deter managerial misconduct. While some have suggested abolishing shareholder litigation altogether, this Article takes a more moderate approach. I propose allowing shareholders to enforce charter and bylaw provisions that require arbitration of certain disputes. For example, an acquisitive company may require arbitration of merger-related suits while allowing non-merger suits to proceed in court. Likewise, a company in an industry known for volatile stock prices could require a price drop of three or four standard deviations before the suit could be brought in court, rather than arbitration. Because enforcement would be customized on a company-by-company basis, shareholders could set a better balance between costs and benefits than the ham-fisted, one-size-fits-all regime functioning today. This proposal requires no legislative action; it requires only that the SEC bring its statutory interpretation in line with current Supreme Court precedent.

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I. INTRODUCTION

Shareholder litigation is inefficient at compensating harmed shareholders and deterring managerial misconduct. It is also plagued by strike suits designed to force nuisance settlements. Several reforms have been offered, but these reforms are either rigid, which harms both meritless and meritorious suits alike, or flexible, which are often costly and subject to political pressures. Customized arbitration provisions improve upon these reforms by allowing enforcement to be tailored to each company’s needs, granting some suits a quick death in arbitration and others the full protections of litigation. The concerns about arbitration arise from two misconceptions.

First, shareholder litigation is not about management. Managers and directors may have their names on the complaint, but at the end of the day, the shareholders write the check, and the managers keep their yachts. Studies show that shareholder litigation has little effect on a manager or director’s wallet or reputation. So when evaluating remedies, the balance is not between the needs of shareholders and management; it is about finding the right balance of benefits and costs to shareholders in a suit against themselves.

Second, this is not about litigation. Nearly all shareholder suits settle. These suits are about settlement, not judgment. So when evaluating the benefits and drawbacks of reform proposals, such as arbitration, we err by comparing them to litigation. With these perceptions corrected, most of the disadvantages of arbitration melt away.
I propose allowing shareholders to decide what level of protection shareholder litigation should provide. I propose doing this by allowing firms to include mandatory arbitration provisions in their charters or bylaws. This does not require a change in the law; instead it requires the SEC to reverse its position that arbitration violates the Securities and Exchange Act of 1934, bringing the commission back in line with current Supreme Court precedent.

Under my proposal, some firms may choose to retain the current regime. Others might opt for binding arbitration of all claims. I suspect most would explore a mix of arbitration and litigation, customized to their needs. For example, acquisitive firms may push claims regarding mergers into arbitration but allow more typical fraud claims to continue through the courts. This proposal adds flexibility, lowers the cost to taxpayers, and customizes solutions on a company-by-company basis. To invoke Smith, Wright, and Hintze's seminal theory, it leverages corporations as "laboratories of corporate governance."\(^1\)

Further, because I do not propose imposing arbitration on any company, but instead allowing each company the freedom to adopt arbitration as it sees fit, it is not clear why we should care whether it offers benefits to the company. Because managers are rationally apathetic to shareholder litigation, there is little reason to suspect they will spend political capital pushing through arbitration against the shareholders' will. And if it is the shareholders' will to limit their own remedy, why should the government stop them?

Part II of this Article summarizes the current theory, criticisms, and proposed reforms of shareholder litigation.

Part III sets out my proposal, which is to allow corporations to creatively structure arbitration agreements to balance the benefits and costs of enforcement.

Part IV addresses likely responses. This Part will show why an arbitration provision would not violate securities laws, a claim the SEC is likely to make. It will also show that, while legislators will likely rail against arbitration, federal legislation is unlikely, and state legislation is likely preempted by the Federal Arbitration Act. The plaintiffs' bar will likely sue to stop enforcement, but state contract defenses to enforcement will likely fail.

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II. THE THEORY, CRITICISMS, AND PROPOSED REFORMS OF SHAREHOLDER LITIGATION

A. Balancing Shareholder Costs

The debate over shareholder litigation has often been framed as a struggle between shareholders and management. This makes sense. The separation of capital from management creates misaligned incentives that often cause management to cheat. To prevent these agency costs, shareholders incur monitoring and enforcement costs.

Because all of these costs are focused on keeping management in line, a great deal of effort has gone into reaching the right balance between shareholder protection, managerial innovation, and freedom to operate.

This balance misses the larger point. The costs of managerial misconduct are all borne by shareholders. They bear the cost of fraud, of monitoring, of enforcing, and of missed opportunities caused by overly restricting management. In addition, if the markets lose their reputation for trustworthiness, shareholders pay the risk premium associated with less trustworthy markets.

Because the costs of misconduct and the costs to prevent misconduct are all borne by shareholders, the goal should not be to balance management and shareholder interests but to balance shareholders’ overall costs.

To discuss this balance, it is necessary to briefly consider the costs shareholders face, in particular the cost of managerial fraud.

1. The direct costs of fraud

Fraud has severe direct costs on shareholders. Although this is noncontroversial, a few notable examples highlight the point.

When Enron, once the seventh largest corporation in America,\(^2\) revealed its accounting fraud, its investors lost around $11 billion.\(^3\)


Less than a year later Worldcom revealed fraud that some estimate cost its investors over $175 billion. These frauds wiped out the retirement investments of thousands of employees, who also found themselves out of work.

More recently, Bernie Madoff, former chairman of the NASDAQ and Wall Street legend, pled guilty to bilking investors out of around $65 billion through a Ponzi scheme. In short, the direct costs of fraud are high.

2. Collateral costs of fraud

In addition to the direct costs, when fraud is revealed, share prices typically drop further than the cost of the fraud per share. This abnormal return may reflect damage to management's reputation, uncertainty about the actual effect of the loss, or an expectation of higher enforcement and monitoring costs to come.

A more diffuse cost is the effect of fraud on the perception of the market as a whole. Trust in the market is a public good that can become subject to the tragedy of the commons. That is, fraud is costly, so rational investors will require a higher premium to invest in markets that are perceived as more conducive to fraud. Businesses seeking to raise capital at the lowest possible cost have an interest in rigorously excluding those who harm the perception of a fair market. Every fraud hurts everyone.

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3. Costs of preventing fraud

Investors also face the costs of preventing fraud, which include monitoring and enforcement costs. These costs usually increase in response to increased direct costs as litigation creates new enforcement costs and political pressure creates new monitoring requirements.

For example, after the accounting scandals that rocked Enron and WorldCom, and to a lesser extent Halliburton, Qwest, Tyco, AIG, and Parmalat, Congress passed the Sarbanes-Oxley Act of 2002, which requires new internal control procedures designed to expose and prevent fraud. The compliance cost of these new procedures in 2007 was around $1.7 million per company, more than eighteen times the SEC’s original cost estimate.

Likewise, enforcement costs can quickly get out of hand. Cleaning up the Madoff fraud, which had a net cost to direct investors of about $18 billion, will likely cost more than $1.1 billion for attorneys, accountants, and consultants.

This paper focuses on enforcement costs, specifically shareholder litigation. Enforcement serves as a deterrent to prevent fraud, but over-enforcement or inefficient enforcement can create more costs than benefits. Shareholders may find that arbitration reduces their enforcement costs more than it increases agency and monitoring costs.

12. See Joseph A. Grundfest & Steven E. Bochner, Fixing 404, 105 MICH. L. REV. 1643, 1645-46 (2007) (noting also that first-year implementation costs were eighty times greater than the SEC had estimated for companies with market capitalizations over $700 million).
costs, in which case it would be a net gain for shareholders. I begin with a more detailed review of shareholder litigation.

B. Shareholder Litigation Theory

This section discusses the sources, purposes, problems, and proposed reforms of shareholder litigation.

1. Sources of shareholder litigation

There are three major sources of shareholder litigation. The most criticized is derivative litigation, which allows a shareholder to sue on behalf of the company. These suits are usually brought against the officers and directors of a corporation for breach of a fiduciary duty.  

A second common source of shareholder litigation is shareholder securities fraud class action suits. Professors Baker and Griffith found that ninety-three percent of securities class actions brought in 2005 alleged fraud, specifically violations of Rule 10b-5 under the Securities and Exchange Act of 1934 (the "Exchange Act"). Rule 10b-5 of the Exchange Act prohibits fraud and misstatements in the sale of a security. These claims are brought directly under the federal securities laws and are removable to federal court.  

A third common type of shareholder litigation is class actions challenging director action in an acquisition. Thompson and Thomas


17. 17 C.F.R. § 240.10b-5 (2012). The statute states the following:
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
   (a) To employ any device, scheme, or artifice to defraud,
   (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
   (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

found that this type of litigation makes up around eighty percent of all breach of fiduciary duty claims in the Delaware Court of Chancery.¹⁹

2. Purpose and problems of shareholder litigation

Shareholder litigation is meant to allow shareholders to check the agency cost of managers and directors. In that sense shareholder litigation is designed to be compensatory—it puts cash back into the pockets of wronged shareholders—and a deterrent—it punishes managers for their bad acts, which incentivizes them to behave well.

a. Compensation theory, pocket-shifting, and well-diversified investors. The compensation justification is widely rejected by scholars.²⁰ Because settlements to shareholders are paid from the company’s treasury, which already belongs to the shareholders, the payments are mere pocket-shifting.²¹ This means shareholder settlements are little more than a court-enforced dividend with heavy transaction costs.²² Even settlements paid by insurers or consultants are paid by the shareholders through higher fees.²³ Put simply, shareholders cannot come out ahead by suing themselves.

Diversification creates a more subtle problem. The bad acts that form the basis of these suits create winners and losers among shareholders. For example, those who hold shares when a manager tells a pleasant lie benefit from the lie. Those who hold shares when the lie

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¹⁹. Thompson & Thomas, supra note 15, at 137.


²¹. See, e.g., Alexander, supra note 20, at 1503; Easterbrook & Fischel, supra note 20, at 641–42 (pointing out that a diversified investor is as likely to benefit from fraud as to be harmed by it, so payments from current to past shareholders are inefficient in the face of monitoring and enforcement costs).

²². See, e.g., Coffee, Jr., supra note 20, at 1545–47.

²³. Suits against consultants are uncommon. In 2011, auditors were named in only 3% of securities class actions, and underwriters were named in only 10%. CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILING: 2011 YEAR IN REVIEW 27 (2012), available at http://bit.ly/U1Lnnml; see also Langevoort, supra note 20, at 648–50 (arguing persuasively that securities litigation settlements are funded in three ways: (1) from the company, (2) from an insurer, or (3) from a service provider, such as an accounting firm). Transfers from the company are “pocket-shifting,” and transfers from insurers or service providers are reflected in higher premiums and fees. Id.
is revealed are harmed by the lie. For shareholders that buy and hold the company's shares through both of these events, the direct benefits and costs of the lie balance each other out. But while the fraud is ongoing, active shareholders may sell (thereby benefiting) or buy (thereby being harmed). A well-diversified investor is as likely to benefit from the fraud as to be harmed by it, so, in the end, well-diversified investors net to zero. So well-diversified investors, ex ante, should show as little concern to the direct costs of the fraud as to the direct benefits because they are equally likely to face either.  

Of course, opportunism will spur concern when applied to a specific situation. But shareholder litigation doesn't cure these harms; it merely complicates the accounting by repaying shareholders harmed by the fraud with money taken from current shareholders, who may not have benefited from the fraud. In the end, the current shareholders must repay not only the benefits taken by those who sold earlier but also the litigation costs associated with making those payments.

Because shareholders are paying their own recoveries, and because well-diversified investors net to zero, compensating shareholders cannot justify shareholder litigation.

Professor Daniel Morrissey argues that this reasoning applies only to well-diversified investors, so a simple shareholder with an unvaried portfolio may still benefit from shareholder litigation. This assumes simple shareholders trade as actively as more sophisticated investors. Shareholder settlements are paid only to those that bought or sold during the period tainted by fraud. If simple investors are more likely to adopt a buy-and-hold strategy, they are less likely to be part of any settlements, so there will be no litigation gains to offset litigation losses. Shareholder litigation is likely more costly to simple investors with unvaried portfolios, not less.

24. By no means do I mean to discount the indirect costs of fraud discussed elsewhere in this Part, but indirect costs do not justify shareholder litigation under the compensation theory.


27. Professor Zhang finds that about 78% of trading volume is conducted by high-frequency traders, which make up 1–2% of all trading firms. X. FRANK ZHANG, HIGH-FREQUENCY TRADING, STOCK VOLATILITY, AND PRICE DISCOVERY 16 (2010), available at http://ssrn.com/abstract=1691679. This suggests it is unlikely that simple investors make up much of the remaining volume.
b. Deterrence. Shareholder litigation's second justification is deterrence. The deterrence theory says that managers will be less likely to misbehave if they will be punished for it. In effect, shareholder litigation supplements pre-fraud monitoring. The theory fails because shareholder litigation rarely punishes managers.

Ninety-six percent of shareholder securities class actions settle within common insurance limits, leaving insurers to fully fund the settlement. Even when insurers do not cover the entire settlement, individual defendants rarely make up the difference with personal funds.

An argument could be made that shareholder litigation has reputational costs, but this is unlikely because litigation is ubiquitous. Over a five-year period, the average public company has a ten percent chance of facing a class action securities suit. Transaction-oriented firms face even worse odds. Approximately ninety-four percent of mergers now lead to shareholder suits. If everyone is being sued, being sued no longer signals incompetence.

Professor Eric Helland's always insightful work bears this out. His review of director elections after a shareholder class action found that directors suffered a loss of reputation only in shareholder suits that resulted in settlement values in the top quartile or where the SEC was involved. SEC involvement signals possible criminal activity, and high settlement values may signal incompetent negotiating.

Because there is no out-of-pocket cost or reputational cost to most shareholder suits, they are an ineffective deterrent.

c. Other justifications: corporate governance and informed trading. Professor Lawrence E. Mitchell offers a clever, alternative
justification for securities litigation: punishing shareholders. Mitchell argues that shareholders have a “responsibility to protect the integrity of our financial markets through their voting and trading.” Failing in this duty leads to fraud, which leads to the pains of shareholder litigation, which may prod otherwise free-riding shareholders to monitor management more closely. In effect, he fixes the deterrence problem not by changing who is punished but by redefining who deserves punishment.

This argument has a few weaknesses. First, state law places sharp limits on shareholders’ ability to control management. Increasing the incentive to act cannot overcome the inability to act. Second, it is unclear what the punishment should urge the shareholders to do. Collective action necessary to modify controls on management can be extremely costly, often involving a proxy contest. In contrast, the cost of shareholder litigation, on a per share basis, is still just a gadfly. The costs of shareholder litigation will rarely be sufficient to incentivize a rational investor to run a proxy contest rather than sell his shares. Finally, shareholder litigation no longer signals that management has misbehaved. As discussed above, shareholder litigation has become so ubiquitous that even a shareholder that is willing to act would not see the shareholder suit as a signal that action is needed.

Empirical evidence also challenges this theory. Professor Talley found that very few corporate governance practices were statistically significant in predicting the targets of shareholder litigation. Share price, volatility, and volume were far better predictors. If corporate governance is not a good predictor of litigation, then a properly mo-

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35. Id. at 292.
39. Id. at 349–50.
tivated shareholder would not attempt to reduce shareholder litigation by focusing on corporate governance.

Professor Jill Fisch offers an alternative justification, arguing that securities litigation promotes informed trading. She argues that securities fraud disproportionately harms informed investors, who actively trade on information, including false information.\(^{40}\) Research done by these investors becomes incorporated into share prices, and accurate share prices are a public good. In this sense, informed trading creates an externality. However, informed traders are less likely to be diversified, she argues, because of the high research costs associated with investing in an additional company.\(^{41}\) Because they are less diversified, and because they actively trade on information, they are more likely to be net losers from fraud. On the other hand, because they trade more frequently than buy-and-hold investors, and trade based on new information, they are more likely to be part of the class in securities litigation, making them net winners in litigation. She argues that securities litigation compensates informed traders for the externalities they provide by offsetting their greater-than-average losses from fraud.\(^{42}\)

One problem with this argument is that a trade requires activity from two parties: a buyer and a seller. So if a trade occurs during the period affected by fraud, the fraud creates one winner and one loser. If the buyer and seller are both informed traders, then informed traders as a whole have not been made worse off. If both are uninformed traders, then there is no net effect on informed traders. So the theory works only when a trade occurs between an informed trader and an uninformed trader, and then only if they are on the right side. Though certainly possible, it seems unlikely that these trades could make up enough volume for this theory to find support.\(^{43}\)

\(^{41}\) \textit{Id.}
\(^{42}\) \textit{Id.}
\(^{43}\) Professor Zhang has found that about seventy-eight percent of trading volume is by high-frequency traders and that these trades hinder price discovery rather than improve it. X. Frank Zhang, \textit{supra} note 27, at 13–16, 26. This raises questions of how often uninformed traders trade with informed traders and the value added by these traders. Without more clearly defined terms, it is difficult to say whether these high-frequency traders are informed or not.
d. Costs. In addition to offering very little bang, shareholder litigation costs a lot of buck. These suits are expensive, so as a compensatory device, they are grossly inefficient. A survey of settlements from 2002 found that the average securities class action settled for 2.9% of its estimated damages. From these recoveries, plaintiffs’ attorneys take 25–35%. The payout to small investors after these fees is often so low that they do not even bother to collect it.

A full accounting of costs must also include defense costs, which the shareholders must pay, and which likely match the plaintiff-side costs, and the costs of distracting managers from their duties. As CEO salaries rise, so does the cost of wasting their time.

These suits create public costs as well. On an unconsolidated basis, securities class actions made up 48% of all class actions that were pending in federal court between 2004 and 2005.

Finally, these suits cost the U.S. markets their competitiveness. The Committee on Capital Markets Regulation found that foreign issuers commonly cite the enforcement system as the most important reason for not listing in U.S. markets. The increased cost of the U.S. enforcement system is reflected in insurance rates. Fortune 500 companies listed in the U.S. typically carry twice as much D&O insurance as those listed in Europe and pay triple the rate per dollar of coverage. These increased costs harm the competitiveness of the U.S. capital markets, which has declined in nearly every measure over the last few years.

45. COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 79 (2006).
47. COMM. ON CAPITAL MKTS. REGULATION, supra note 45.
48. Id. at 74. This figure likely overstates the total burden because discovery is often consolidated, and only 8% of these cases proceed to a ruling on summary judgment. See CORNERSTONE RESEARCH, supra note 23, at 18.
49. COMM. ON CAPITAL MKTS. REGULATION, supra note 45, at 71.
50. Id. at 78.
51. COMM. ON CAPITAL MKTS. REGULATION, THE COMPETITIVE POSITION OF THE U.S. PUBLIC
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e. Unintended consequences. Shareholder litigation also creates other unfortunate consequences. Ironically, shareholder litigation can actually make it more difficult to detect and punish managerial fraud. The typical shareholder suit runs something like this. After the announcement of a merger or a major decline in the stock price, entrepreneurial plaintiffs’ attorneys file suit and attempt to force a quick settlement. Their ability to quickly stake a claim and then settle has led many in the industry to label them “pilgrims.”

The problem is that managers have learned to play along. They realize that large transactions will inevitably lead to shareholder suits and that settling with pilgrims can create a bar against later, possibly meritorious, suits. By settling quickly with the pilgrims, management avoids the costs of discovery, substantive negotiation, and the risks of actual litigation. This wide release from future claims eliminates the primary goals of shareholder suits: to detect, deter, and punish managerial misconduct.

A second unintended consequence flows from these settlements. In 2005, shareholders sued in 38.7% of large acquisitions. By 2011 that number had climbed to 94.2%. Because litigation is expected, a rational dealmaker will account for it as a transaction cost during negotiations. This operates as a tax on every transaction, which, like most taxes, creates a deadweight loss. Because rational dealmakers expect this cost, there are mutually beneficial deals on the margin that are never done, creating efficiency losses to no one’s gain.

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EQUITY MARKET S (2007) (showing a decline in U.S. competitiveness across a number of measures, including number of U.S. initial public offerings listed only abroad and foreign delisting on the New York Stock Exchange).

52. See In re Revlon, Inc. S’holders Litig., 990 A.2d 940, 945 (Del. Ch. 2010).
53. Cain and Davidoff found that 94.2% of mergers resulted in shareholder litigation in 2011—up from 38.7% in 2005. CAIN & DAVIDOFF, supra note 31.
54. See Revlon, 990 A.2d at 952, 956, 59–60.
55. See id. (noting that the plaintiffs’ counsel never even bothered to put on a facade of discovery).
56. CAIN & DAVIDOFF, supra note 31.
57. Id.
58. See Romano, supra note 33, at 62–63.
3. Past proposals for reform

For years, shareholders, legislators, and academics have proposed reforms. Reform proposals come in two types: rigid reforms that affect all suits and flexible reforms that rely on gatekeeper discretion.

Among the rigid reforms are those that heighten pleading requirements, expand safe harbors, limit who can sue, cap damage amounts, or delay discovery. These reforms have the advantage of being easy to administer and remaining uninfluenced by discretionary politics or prejudice. They tend to keep the playing field level while moving back the goal posts.

The downside is that they are blunt instruments which cannot actively balance over-enforcement with under-enforcement. The filters restrict the meritorious and frivolous alike.

This has led some scholars to call for a regulatory gatekeeper, which would prescreen suits to determine whether to allow them to proceed. Professor Amanda Rose argues that the SEC could fulfill this role. Professor A.C. Pritchard goes a step further, arguing for the elimination of private enforcement of some types of shareholder suits and instead authorizing the securities exchanges to be the sole enforcers.

The gatekeeper approach has many advantages. It preserves the benefits of discretionary non-enforcement, limits over-enforcement, and avoids the under-enforcement caused by more rigid reforms.

However, it has two large drawbacks. First, the gatekeeper’s incentives may not align with the shareholders’. Gatekeepers are subject to regulatory capture and political pressure, which could cause under-enforcement in industries that capture the gatekeeper and over-enforcement in industries that are politically unpopular.

60. Id. at 749–51.
61. Id. at 740 (preventing a person from being a lead plaintiff more than five times in three years).
Second, gatekeepers are expensive. Prescreening every suit would entail huge costs that would require increased taxes or fees. If the regulator were the sole enforcer, these costs would be even higher.

III. THE REMEDY: FREEDOM TO ARBITRATE

I propose allowing shareholders and management to set the balance between over- and under-enforcement by adopting arbitration provisions in their bylaws or charter.

A. Allowing Arbitration

What follows is the affirmative argument explaining how these provisions might work and some examples of the many variations creative shareholders might develop to suit their needs. I address the legal arguments against enforcement in Part IV below.

1. Why an arbitration provision will likely be enforceable

An arbitration provision is enforceable whether analyzed under the Federal Arbitration Act or Delaware law.

The Federal Arbitration Act requires enforcement of all agreements to arbitrate. A corporation's bylaws and charter form a binding agreement between the corporation and its shareholders and directors. So if either the bylaws or charter require arbitration of shareholder disputes, it is an agreement to arbitrate that must be enforced under the Federal Arbitration Act.

Looking at it another way, the Delaware Court of Chancery recently suggested that corporations may include forum selection clauses in their charter to avoid litigating shareholder disputes in forums other than the Court of Chancery. An arbitration clause is nothing more than a "specialized kind of forum-selection clause." So if a corporation can amend its charter to select the

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66. It may be possible to bill the plaintiffs for this screening under the assumption that if the claim is not worth the screening fee, it should not be brought.
68. See Kidsco, Inc. v. Dinsmore, 674 A.2d 483, 492 (Del. Ch. 1995).
69. See In re Revlon, Inc. S'holders Litig., 990 A.2d 940, 960 (Del. Ch. 2010).
Court of Chancery as the forum, it can likewise select arbitration as the forum.

2. Setting loose the “laboratories of corporate governance”

   The exact language of the provision could be as unique as the company chooses. It might apply arbitration to all claims or only to certain categories of claims, such as those involving mergers or those valued above a certain amount. Arbitration could be the initial forum, or apply only when a party requests arbitration or after the complaint survives a motion to dismiss.

   One variation that might create a good balance would be to begin the case in arbitration but allow shareholders to remove the case to federal court with the written consent of some percentage of the outstanding shares. This would ensure a low-cost death for frivolous claims but allow the full protections of federal court when shareholders agree the suit is worthwhile.

   A variation on that alternative would be to expand or contract the scope of judicial review of the arbitral award. The provision could provide for complete de novo review by the courts or de novo review of law, with limited review of facts.

   Firms with complex arbitration provisions may allow an arbitrator to determine if a dispute is subject to arbitration—a practice approved by the Supreme Court.

   These are just a few examples of what corporations may discover. Allowing the freedom to adopt a provision that is right for them leverages the full creativity of these “laboratories of corporate governance.”

    71. Smith, Wright & Hintze, supra note 1, at 181.
    74. See First Options of Chicago, Inc. v. Kaplan, 514 U.S. 938, 944-45 (implying that in some circumstances the parties likely considered the scope of arbitration when drafting the contract).
    75. Smith, Wright & Hintze, supra note 1, at 181.
B. Pros and Cons of Arbitration

There are many benefits to arbitration.

[I]t is usually cheaper and faster than litigation; it can have simpler procedural and evidentiary rules; it normally minimizes hostility and is less disruptive of ongoing and future business dealings among the parties; it is often more flexible in regard to scheduling of times and places of hearings and discovery devices.\cite{65}

At the outset, it is worth noting that my proposal is not that every corporation should adopt an arbitration provision or that one arbitration provision would work best for all corporations. Because I propose allowing each corporation to choose for itself the extent that it uses arbitration, if at all, the counterarguments carry the day only by showing (1) that arbitration is always worse for every corporation in every form or (2) that corporations will systematically adopt arbitration provisions that are worse than the current enforcement regime. This is a high bar, which I do not see met.

1. Costs

The most cited benefit of arbitration is the cost savings. I break down this analysis by considering procedural costs, liability costs, and spillover costs.\cite{77} It is worth mentioning that even if the average firm would pay more under arbitration, this is no reason to prohibit it. Not every firm is the average firm, so some may find it cost-effective. And if the firm chooses to take upon itself higher costs, it’s not clear why the government should prohibit if from doing so.

a. Procedural costs. Procedural costs are the costs of reaching a disposition. Scholars generally agree that arbitration is less expensive than litigation because, as Professor David Schwartz explains, arbitration “offers less room for complexity.”\cite{78}


\cite{77} See David S. Schwartz, Mandatory Arbitration and Fairness, 84 NOTRE DAME L. REV. 1247, 1266 67 (2009) (dividing up arbitration costs by liability and procedural costs).

\cite{78} Id. at 1268.

It is not clear how much of these cost savings will apply in shareholder disputes. Under the Private Securities Litigation Reform Act (PSLRA), discovery does not begin until after the court rules on any motion to dismiss.\footnote{15 U.S.C. § 77z-1(b)(1) (2012) (applying discovery stay to litigation under the Securities Act of 1933); 15 U.S.C. § 78u-4(b)(3)(B) (2012) (applying discovery stay to litigation under the Securities Exchange Act of 1934).} About 16% of cases settle before this, and another 9% are voluntarily dismissed, meaning 25% never reach discovery anyway.\footnote{CORNERSTONE RESEARCH, supra note 23, at 18.} Nearly 90% of the remaining cases are either dismissed or settled after surviving a motion to dismiss, with only 8% of all filings reaching a ruling on summary judgment.\footnote{See, e.g., In re Revlon, Inc. S’holders Litig., 990 A.2d 940, 945 (Del. Ch. 2010).} While it is unclear how much discovery occurs between a rejected motion to dismiss and an eventual settlement,\footnote{Tom Baker & Sean J. Griffith, How the Merits Matter: Directors’ and Officers’ Insurance and Securities Settlements, 157 U. PA. L. REV. 755, 777 n.93 (2009).} discovery seems to be the exception, rather than the rule.

Discovery in significant securities class actions is typically conducted through an e-discovery database, which costs one to three million dollars to set up.\footnote{Id.} Defendants obviously want to settle quickly and avoid these costs, but because the costs will be covered by insurance, which also pays for the plaintiffs’ recovery, the plaintiffs also have an incentive to reduce costs.\footnote{Id.} With these aligned incentives, one would expect that few litigants would commence such costly discovery, but an illuminating survey by Professors Baker and Griffith found that the parties “emphasized” that they must “prepare for trial, if only to have a credible threat.”\footnote{Id.}

Because discovery costs can be astronomical and because the parties insist on incurring them, it seems that any cost benefit gained from early dismissals is overwhelmed by enormous discovery costs.

\footnotesize
81. CORNERSTONE RESEARCH, supra note 23, at 18.
82. Id.
83. See, e.g., In re Revlon, Inc. S’holders Litig., 990 A.2d 940, 945 (Del. Ch. 2010).
85. Id.
86. Id.
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This suggests that arbitration likely offers substantial net savings in procedural costs.

Going further, firms may decide to leverage the benefits of both systems, adopting an arbitration provision that kicks in only if the case survives a motion to dismiss.87 This avoids the high cost of discovery without giving up the benefits of quick dismissals.88

b. Liability costs. Arbitration likely reduces liability costs as well. Jury verdicts in shareholder litigation suits are exceptionally rare.89 One commentator has noted that since the PSLRA was passed in 1995, only seven securities class actions have reached a jury verdict.90 Because settlement is the near-certain outcome, liability costs are best calculated as settlement costs.

Arbitration would likely reduce settlement costs significantly. By reducing the procedural costs of discovery, the alternative to settlement is not as ruinous, which reduces the plaintiffs’ power to extort large settlement values.

Arbitration will also encourage early settlement because consistent outcomes are easier to predict; predictable outcomes mean the parties will have settlement valuations of the case, which increases the chance of an early settlement.

There are a few reasons to think that arbitration would not reduce settlement values. First, the largest cost of shareholder litigation is often the decline in share price.91 For external shocks, share prices drop on a one-to-one ratio with the announced loss, but for announcements of internal fraud, the ratio is much higher.92 Even without the pressure of high procedural and liability costs, a corporation may settle high to

87. See Bondi, supra note 72, at 635.
88. See id.
89. See id. at 633 (“[L]ess than two percent of civil claims filed in court are decided by a judge or jury.”).
91. See Cummins, Lewis & Wei, supra note 8, at 34–35.
92. Perry & De Fontnouvelle, supra note 8, at 2–3.
quickly regain its losses in share price. This is unlikely. Empirically, although stocks decline with the announcement of a suit, there is no statistically significant bounce back when the suit is terminated.93

Second, corporations may not push for lower settlement values because they have no skin in the game. Because D&O insurance typically covers the entire settlement, corporations may face little incentive to reduce the total settlement amount. This is unlikely because D&O insurers may raise premiums in response to high settlements.94

Third, because arbitration settlements are more likely to be confidential,95 a corporation may settle higher because there is less precedential value in a high settlement. However, this is unlikely because if the settlement value is material it would likely need to be reported on Form 8-K or the company's annual report.96

Fourth, some commentators believe that arbitrators are more likely to adopt a split-the-baby approach to awards, giving more money to plaintiffs' counsel than the suit is otherwise worth. However, the current regime is one of settlement, not judgment. Settlement is a split-the-baby approach because plaintiffs' counsel has no incentive to settle without some payment.

c. Feedback between liability costs and procedural costs. One might argue that because liability costs concern only the amount of money transferred from one pocket to the other, we should not care whether they are high or low but should focus on efficiency and procedural costs. This argument has some merit, but attorney fees are often calculated as a percentage of the settlement value,97 so higher settlements lead to higher attorney fees.

94. Romano, supra note 33, at 57.
96. U.S. SEC. & EXCH. COMM'N, CURRENT REPORT: PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 (Form 8-K) Item 1.01.
97. These fees typically run 25-35% of the total recovery. COMM. ON CAPITAL MKTS. REGULATION, supra note 45.
In addition, high recoveries encourage more strike suits. If arbitration reduces recoveries, bounty-hunting plaintiff attorneys would have less incentive to file strike suits. If defendants do not face the risk of mega-awards or the high procedural costs of litigation, there is less incentive to settle high on a bogus claim. The plaintiffs' bar will realize the reduced value of strike suits and will be less likely to file them.

d. Spillover costs. Arbitration would also reduce spillover costs to society and firms that are not being sued. With lower procedural and liability costs, D&O insurance rates will likely decline for all firms. And the public will benefit from moving the cases out of congested, publicly funded courts into privately funded arbitration.

2. Speed

A second advantage of arbitration is that it would likely be faster than the current regime. Currently, the average federal securities class action takes over four years to settle.

Studies of bilateral arbitration have found it is two to three times faster than similar litigation. Class actions are more complex, but studies still show that they "take considerably less time than in-court proceedings in which class certification is sought." If the advantages of bilateral arbitration applied at the same ratio, it could shave an average of thirty-one months off the time it takes to settle a case.

98. D&O insurance rates in the U.S. are currently about six times higher than in Europe per dollar of coverage, which experts attribute to higher enforcement costs in the U.S. Id. at 71.


101. AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740, 1759 (2011) (Breyer, J., dissenting). But see id. at 1751 (majority opinion) (criticizing the slow speed of class action arbitration compared to bilateral arbitration).
shareholder suit.102 Even a fraction of this benefit would be a welcome reform.

3. Expertise

Arbitration would likely improve the quality of the disposition because arbitrators would have more experience in securities disputes than federal judges. In securities class actions between 1996 and 2011, 160 judges ruled on summary judgment motions.103 For 133 of those judges (83%) it was the first time ever handling summary judgment in a securities class action.104 Only eight judges had ruled on three securities class action summary judgment motions in their entire career, and no judge had ruled on more than three.105

If firms increasingly opt-in to arbitration, it is likely that a relatively small number of arbitrators would handle most of the cases. The parties would benefit from increased expertise, which would lead to more thoughtful rulings and decrease the costs of educating the adjudicator.

A third benefit of expertise is consistency. With fewer decision makers, the results would be more consistent, suffering less from the natural variations that occur when there are a large number of decision makers. This added consistency would increase fairness by ensuring that similar companies are treated similarly for similar acts.

It would also increase the predictability of the outcome. Because most judges have ruled on only a handful of these cases in their careers, it is difficult for litigants to predict how the judge might view the case. The judge's view of the case directly determines settlement values, and if the value is more difficult to determine, the parties are

102. I reach this figure by assuming the average securities class action takes 4.1 years to reach a dispositions. See Ryan & Simmons, supra note 99. I calculate the total time in arbitration by dividing 4.1 by 2.78. See Eisenberg & Hill, supra note 100.

103. CORNERSTONE RESEARCH, supra note 23, at 20 fig.18. This figure is limited to summary judgment motions, though the broader point holds true for initial filings. In total 843 judges presided over filed securities class actions. Of those, 582 judges (69%) had worked on three or less, and only 65 judges (8%) had worked on ten or more. Id. at 19 fig.17.

104. Id. at 20 fig.18.

105. Id.
more likely to have different views of what the case is worth. Arbitrators specializing in shareholder litigation would have a track record that would allow better outcome prediction, leading to better case valuations and increasing the chance of settlement.

4. Customization improves the overall balance

The current private enforcement framework is an attempt to balance the costs and benefits of shareholder litigation. Theoretically, this framework could be optimized by increasing the level of enforcement until the marginal costs of enforcement equal its marginal benefits for the average firm. The problem is that very few firms are the average firm.

For example, 94.2% of mergers now lead to litigation. 106 So shareholders in a firm that is actively engaged in mergers and acquisitions face a higher than average litigation cost. Unless there is some reason to expect higher than average benefits from this type of litigation, the balance is way off. My proposal would allow shareholders at merger-oriented firms to limit merger-related suits to arbitration while allowing other suits to reach the courts. This would correct the balance on a company-by-company basis.

Likewise, studies show that share price and volatility are better predictors of litigation risk than corporate governance measures. 107 A firm in a volatile industry could require a larger drop in shareholder price before the claim would be allowed out of arbitration.

This principle applies equally well to any characteristic that leads to a disproportionate amount of litigation. The corporation's shareholders could isolate the characteristic and reduce the litigation to a proper balance.

Enforcement customization is already well established in other areas of securities law. For example, well-known seasoned issuers are subject to looser enforcement when filing shelf registration statements. 108 Allowing customization of shareholder litigation is a continuation of this philosophy.

106. CAIN & DAVIDOFF, supra note 31.
108. 17 C.F.R. § 239.13(d) (2007); id. § 230.415.
5. Advantages over other reform proposals

This proposal has several advantages over prior reform proposals. It improves the current system by weeding out bad suits quickly and cost-effectively. It is an improvement upon rigid reforms because it is customized on a company-by-company basis to set a better balance between over- and under-enforcement. It is also superior to the more flexible reforms, such as those employing gatekeepers. There is virtually no threat of capture or political distortions, and because the shareholders serve as their own gatekeepers, the system would not require public funds; on the contrary, the public would save money by shifting from publicly funded courts into private arbitration.

6. Director overreaching, deterrence, and compensation

We may be concerned that the corporations will set the wrong balance, pushing everything into arbitration and thereby eliminating any deterrent or compensatory effect those suits now have. In other words, we may be worry that management may grant itself a license to commit fraud.

This concern is not troubling for two reasons. First, as explained above, shareholder litigation has few benefits now, so there is not much deterrent or compensatory benefit to lose.\(^\text{109}\)

Second, there is no reason to think shareholders or management would set such an extreme balance. If shareholders set the balance, it is not clear why we should second-guess their decision to limit their own remedy. And it is unlikely that management would implement overly broad arbitration provisions because, frankly, they have no dog in that fight.

Shareholder litigation is not a fight between management and shareholders; damages are paid by the shareholders or the insurance company, not by management. Whether the suit is litigated or arbitrated, whether it succeeds or fails, managers still get to keep their yachts.\(^\text{110}\) Because management is rationally apathetic to shareholder litigation, it is not clear why we should expect them to spend politi-

\(^{109}\) See supra Part II.B.2.

\(^{110}\) See supra text accompanying note 29.
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cal capital to push an unpopular arbitration provision. In short, managers will not try to throw off the constraints of shareholder litigation because shareholder litigation imposes no constraints.

Pfizer Inc. and Gannett Co., Inc. have recently provided wonderful evidence of rational managerial apathy to shareholder suits. Donald and Susan Vuchetich owned stock in both Pfizer and Gannett and sought to include in the companies’ proxy materials an arbitration provision requiring arbitration of direct and derivative claims. The companies sought to exclude the provision, which the SEC allowed, finding that “there [was] some basis for [the] view that implementation of the proposal would cause the company to violate the federal securities laws.” The companies also argued that because the provision was untested, it was likely to lead to litigation.

Pfizer’s and Gannett’s management showed that they would rather be subject to shareholder litigation than litigate whether the arbitration provision was enforceable. This suggests managerial ambivalence to shareholder litigation and undercuts arguments that managers will overreach with arbitration provisions.

7. Corporate favoritism

The most common complaint against arbitration is that it favors corporations over consumers. The argument is that the corporation is a repeat player, so the arbitrator, recognizing who butters his bread, unfairly tips the scales against consumers.

There are several problems with this argument as applied to shareholder litigation. First, several studies show just the opposite. Consumers win more frequently in arbitration than in litigation, pay fewer fees, and wait less time for a resolution.

111. Five companies just proved this point, dropping from their bylaws an unpopular provision that would have required all shareholder suits to be brought in Delaware. See Brian J. Quinn, Firms Surrender on Exclusive Forum Bylaw, M & A L. PROF. BLOG (Mar. 24, 2012), http://lawprofessors.typepad.com/mergers/2012/03/firms-surrender-on-exclusive-forum-bylaw.html.


Second, the shareholders are more likely to benefit from any repeat player favoritism. In 2011, 86.2% of class action fraud complaints were filed against a corporation that had not been subject to a suit yet that year.\textsuperscript{116} Between 1997 and 2010 this figure was slightly higher at 89.1%.\textsuperscript{117} Very few corporations face more than one class action fraud complaint per year. In any given year, only about 2–3% of all listed companies face any class action litigation at all.\textsuperscript{118} Combining these figures, less than one percent of listed companies are repeat players, facing two or more suits in a year.

On the other side, plaintiffs' counsel is much more likely to be a repeat player. One law firm, Robbins Geller Rudman & Dowd, was lead counsel in 52% of federal securities class actions in 2009 and 33% in 2011.\textsuperscript{119} In 2009 the top seven firms served as lead counsel in 85% of cases, and in 2010, 91% of cases were led by one of only nine firms.\textsuperscript{120}

These results are a bit startling. While less than one percent of listed companies will face even two of these cases a year, 91% of plaintiffs' attorneys will come from just nine firms.\textsuperscript{121} Plaintiffs' counsel will be the repeat player, so any arbitrator looking to please his benefactor will favor plaintiffs, not management.

8. Protecting shareholders’ day in court

A common complaint about arbitration is that it deprives the litigant of the dignity of having her day in court. This concern is not troubling because “most publicly available information is reflected in [the] market price [of a share].”\textsuperscript{122} Once an arbitration provision is adopted, the market price will reflect the arbitration requirement, so new purchasers will receive an appropriate price discount (or pay a premium) reflecting the value of the arbitration provision. In other

\textsuperscript{116} Cornerstone Research, supra note 23, at 8.
\textsuperscript{117} Id.
\textsuperscript{118} Id. at 9.
\textsuperscript{119} Id. at 21.
\textsuperscript{120} Id.
\textsuperscript{121} These numbers will likely adjust as shareholder arbitration provisions become more common, but there is no reason to suspect that shareholders bringing a suit will turn to a wider range of counselors than now.
\textsuperscript{122} Basic Inc. v. Levinson, 485 U.S. 224, 247 (1988).
words, the shareholder sold the value she places on the dignity of going to court by purchasing at a lower share price.

Investors who purchased before an arbitration provision was adopted either (1) had a chance to vote on the provision, (2) granted the board power to unilaterally amend the bylaws, or (3) purchased shares at a price that reflected the board’s power to unilaterally adopt bylaws. So if the stock trades in an efficient market, the shareholder has already been compensated for the cost of the chance of an arbitration provision through the share price.123

As former SEC Chairman Harvey Pitt said, “If somebody tells you that you’re going to have a very different set of remedies if you make this investment, and you still want to invest, it seems to me government has done its job.”124

9. Atrophy of the law

One serious concern of allowing arbitration is the atrophy of corporate law.125 Written opinions are a public good because they provide guidance to third parties. Arbitration decisions are nonprecedential, and arbitrators usually are not required to write detailed opinions. If arbitration becomes widespread, it could slow the development of the law because fewer written opinions will be issued.

This concern will likely have a smaller effect in shareholder litigation than it does in other areas of the law for three reasons. First, unlike other disputes, shareholder litigation is already under the eye of several watchdogs—the SEC, the exchanges, and FINRA to name a few. Any of these groups could require that arbitrators issue written opinions or could study the arbitration process and require adjustments. The law would continue to develop because these regulators maintain their mandate to protect investors and, like the companies themselves, have an incentive to improve the efficiency of the capital markets.

123. See Kidsco Inc. v. Dinsmore, 674 A.2d 483, 492 (Del. Ch. 1995) (“[W]here a corporation’s by-laws put all on notice that the by-laws may be amended at any time, no vested rights can arise that would contractually prohibit an amendment.”).


125. JOHNSON & BRUNET, supra note 73, at 4.
Second, this concern is likely overstated. Adoption of arbitration provisions will not be universal, as explained above in the section discussing director overreaching.\textsuperscript{126}

Finally, it is unlikely that this atrophy will be worse than the current state of the law in terms of quantity and quality. Litigation creates very few precedential decisions and does so inefficiently. In 2011, the Delaware Court of Chancery produced only 23 opinions.\textsuperscript{127} The inefficiency is more difficult to see. One hundred eighty-eight federal securities class actions were filed in 2011.\textsuperscript{128} Between 1996 and 2011, 60% of federal securities class actions were voluntarily dismissed or settled, meaning no appeal was filed so no precedential decision was possible.\textsuperscript{129} Of the remaining 40%, it is likely that only a fraction were appealed, and of those that were appealed, an even smaller fraction would garner a full opinion rather than a memorandum disposition that offers little guidance to future parties.\textsuperscript{130} It takes hundreds of suits to create relatively few precedential decisions; because of this, it is difficult to argue that litigation is a cost-effective way to create any public benefits.\textsuperscript{131}

Along with the low quantity, the quality of these decisions is questionable. Judges typically have very little experience handling securities class actions. A study of the careers of judges presiding over federal securities class actions in 2011 revealed that not one judge had previously ruled on more than three class action summary judgment motions.\textsuperscript{132} The diverse field of newcomer adjudicators likely decreases the quality of new opinions.\textsuperscript{133} Certainly Delaware

\textsuperscript{126} See supra Part III.B.6.

\textsuperscript{127} Court of Chancery Opinions and Orders, DELAWARE STATE COURTS (2011), http://courts.delaware.gov/opinions/list.aspx?ag=court+of+chancery (sort by description). There were also 82 memorandum opinions, 17 master’s final reports, 73 letter opinions, and two letter decisions. \textit{id}.

\textsuperscript{128} CORNERSTONE RESEARCH, supra note 23, at 1.

\textsuperscript{129} \textit{Id}. at 18.


\textsuperscript{132} CORNERSTONE RESEARCH, supra note 23, at 19–20.

\textsuperscript{133} \textit{Id}.
provides expert judges, but plaintiffs' counsel is increasingly looking to file "anywhere but Delaware."\textsuperscript{134}

10. Lacks transparency

A related concern is that arbitration lacks transparency. Transparency is beneficial because it guides future litigants and lawmakers, and it allows reputational damage to the bad actors, which might increase the deterrent effect.\textsuperscript{135} Arbitration typically lacks transparency because arbitrators are not required to issue lengthy opinions for their rulings, making their reasoning difficult to evaluate.

The lack of transparency in arbitration is not a virtue, but it is not a concern either, because it is no worse than the current situation. As stated earlier, these actions almost universally settle.\textsuperscript{136} To criticize arbitration for a lack of transparency, we must compare it to the transparency of settlements.

Like decisions in arbitration, settlements often provide only an outcome. Some arbitration provisions, like that recently proposed by Carlyle Group,\textsuperscript{137} include confidentiality clauses, but any material settlement would need to be reported under the Exchange Act.\textsuperscript{138} In both arbitration and settlement, shareholders see only the outcome without any justification. Shareholders are not entitled to review settlement negotiations, board minutes, or internal evaluations. In short, the high settlement rate in securities litigation cuts the legs out from under any argument opposing arbitration based on transparency.


\textsuperscript{135} JOHNSON & BRUNET, supra note 73, at 30.

\textsuperscript{136} One commentator has noted that since the PSLRA was passed in 1996, only seven securities class actions have reached a jury verdict. See Savett, supra note 90.

\textsuperscript{137} The Carlyle Grp. L.P., supra note 95.

\textsuperscript{138} See U.S. SEC. & EXCH. COMM'N, CURRENT REPORT: PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 (Form 8-K) Item 1.01.
11. Arbitration may not be a good fit for high-stakes disputes

Because arbitrators are less confined by legal rules, and there are fewer options to overturn an erroneous decision, some have speculated that arbitration is poorly suited for high-stakes disputes. This argument is belied by the large number of high-stakes disputes recently submitted to arbitration. Johnson & Johnson and Merck & Co. recently paid $500 million to settle a suit in arbitration. Chevron’s dispute over Venezuela’s nationalization program recently led to a $250 million settlement. A quick Google search of “arbitration million” reveals hundreds of multi-million dollar arbitration disputes.

Even if high-stakes arbitration is risky, it is not clear why it should be outlawed. The typical approach, reflected in the business judgment rule, is to allow companies the freedom to take risks.

C. Implementation

A corporation can form an agreement to arbitrate shareholder disputes by adopting a binding arbitration provision in its charter or bylaws. While either is likely to be upheld, a charter amendment may offer more protection.

1. Charters and bylaws bind shareholders

Delaware treats a corporation’s charter and bylaws as contracts that bind shareholders, even if unilaterally adopted by the directors.

For example, in Kidsco Inc. v. Dinsmore, the Delaware Court of Chancery upheld a bylaw amendment that was unilaterally adopted by the directors to delay a hostile acquisition. The hostile bidder
had issued a press release, stating that it had begun soliciting shareholders to call a special meeting to remove the target’s board. Later that day, the directors of the target corporation met, largely by telephone, and after fifteen minutes of deliberations, amended the bylaws to prevent a shareholder meeting from being held within sixty days of the date it was requested. This would delay the hostile bidder’s attempts to replace the board.

Shareholders supporting the hostile bidder sued, arguing that they had a vested right to an earlier meeting because they had already begun soliciting proxies. They argued that they should not be bound by the board’s unilateral amendment because the process for calling a meeting was already in progress.

Then-Vice Chancellor Jacobs rejected these arguments because “although the by-laws are a contract between the corporation and its stockholders, the contract was subject to the board’s power to amend the by-laws unilaterally.” The shareholders were bound by the unilateral amendment, and the meeting was delayed.

Delaware is not breaking new ground with this holding. Every state to address the issue has held that bylaws and charters are contracts binding upon shareholders. Appendix A provides citations for forty-three states that have addressed the issue, each finding that the bylaws and charter bind shareholders. These holdings go back as far as 1844.

The major treatises are also unanimous. The Corpus Juris Secundum, the American Jurisprudence (Second Edition), and the Fletch-
er Cyclopedia of the Law of Corporations.\textsuperscript{153} all treat bylaws and charters as an agreement binding upon shareholders.

This result makes sense. A corporation's charter contains the rights and limitations on the stock, including mandatory dividends, liquidation preferences, and participation rights.\textsuperscript{154} These protections would be meaningless if charter provisions could not be enforced against the corporation or against fellow shareholders.

Likewise, bylaw provisions can regulate such things as when a special meeting of shareholders may be called.\textsuperscript{155} If these were not enforceable against shareholders, they would also be meaningless.

2. Whether to use a charter or bylaw

For Delaware\textsuperscript{156} corporations, an arbitration agreement is more likely to be upheld if it is included in the charter rather than the bylaws. Delaware requires a shareholder vote to amend the charter.\textsuperscript{157} In contrast, bylaws may be amended by the directors without a shareholder vote if the charter allows it, so the case for enforcing an arbitration bylaw against shareholders is weaker. However, courts are likely to uphold even a unilaterally adopted bylaw.\textsuperscript{158}

\textit{a. Charter.} A charter provision is the most natural place for an arbitration provision. A corporation's charter may contain "any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders."\textsuperscript{159} This broad language would permit an arbitration clause to be included in the charter.

A recent case from the Delaware Court of Chancery supports this conclusion. The court suggested that companies use a charter

\textsuperscript{153} 8 WILLIAM MEADE FLETCHER, FLETCHER Cyclopedia of THE LAW OF CORPORATIONS § 4198 (rev. vol. 2012).
\textsuperscript{154}  DEL. CODE ANN. tit. 8, § 102(a)(4) (1998).
\textsuperscript{155}  See Kidsco v. Dinsmore, 674 A.2d 483, 492 (Del. Ch. 1995).
\textsuperscript{156}  I focus on Delaware law because about 60\% of public companies are incorporated there. Lucian Arye Bebchuk & Alma Cohen, Firms' Decisions Where to Incorporate, 46 J.L. & Econ. 383, 391, 395 (2003); see also Lewis, supra note 134.
\textsuperscript{157}  DEL. CODE ANN. tit. 8, § 242(a), (a)(3), (b) (1998).
\textsuperscript{158}  See Kidsco, 674 A.2d at 492.
\textsuperscript{159}  DEL. CODE ANN. tit. 8, § 102(b)(1) (1998).
amendment for forum selection clauses.\textsuperscript{160} Although the court did not refer directly to arbitration, arbitration agreements are typically analyzed as forum selection clauses,\textsuperscript{161} so the provision would likely be upheld under Delaware law.

\textit{b. Bylaws.} An arbitration provision could also be included in the corporation's bylaws,\textsuperscript{162} but there are several reasons this is riskier than including it in the charter.

First, Delaware requires that the "rights" and "limitations" on shares be listed in the charter.\textsuperscript{163} If an arbitration provision creates a right or limitation on the shares, it would need to be included in the charter. The Supreme Court has rejected the view that arbitration affects the substantive rights of the parties, so a litigant would probably be unable to argue that an arbitration provision affects the rights or limitations on the shares.\textsuperscript{164}

Second, if the bylaw is enacted by the directors without the vote of shareholders, it weakens the argument that the shareholders consented to arbitration. Economically, this shouldn't matter. Once the bylaw amendment is adopted, the market price will reflect the arbitration requirement, so new purchasers will have received a commensurate price discount (or paid a premium).\textsuperscript{165} Those who held the stock before the bylaw was adopted either approved the charter

\textsuperscript{160} \textit{In re} Revlon, Inc. S’holders Litig., 990 A.2d 940, 960 (Del. Ch. 2010) ("[I]f boards of directors and stockholders believe that a particular forum would provide an efficient and value-promoting locus for dispute resolution, then corporations are free to respond with charter provisions selecting an exclusive forum for intra-entity disputes.").

\textsuperscript{161} See, e.g., Rodriguez de Quijas v. Shearson/Am. Express, Inc., 490 U.S. 477, 482-83 (1989) ("[A]rbitration agreements . . . are 'in effect, a specialized kind of forum-selection clause.'") (quoting Scherk v. Alberto-Culver Co., 417 U.S. 506, 519 (1974)); see also Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 630 (1985) ("[A]n agreement to arbitrate before a specified tribunal [is], in effect, a specialized kind of forum-selection clause that posits not only the situs of suit but also the procedure to be used in resolving the dispute.") (quoting Scherk, 417 U.S. at 519).

\textsuperscript{162} In Delaware, bylaws can address any issue "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," as long as the provision does not contradict the charter or violate the law. \textbf{DEL. CODE ANN. tit. 8, § 109(b) (1998).}

\textsuperscript{163} Id. § 102(a)(4).

\textsuperscript{164} See Rodriguez de Quijas, 490 U.S. at 486 ("[R]esort to the arbitration process does not inherently undermine any of the substantive rights afforded to petitioners under the Securities Act.") (emphasis added).

\textsuperscript{165} See Basic Inc. v. Levinson, 485 U.S. 224, 246 (1988).
provision that gave the board power to unilaterally amend the bylaws or they purchased the stock at a price that reflected this power.¹⁶⁶ So if the stock trades in an efficient market, lack of shareholder participation probably won’t defeat an arbitration bylaw provision.¹⁶⁷ Still, one court has found shareholder approval to be relevant in an analogous context.¹⁶⁸

Third, if the bylaw is adopted unilaterally by the shareholders, it may violate Section 141(a) of the Delaware General Corporation Law, which prohibits shareholder bylaws that substantively limit the board’s managerial authority.¹⁶⁹ Because arbitration is procedural,¹⁷⁰ not substantive,¹⁷¹ this argument likely fails.

Practically speaking, if the shareholders are intent on an arbitration provision, it seems unlikely that management, which is rationally apathetic to shareholder litigation,¹⁷² would object. The better practice is to include the provision in the charter and avoid the fight.

Fourth, a shareholder-adopted arbitration bylaw would be void if it prohibited directors from exercising their fiduciary duties.¹⁷³ This probably is not a problem. A reviewing court evaluates the bylaw as applied to the facts of the case, presumes the bylaw is valid, and if possible, construes it so that it does not violate the law.¹⁷⁴ So a challenger would have to show that arbitration of the current dispute violates the directors’ fiduciary duties. Given the benefits of arbitration, this is unlikely to succeed.

¹⁶⁶. See Lewis, supra note 134, at 212.
¹⁶⁷. See Kidsco Inc. v. Dinsmore, 674 A.2d 483, 492 (Del. Ch. 1995) ("[W]here a corporation’s by-laws put all on notice that the by-laws may be amended at any time, no vested rights can arise that would contrarily prohibit an amendment.").
¹⁶⁸. See Galaviz v. Berg, 763 F. Supp. 2d 1170, 1175 (N.D. Cal. 2011) ("Certainly were a majority of shareholders to approve such a[n] . . . amendment [limiting the forum to Delaware], the arguments for treating the venue provision like those in commercial contracts would be much stronger, even in the case of a plaintiff shareholder who had personally voted against the amendment.").
¹⁷⁰. Id. at 235.
¹⁷¹. A bylaw is procedural if it “establishes or regulates a process for substantive director decision-making.” Id. It is substantive if it “mandates the decision itself.” Id. Arbitration does not determine liability; it defines only the process used to establish liability, so it is likely procedural.
¹⁷². See supra text accompanying note 97.
¹⁷³. CA, Inc., 953 A.2d at 238.
¹⁷⁴. Id.
IV. LIKELY RESPONSES

Arbitration of shareholder disputes is likely to cause some energetic responses from regulators, legislators, and the plaintiffs' bar.

A. SEC Approval and the Legality of Arbitration Under the Securities Laws

Because arbitration provisions seem most likely to first appear in the charters of companies preparing for an initial public offering, which must be approved by the SEC, I begin with an analysis of whether the SEC would approve an arbitration provision. In 1990, the SEC rejected a registration statement of a company whose charter included an arbitration provision. More recently, while this paper was in draft, the SEC nixed an arbitration provision in the charter of Carlyle Group before allowing the S-1 to become effective.175

The SEC's opposition stems from Section 29(a) of the Exchange Act. Section 29(a) makes void any waiver of compliance with the Exchange Act. 176 This chapter includes the statutes regulating federal securities class actions,177 so waiver of the right to class action litigation is seen as a waiver of compliance with the chapter.

The SEC's argument relies on the premise that arbitrating claims under the Exchange Act is a waiver of compliance with the Exchange Act. The Supreme Court expressly rejected this position in Shearson/American Express Inc. v. McMahon.178

1. Shearson/American Express Inc. v. McMahon

In Shearson/American Express Inc. v. McMahon, two investors sued their broker for, among other things, violating the Exchange Act's anti-fraud provisions—section 10(b) and Rule 10b-5.179 These are

175. An SEC spokesman said, "We advised [Carlyle] that the staff was not prepared to clear the filing with the mandatory-arbitration provision included." Miles Weiss et al., Carlyle Drops Class-Action Lawsuit Ban as Opposition Mounts, BLOOMBERG (Feb. 4, 2012), http://www.bloomberg.com/news/2012-02-03/carlyle-drops-class-action-lawsuit-ban.html.
176. "Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void." 15 U.S.C. § 78cc(a) (2012).
179. Id. at 223.
the same sections that form the basis of most securities class actions. 180

The broker invoked the mandatory arbitration clause in the brokerage agreement. 181 The district court ordered arbitration on the Exchange Act claims, 182 and the circuit court reversed. 183 The Supreme Court granted certiorari and held that the Exchange Act claims were arbitrable. 184

The question was whether the Federal Arbitration Act (the "FAA") applied to Exchange Act claims. 185 The FAA makes arbitration agreements "valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 186

The Court held that the FAA presumptively allows arbitration of statutory rights, so arbitration agreements are enforceable unless the challengers show "Congress intended to make an exception to the [Federal] Arbitration Act for claims arising under . . . the Exchange Act, an intention discernible from the text, history, or purposes of the statute." 187

Turning to the statutory text, the Court first considered whether Section 29(a) created an exception to the FAA. 188 Section 29(a) would be triggered only if the arbitration provision waived compliance with the Exchange Act, so the question was whether the arbitration provision waived compliance with any part of the Exchange Act.

The investors pointed out that Section 27 of the Exchange Act grants exclusive jurisdiction over Exchange Act claims to the district courts. 189 They argued that because the arbitration provision grants

181. McMahon, 482 U.S. at 223.
182. Id. at 224.
183. Id. at 224–25.
184. Id. at 242.
185. Id. at 226–27.
188. Id. at 227.
189. Id. Section 27 of the Exchange Act states the following:
   The district courts of the United States . . . shall have exclusive jurisdiction of viola-
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jurisdiction to arbitrators rather than district courts, it violates Section 27, making the arbitration provision void under Section 29(a).

The Court disagreed. It held that Section 29(a) prohibits waiver only of the “substantive obligations imposed by the Exchange Act." Because the jurisdictional statute did not create a substantive obligation, the arbitration provision did not waive a substantive obligation, and Section 29 was never triggered. “[W]here arbitration does provide an adequate means of enforcing the provisions of the Exchange Act, § 29(a) does not void a predispute waiver of § 27.”

Next, the investors argued that the arbitration provision waived compliance with the substantive protections of the Exchange Act. The Court rejected this broader argument, holding that “[b]y 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.” That is, because the arbitration provision was merely a change in forum, it did not affect substantive rights, so there was no waiver of compliance, and Section 29(a) was not triggered.

Next the Court addressed the suitability of arbitration for Exchange Act claims, addressing the investors’ argument that arbitration weakened their protections. The Court pointed out that the SEC approved the arbitration procedures that were adopted by the exchanges and invoked by the broker agreement. It held that “where, as in this case, the prescribed procedures are subject to the SEC’s authority [over self-regulatory organizations], an arbitration agreement does not effect a waiver of the protections of the [Ex-

190. McMahon, 482 U.S. at 228.
191. Id. at 229.
192. Id.
193. Id. at 229-30.
194. Id. at 231-34.
195. Id. at 234.
change] Act." 196 This point was reemphasized in the conclusion: "[W]here the SEC has sufficient statutory authority to ensure that arbitration is adequate to vindicate Exchange Act rights, enforcement does not effect a waiver . . . under § 29(a)." 197

Having rejected each of the investors' arguments, the Supreme Court held that claims under the Exchange Act were subject to pre-dispute arbitration agreements. 198

2. SEC approved procedures

Applying McMahon's holdings to arbitration of shareholder disputes, only one of the investors' arguments creates some pause. The Court ruled that an arbitration provision did not necessarily violate the substantive protections of the Exchange Act because the arbitration procedures were subject to SEC review. 199 This implies that a firm hoping to adopt an arbitration provision increases its chances of a favorable ruling by deferring to procedures that the SEC has adopted.

Finding such a regime may be tricky. The majority of securities fraud arbitration claims are filed with FINRA, 200 and FINRA's arbitration provisions specifically prohibit class-wide arbitration, requiring that each claimant's case be arbitrated separately, a process known as bilateral arbitration. 201 The NYSE, 202 NYSE Arca, 203 and NYSE Amex 204 each defer to FINRA's rules, and the NASDAQ 205

196. Id.
197. Id. at 238.
198. Id.
199. Id.
and Chicago Stock Exchange require that arbitration agreements exclude class actions. In short, the SEC has not approved procedures for class-wide arbitration.

Some clarification by the SEC would be helpful, but an exact match may not be necessary. Later in the McMahon opinion, the Court reaffirmed that "potential complexity should not suffice to ward off arbitration." If the procedures are already calibrated to be fair to the parties, expanding the arbitration to a class action is just an increase in complexity, which may be insufficient to defeat arbitration.

Later rulings by the Court suggest that the SEC's approval of the arbitration process is not necessary. Two years after McMahon held that Exchange Act claims are arbitral, the Court held that claims under the Securities Act of 1933 are arbitral in Rodriguez de Quijas v. Shearson/American Express Inc., overruling an earlier decision. In doing so it never discussed whether the arbitration procedures were subject to the SEC's regulatory authority. Instead, the Court treated the arbitration agreement as a forum selection clause, holding that "[t]here is nothing in the record before us, nor in the facts of which we can take judicial notice, to indicate that the arbitral system . . . would not afford the plaintiff the rights to which he is entitled."

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209. But see AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740, 1750-51 (2011) (highlighting the differences between bilateral and class arbitration).
211. They were though. See Rodriguez de Quijas v. Shearson/Lehman Bros., Inc., 845 F.2d 1296, 1297 n.2 (5th Cir. 1988), rev'd 490 U.S. 477 (1989). The agreement relied on NASD's arbitration rules. NASD is now FINRA, so it relied on the rules used for the majority of securities claims.
212. Rodriguez de Quijas, 490 U.S. at 481.
213. Id. at 483 (quoting Wilko v. Swan, 346 U.S. 427, 439 (1953)(Frankfurter, J., dissenting)).
Addressing investor protection a second time, the Court again declined to address SEC oversight and instead looked to the FAA’s saving clause, which nullifies arbitration agreements obtained “from the sort of fraud or overwhelming economic power that would provide grounds ‘for the revocation of any contract.’” 214

In its conclusion, the Court reiterated a third time that “resort to the arbitration process does not inherently undermine any of the substantive rights afforded to petitioners under the Securities Act,” again endorsing arbitration generally without regard to whether the SEC approved the procedures. 215 While the Court specifically referred to SEC approved procedures, it seems likely that if a corporation adopts the arbitration provisions of any generally accepted program, those procedures would be upheld.

A narrower reading—one that would permit only those procedures approved by the SEC—would lead to a perverse result. The SEC has not approved any procedures allowing for classwide arbitration; however, FINRA’s rules permit bilateral arbitration. The SEC has regulatory authority over FINRA’s arbitration procedures, so an arbitration agreement invoking them would likely be affirmed under McMahon. So if SEC-approved procedures are required, a company would be free to adopt bilateral arbitration, relying on FINRA’s rules, but would be prohibited from adopting classwide arbitration, which has not been SEC approved. 216 This result is absurd because bilateral arbitration is effectively a one-man securities suit, so the costs will easily outweigh the benefits. So in an attempt to preserve shareholder litigation from arbitration, such a ruling would eliminate shareholder litigation altogether.

In the end, SEC approval may be a matter of politics more than statutory interpretation. After the SEC shot down Carlyle’s arbitration provision, Harvey Pitt, the SEC Chairman under President

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214. Id. at 483–84 (quoting Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 627 (1985)).

215. Id. at 485–86.

216. It is worth noting that the Supreme Court recently held that contracts may require bilateral—rather than class-wide—arbitration even for claims that could legally be litigated as a class. AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740, 1753 (2011).
George W. Bush, said "[i]t would have passed on my commis-

sion." A company looking to include a shareholder arbitration
provision may just need to wait for a new chairman.

B. Legislative Response and the Limits on State Power

If the SEC permits arbitration, there is likely to be some legisla-
tive backlash. Professors Johnson and Brunet have set out a wonde-
ful list of bills and letters from congressmen seeking to limit arbitra-
tion. Populist and judicial outrage at arbitration is why the FAA
was passed to begin with.

When Carlyle's arbitration provision hit the press, several con-
gressmen openly opposed allowing arbitration of shareholder dis-
putes. Senator Blumenthal said the provision would "eviscerate
shareholder rights." Representative Ackerman spoke less strongly
but agreed it would cause shareholders to forfeit their rights, adding,
"It should not be allowed to happen."

Because the FAA is the basis for most arbitration enforcement,
legislative attempts to stop arbitration of shareholder disputes would
likely be effective only on the federal level. The reform would likely
be controversial, making it unlikely to succeed in a divided Congress.

State legislatures, which face less publicity, may have the politi-
cal leeway to pass legislation, but any state legislation would likely
be ineffective. My proposal would insert the arbitration provision in-
to a corporation's charter or bylaws, which are governed by state law.
Contract law applies to the interpretation of charters and bylaws, which is also state law. But these state law issues are constrained by
the FAA and the internal affairs doctrine.

217. Weiss, supra note 175.
218. JOHNSON & BRUNET, supra note 73, at 10. I highly recommend this piece for those
studying arbitration of shareholder litigation. The paper is filled with insightful nuggets of wis-
dom.
220. Weiss, supra note 46.
221. Id.
1. The Federal Arbitration Act's limits on state laws

Under the FAA, states retain power to apply traditional contract defenses.222 “Thus state law, whether of legislative or judicial origin, is applicable if that law arose to govern issues concerning the validity, revocability, and enforceability of contracts generally.”223

However, any law attempting to make an arbitration provision in a charter unenforceable would have to be “generally applicable.”224 It could not “rely on the uniqueness of an agreement to arbitrate” as the basis for finding a contract unenforceable.225 This prohibits laws that discriminate against arbitration directly or that “disproportionately impact” arbitration.226 It is difficult to imagine that any state law limiting arbitration of shareholder disputes could avoid these pitfalls.

Also, the state law cannot target charters and bylaws specifically. Circuit courts have expanded the “generally applicable” requirement to strike down state laws that apply unique rules to certain types of contracts, such as franchise contracts, when those laws are applied to contracts containing an arbitration provision.227 They have reasoned

222. 9 U.S.C. § 2 (2012). Section 2 states the following:
A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

225. Id. at 1747 (quoting Perry, 482 U.S. at 492 n.9).
226. Id. at 1747 (criticizing procedures that apply to both arbitration and litigation yet have a disproportionate impact on arbitration agreements).
227. See: Bradley v. Harris Research, Inc., 275 F.3d 884, 890 (9th Cir. 2001); KKW Enters., Inc. v. Gloria Jean's Gourmet Coffee Franchising Corp., 184 F.3d 42, 51 (1st Cir. 1999) (holding that the FAA preempts a Rhode Island statute prohibiting franchise agreements from selecting forums outside Rhode Island because the statute is not generally applicable; it is applicable only to franchise agreements); Doctor's Assocs. v. Hamilton, 150 F.3d 157, 163 (2d Cir. 1998) (same for New Jersey law); Mgmt. Recruiters Int'l, Inc. v. Bloom, 129 F.3d 851, 856 (6th Cir. 1997) (doubting that the FAA would allow a state law requiring in-state arbitration); Mitchell v. Am. Fair Credit Ass'n, 122 Cal. Rptr. 2d 193, 202–03 (Ct. App. 2002) (collecting circuit cases).
that because the statute does not apply to every contract, it is not generally applicable.\textsuperscript{228}

Furthermore, state law cannot invalidate the agreement through clever interpretations. A court may not "in assessing the rights of litigants to enforce an arbitration agreement, construe that agreement in a manner different from that in which it otherwise construes nonarbitration agreements under state law."\textsuperscript{229} The same principles of contract interpretation must apply.

With these limitations, it seems unlikely that a state could prevent enforcement of an arbitration provision in a company's charter or bylaws. Doing so would require a modification to its entire contract regime, which is more risky than it is worth.

2. The internal affairs doctrine's limits on state laws

Even if a state could craft a law to circumvent the FAA, it likely would not matter. Sixty percent of corporations are incorporated in Delaware,\textsuperscript{230} and the internal affairs doctrine requires courts resolving disputes about the adoption or interpretation of charter and by-law amendments to apply the law of the state of incorporation.\textsuperscript{231} Thus, even if California modified its laws, Delaware law would likely apply.

However, because the internal affairs doctrine is a state choice of law provision, each state can choose whether to follow it. Most do, but New York and California have carved out exceptions.

New York applies its own statutes to foreign corporations but will not apply most of its provisions\textsuperscript{232} to corporations that are listed

\textsuperscript{228} See supra note 227.

\textsuperscript{229} Perry, 482 U.S. at 492 n.9.

\textsuperscript{230} Bebchuk & Cohen, supra note 156, at 391, 395; see also Lewis, supra note 134.

\textsuperscript{231} See RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 302, cmt. a (1971). The restatement provides the following:

Matters falling within the scope of the rule of this Section [which defers to the state of incorporation] and which involve primarily a corporation's relationship to its shareholders include . . . the adoption of by-laws, . . . shareholders' rights to examine corporate records, charter and by-law amendments, mergers, consolidations and reorganizations and the reclassification of shares.

\textsuperscript{ld.}; see also id. at cmt. e (suggesting that whether an amendment was validly adopted is a question of Delaware law).

\textsuperscript{232} One provision that always applies is the right to bring a derivative suit. N.Y. Bus. CORP. LAW § 1319(a) (McKinney 2011). However, any restrictions on arbitration of this suit are
on a national securities exchange\textsuperscript{233} or those that have less than half of their income allocable to New York for state tax purposes.\textsuperscript{234} Because targets of shareholder litigation are almost always listed on a national exchange, New York law probably would not apply.

California is the state most likely to be hostile to an arbitration provision in a charter or bylaw. The state usually applies the internal affairs doctrine but occasionally limits it through cases or statutes.\textsuperscript{235} Like New York, California does not apply its own laws to corporations listed on the NYSE or NASDAQ exchanges.\textsuperscript{236} California also expressly defers to the state of incorporation for suits against directors for breach of an official duty, which covers nearly all shareholder litigation.\textsuperscript{237}

The Delaware Supreme Court has held that applying another state's law to the internal affairs of Delaware corporations violates the federal constitution's due process clause and dormant commerce clause.\textsuperscript{238} California, of course, disagrees,\textsuperscript{239} so the internal affairs doctrine is not the most reliable limitation.

\textbf{C. Plaintiffs' Attorneys' Response and the Applicability of Traditional Defenses in Contract and Equity}

The plaintiffs' bar is the most likely to fight fiercely against arbitration. Plaintiffs' attorneys will likely find a client to bring a suit to block enforcement. This section analyzes various contract defenses that may be argued.\textsuperscript{240}

\textsuperscript{233} See \textit{id.} § 1320(a)(1).
\textsuperscript{234} See \textit{id.} § 1320(a).
\textsuperscript{235} \textit{CAL. CORP. CODE} § 239 (West 2012).
\textsuperscript{236} See \textit{id.} § 2115(c).
\textsuperscript{237} See \textit{id.} § 2116. \textit{But see supra} Part II.B.1.
\textsuperscript{240} Because defenses differ from state to state, this section focuses on those defenses
As stated above, the FAA preempts any defense that is not "generally applicable," meaning it cannot "rely on the uniqueness of an agreement to arbitrate" as the basis for finding a contract unenforceable. Defenses cannot discriminate against arbitration directly or "disproportionate[ly] impact" arbitration. Under this doctrine, only defenses focused on how a provision was adopted and whom it binds will survive.

There are also three practical barriers when enforcing state law defenses to prevent arbitration. The simplest is that the party challenging arbitration bears the burden of showing that the defense applies. More formidable is the strong policy favoring arbitration. Once a court finds an agreement to arbitrate, that agreement

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241. Lewis, supra note 134.
242. AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740, 1747 (quoting Perry v. Thomas, 482 U.S. 483, 493 n.9 (1987)).
243. Id. (criticizing procedures that apply to both arbitration and litigation yet have a disproportionate impact on arbitration agreements).
245. Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24 (1983); see also Perry, 482 U.S. at 489 ("Section 2, therefore, embodies a clear federal policy of requiring arbitration unless the agreement to arbitrate is not part of a contract evidencing interstate commerce or is revocable 'upon such grounds as exist at law or in equity for the revocation of any contract.'"). But see Gotham Holdings, LP v. Health Grades, Inc., 580 F.3d 664, 666 (7th Cir. 2009) (holding that there is no policy favoring arbitration, just a policy of favoring the enforcement of contracts); Lawrence A. Cunningham, Rhetoric versus Reality in Arbitration Jurisprudence: How the Supreme Court Flaunts and Flunks Contracts 5 (Paul D. Butler & Scott B. Pagel eds., 2011), available at http://ssrn.com/abstract=1809005 (arguing that the Supreme Court's policy favoring arbitration removes it from true contract law principles).
246. Courts have not always applied this preference at the same analytical stage. Some courts apply the policy preference only to defenses. See, e.g., Am. United Logistics, Inc. v. Catellus Dev. Corp., 319 F.3d 921, 929 (7th Cir. 2003); AGCO Corp. v. Anglin, 216 F.3d 589, 593–94 (7th Cir. 2000) ("[S]uch agreements must not be so broadly construed as to encompass claims that were not intended to be arbitrated under the original contract."); Kalmar Indus. USA LLC v. Int'l Bhd. of Teamsters Local 838, 452 F. Supp. 2d 1154, 1162–63 (D. Kan. 2006). Other courts apply the preference once an agreement to arbitrate has been found. See Janiga v. Questar Capital Corp. 615 F.3d 735, 740 (7th Cir. 2010) ("Any 'preference' for arbitration is reserved for the interpretation of the scope of a valid arbitration clause . . . ."); see also Bd. of Trs. of Delray Beach Police & Firefighters Ret. Sys. v. Citigroup Global Mkts. Inc., 622 F.3d 1335, 1342 (11th Cir. 2010). Other courts have applied the preference for arbitration throughout, including to determine if there was an agreement to arbitrate. See Howard Elec. & Mech. Co. v. Frank Briscoe Co., 754 F.2d 847, 850 (9th Cir. 1985) (applying preference to the question of "whether an arbi-
must be “rigorously enforce[d],” and “any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration, whether the problem at hand is the construction of the contract language itself or an allegation of waiver, delay, or a like defense to arbitrability.” This strong policy favoring arbitration will make it difficult for any defense to succeed.

In addition, defenses are divided into two types: those that challenge the arbitration provision and those that challenge or would invalidate the entire contract. Defenses challenging only the arbitration provision may be disputed in court, but defenses that would invalidate the entire contract are decided by the arbitrator, whose livelihood depends on the use of arbitration. You can guess how that is likely to turn out. The arbitrator’s decision as to whether the defense applies is subject to the same high standard required to overturn any arbitral award—namely, manifest disregard of the law.

While most potential claims will likely fall to these general barriers, specific claims, such as those for fraud or unconscionability, will face additional challenges.

1. Fraud

Fraud can be a contract defense, but there is nothing inherently fraudulent about an arbitration provision, especially if shareholders...
approve of it. The federal securities laws require corporations to include the charter and bylaws in every major filing with the SEC, which, for reporting companies, would provide constructive notice of the provision to shareholders several times a year.\footnote{251}

2. Overwhelming bargaining power and unconscionability

If the company's directors unilaterally include an arbitration bylaw provision, shareholder plaintiffs may argue that the directors have exercised undue influence or overwhelming bargaining power.\footnote{252} Because few stockholders have the power to influence the affairs of the corporation, the purchase of stock is an adhesion contract with negligible control over corporate affairs.

However, where a deep and liquid market exists, the arbitration provision will be reflected in the share price.\footnote{253} Any bargaining power the directors might exercise over the shareholders is paid for by a reduction (or increase) in the share price.\footnote{254} The market's ability to push back against any harmful action refutes the claim that the directors have overwhelming power over shareholders. As long as an investor has thousands of other stocks competing for her investment, the directors can claim no market power over the investor.

Even assuming the corporation had superior bargaining power, "[s]uperior bargaining power alone without the element of unreasonableness does not permit a finding of unconscionability or unfairness."\footnote{255} Delaware courts find "unconscionability or unfairness" only where "no man in his senses and not under delusion would [agree to it] on the one hand, and as no honest or fair man would accept [the agreement], on the other."\footnote{256}

\footnote{251. See SEC Regulation S-K, Item 601, table (requiring the charter and bylaws to be included as exhibits to forms S-1, S-4, S-11, F-1, F-4, 10, 8-K, 10-D, 10-Q, and 10-K).}
\footnote{252. The courts refer to both "overweening bargaining power" and "overwhelming bargaining power," which I treat as synonymous. See Rodriguez de Quijas v. Shearson/Am. Express, 490 U.S. 477, 483-84 (1989) (quoting Mitsubishi, 473 U.S. at 627).}
\footnote{253. See Basic Inc. v. Levinson, 485 U.S. 224, 246 (1988).}
\footnote{254. See Carnival Cruise Lines, Inc. v. Shute, 499 U.S. 585, 594 (1991) (holding that a forum selection clause in a cruise ticket was reflected in the price of the ticket).}
\footnote{255. Tulowitzki v. Atl. Richfield Co., 396 A.2d 956, 960 (Del. 1978).}
\footnote{256. Id. (quoting Williams v. Walker-Thomas Furniture Co., 350 F.2d 445, 450 (D.C. Cir. 1965) (internal quotation marks omitted)).}
Arbitrating shareholder disputes benefits shareholders by reducing the incentives for strike suits, which provide no benefit, and by bringing quicker enforcement in meritorious suits. The plaintiffs’ bar dislikes arbitration for the same reason it should be valued by shareholders—it gives quick, predictable results. Because of arbitration’s benefits, it is unlikely that a court will find an arbitration provision unconscionable.

3. Enforcement violates public policy

Under Delaware common law, “contracts that offend public policy or harm the public are deemed void.” Any public policy argument against arbitration will certainly fail given the strong federal policy favoring arbitration.

Plaintiffs might point to two public policies that an arbitration provision would offend. First, the federal and state securities laws demonstrate a strong public policy favoring shareholder protection. This argument will fail because the Supreme Court has already upheld arbitration agreements against the shareholder protection policies of the Securities Act of 1933 and the Exchange Act.

Second, plaintiffs might argue that arbitration provisions violate a public policy favoring class action litigation for small, similar claims. Whatever remains of this policy has been significantly narrowed by the Supreme Court’s ruling in AT&T Mobility LLC v. Concepcion, which upheld arbitration of identical claims of $30.22 brought by thousands of litigants.

257. See Lewis, supra note 134, at 202-03 (discussing attempts by plaintiffs to increase unpredictability); Mirvis, supra note 134, at 18; see also Allied-Bruce Terminix Cos. v. Dobson, 513 U.S. 265, 280 (1995) ("The advantages of arbitration are many: it is usually cheaper and faster than litigation; it can have simpler procedural and evidentiary rules; it normally minimizes hostility and is less disruptive of ongoing and future business dealings among the parties; it is often more flexible in regard to scheduling of times and places of hearings and discovery devices.") (quoting H.R. REP. NO. 97-542, at 13 (1982)).


4. Retroactive application

A bylaw or charter provision probably cannot require arbitration of disputes regarding acts that occurred before the provision was approved.

In *Galaviz v. Berg*, the District Court for the Northern District of California rejected retroactive application of a forum selection clause included in a corporation’s bylaws.263 Shareholders derivatively sued the directors of Oracle, a Delaware corporation, for defrauding the federal government.264 Eight years after the fraud began, but before the actions were filed, Oracle’s board adopted a bylaw provision that named the Delaware Court of Chancery as the exclusive forum for any derivative action.265

The court rejected the retroactive application of the bylaw because “the venue provision was unilaterally adopted by the directors who [were] defendants in this action, after the majority of the purported wrongdoing [was] alleged to have occurred, and without the consent of existing shareholders who acquired their shares when no such bylaw was in effect.”266

The same result would likely be reached under Delaware law. The *Galaviz* court did not perform a choice of law analysis, never discussed the internal affairs doctrine, and never said which state’s law applied,267 but in *Salaman v. National Media Corp.*, a Delaware court held that a bylaw amendment could not modify a director indemnity provision after the director had already been sued.268 A company probably could not enforce an arbitration provision that tried to retroactively apply to prior bad acts.

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263. 763 F. Supp. 2d 1170 (N.D. Cal. 2011).
264. Id. at 1171–72.
265. Id.; see also *In re Revlon, Inc. S’holders Litig.*, 990 A.2d 940, 959–61 (Del. Ch. 2010).
267. Id. at 1174 (“Oracle has not pointed to any commercial contract case upholding a venue provision that was inserted by a purported unilateral amendment to existing contract terms.”).
5. Vested rights

Shareholders who purchase their shares after the arbitration provision is adopted will have a difficult time arguing that they should not be bound by it. But shareholders that purchase before the arbitration provision is adopted may argue they have a vested interest in the continued availability of the courts.

This argument will fail because shareholders have no vested rights to any bylaw provision if the directors are authorized to unilaterally amend them.269

6. Detrimental reliance

Shareholders that purchase before the adoption of an arbitration provision may argue that they detrimentally relied on the availability of the courts when purchasing the stock. Detrimental reliance is an element of a claim for equitable estoppel, which arises when “a party, by his conduct or words, intentionally or unintentionally leads another, in reliance on such words or conduct, to change his position to his detriment.”270 This reliance must be reasonable, and Delaware has held that if a corporation allows unilateral bylaw amendments by the board, a party cannot reasonably rely on the bylaws remaining constant.271

7. Duty of good faith and fair dealing and fiduciary duties

If the arbitration provision is adopted unilaterally by the board or by a majority of shareholders over the objections of minority shareholders,272 plaintiffs may argue that the amendment violates the du-

269. Kidsco Inc. v. Dinsmore, 674 A.2d 483, 492 (Del. Ch. 1995) (“[T]he only vested right left is that specified in 8 Del. C. § 394, which prohibits a statutory charter amendment from taking away or impairing any remedy against any corporation or its officers for any liability which shall have been previously incurred.” (alterations omitted) (emphasis omitted) (citations omitted) (internal quotation marks omitted)).


271. Kidsco, 674 A.2d at 493 n.7 (“TLC By-law Section 7.8 undercuts SoftKey’s contention that its rights vested because it detrimentally ‘relied’ on the then-existing by-law. Clearly any such reliance by SoftKey was not justifiable, since SoftKey was on notice that the by-law was subject to amendment by the TLC board.”).

272. Majority shareholders sometimes owe a fiduciary duty to minority shareholders. See
ty of good faith and fair dealing. Every party to a contract has a duty of good faith and fair dealing, which includes how a party exercises its power to amend the terms.273

In evaluating bylaws, Delaware largely defers to the board’s judgment.274 Delaware courts presume bylaws are valid and reject them only if they are “clearly adopted for an inequitable purpose and have an inequitable effect.”275

It is unlikely that a court would find an arbitration bylaw amendment to have an inequitable purpose or effect. As discussed above, arbitration agreements are just a specialized type of forum selection clause,276 and the Delaware Chancery Court has suggested that corporations can include forum selection clauses in their governance documents.277 So a court applying Delaware law would likely reject this defense.

This defense is also preempted by the FAA because it “rel[ies] on the uniqueness of an agreement to arbitrate” as the basis for finding the provision unenforceable.278 Phrased another way, every bylaw or charter provision changes some aspect of the corporation. If the only reason that this change is objectionable is because it requires arbitration, then the defense cannot apply.

8. Gravely difficult and inconvenient forum

Arbitration clauses are a “specialized kind of forum-selection clause.”279 Forum selection clauses are unenforceable if the forum is

Kahn v. Lynch Comm’cns Sys., Inc., 638 A.2d 1110, 1115 (Del. 1994). This duty is never greater than the duty owed by directors, and I find that the directors’ duty is not breached, so I do not analyze the duty of majority shareholders separately.

273. RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. e (1981); see also AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740, 1744 (2011) (upholding an arbitration agreement in a contract that “authorized AT&T to make unilateral amendments, which it did to the arbitration provision on several occasions”).

274. Hollinger Int’l, Inc. v. Black, 844 A.2d 1022, 1080 (Del. Ch. 2004); see also Badie v. Bank of Am., 79 Cal. Rptr. 2d 273, 284 (Dist. Ct. App. 1998) (stating that it would violate the duty of good faith and fair dealing to insert an arbitration agreement into a contract, even where the contract granted power to modify or amend the contract unilaterally).

275. Hollinger, 844 A.2d at 1080.

276. See supra note 161.


278. AT&T, 131 S. Ct. at 1747 (2011) (quoting Perry v. Thomas, 482 U.S. 483, 493 n.9 (1987)).

“so gravely difficult and inconvenient that [a plaintiff] will for all practical purposes be deprived of his day in court.”\textsuperscript{280} Arbitration in Delaware or New York is unlikely to be considered gravely difficult or inconvenient. The difficulty of getting to these corporate hubs is likely overwhelmed by the “strong presumption in favor of enforcement [of forum selection clauses] . . . reinforced by the emphatic federal policy in favor of arbitral dispute resolution.”\textsuperscript{281}

V. CONCLUSION

The inefficiencies of shareholder litigation impose tremendous costs on shareholders. Arbitration can reduce the costs of strike suits and can more rapidly resolve meritorious suits. By allowing corporations the freedom to innovate, we would leverage the full creativity of the shareholders and boards to balance enforcement.

This can be accomplished through an amendment to either the charter or bylaws, which will likely be considered a contract that binds shareholders. Courts applying the Federal Arbitration Act will likely enforce the provision, and it is unlikely that any defense will apply. The only obstacle is the SEC’s position that arbitration violates the Exchange Act. The SEC must bring its statutory interpretation in line with current Supreme Court precedent to allow companies the full benefits of customized enforcement.

\textsuperscript{281} Mitsubishi, 473 U.S. at 631.