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George A. Fowler*

I. INTRODUCTION

While speaking before the Heritage Foundation in the summer of 2017, Michael Piowar, Commissioner of the SEC, sparked controversy when he mentioned that companies undertaking IPOs may have an option to include mandatory shareholder arbitration provisions.¹ Following this statement, he went as far as suggesting that companies that have considered undertaking IPOs should “come to us to ask for relief to put in mandatory arbitration into their charters.”² This “relief” refers to “the SEC ... revers[ing] its position that arbitration violates the Securities and Exchange Act of 1934, bringing the commission back in line with current Supreme Court precedent.”³

While there is speculation about whether Piowar’s statement is backed by any serious consideration of allowing such provisions, the topic has recently been an area of concern to investors.⁴ Some commentators have also been interested in the effects of the interpreting existing law favorably towards arbitration provisions and have supported the use of arbitration in line with the Supreme Court’s holding that “arbitration process does not inherently undermine any of the substantive rights afforded to petitioners under the Securities Act.”⁵

While the topic has heated up recently among investors and commentators, others suggest that this idea has been in the works since the late 1980s, when the U.S. Supreme Court held that security brokerages could enforce mandatory arbitration agreements with customers.⁶ Although many have shrugged off recent

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1. Cydney Posner, *In Senate Testimony, SEC Chair Offers Insights into His Thinking on a Variety of Issues Before the SEC*, COOLEY PUBCO (Oct. 2, 2017), <https://cooleypubco.com/2017/10/02/in-senate-testimony-sec-chair-offers-insights-into-his-thinking-on-a-variety-of-issues-before-the-sec/>.

2. *Id.*

3. Paul Weitzel, *The End of Shareholder Litigation? Allowing Shareholders to Customize Enforcement Through Arbitration Provisions in Charters and Bylaws*, 2013 BYU L. REV. 65, 68 (2013).

4. Rick A. Fleming, *Mandatory Arbitration: An Illusory Remedy for Public Company Shareholders*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Feb. 27, 2018), <https://corpgov.law.harvard.edu/2018/02/27/mandatory-arbitration-an-illusory-remedy-for-public-company-shareholders/>.

5. *Rodriguez de Quijas v. Shearson/Am. Express, Inc.*, 490 U.S. 477, 486 (1989).

6. Alison Frankel, *Shareholder Alert: SEC Commissioner Floats Class-Action-Killing Proposal*, REUTERS (July 18, 2017), <https://www.reuters.com/article/us-otc-arbitration-idUSKBN1A326T>.

suggestions of these provisions, several interviewed securities law professors shared the belief that a pro-arbitration Supreme Court would uphold the legality of these provisions requiring arbitration for shareholder claims against publicly traded companies.⁷ The Supreme Court's past and future opinions on this matter are relevant because it has held that arbitration clauses are not a violation of statutory rights.⁸ This fact, when paired with decisions that stated the FAA preempts state law, which discriminates against arbitration, leaves only the SEC's interpretation of the Exchange Act preventing the enforceability of mandatory arbitration clauses.⁹

In this comment, I argue that the introduction of mandatory arbitration clauses in corporate charters and bylaws will allow for both corporations and shareholders to realize various financial benefits while still protecting parties against corporate misconduct.

I first support these arguments by showing the decrease in the number of companies undertaking initial public offerings ("IPOs").¹⁰ An increase in the average number of companies going public would open up a major source of funding for the companies that have seemed to shy away from public funding.¹¹ The decision to take companies public will create value for both the corporation itself and create the opportunity for capital gain for potential shareholders.¹² While IPOs have decreased, the number of class action suits against publicly funded corporations has remained consistently high and has seen an enormous increase in 2017 and 2018.¹³

I further support this theory by showing that arbitration can deter corporate misconduct despite the fact that arbitration is private by its nature.¹⁴ Here, in securities class action lawsuits, there would be a sufficient number of big investors who would have incentive to bring actions against the corporation.¹⁵ New York University professor Jennifer Arlen believes that the deterrent effect would be lost, saying that, "The very reasons why some corporations would like the ability to require shareholders to arbitrate securities fraud claims are the reasons why it would be bad public policy to allow them to do so."¹⁶ However, others believe that the same big investors who would have potentially served as the lead plaintiff in a class action suit would similarly bring actions in the forum of arbitration, which would in turn deter corporate misconduct in the same way that issues brought to court have deterred similar misconduct.¹⁷

Proving that arbitration can deter corporate misconduct is the first step to showing that mandatory arbitration clauses for shareholders may provide a more

7. *Id.*

8. Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 223 (1987).

9. *Id.* at 227.

10. Michael S. Piwowar, *Opening Remarks at SEC-NYU Dialogue on Securities Market Regulation: Reviving the U.S. IPO Market*, U.S. SEC. & EXCH. COMM'N (May 10, 2017), <https://www.sec.gov/news/speech/opening-remarks-sec-nyu-dialogue-securities-market-regulation-reviving-us-ipo-market>.

11. *Id.*

12. *Id.*

13. U.S. DEP'T OF TREASURY, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES 33 (2017) <https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf>.

14. Frankel, *supra* note 6.

15. *Id.*

16. *Id.*

17. *Id.*

efficient outcome. In order for a better outcome to occur, arbitration must also result in a suitable recovery for those bringing claims. On the other hand, it can be shown that class action lawsuits for shareholder litigation do not provide adequate recoveries.¹⁸ In class action suits, one of the greatest inefficiencies is the minuscule payout offered to small-value plaintiffs.¹⁹ When these payouts are so small that many plaintiffs do not bother to collect their rewards, it can be reasonably inferred that an unjustifiable inefficiency exists.²⁰ Where lead plaintiffs are the only existing group that has enough stake in the game to collect recovery, there is no reason that these same parties cannot represent plaintiffs in an arbitration to protect shareholders from corporate misconduct.²¹

Lastly, I present the ease in which corporations could include these arbitrations provisions in charters and bylaws. These provisions are considered enforceable contracts by law, and if the SEC allowed arbitration provision to be included in these “contracts”, then corporations could carefully craft the provisions to meet specific needs.²² Corporations are in the best position to create company-specific provisions, which will put into place protocols before issues arise in order to create the most efficient guidelines.²³ This, paired with careful regulation by the SEC to ensure that provisions are fair and are not unfairly prejudicial against shareholders, could effectively create favorable provisions for all parties.²⁴

The outcome that these suggestions intend to achieve is showing that arbitration could effectively achieve similar results as litigation while more efficiently managing expenses. Litigation seeks to correct a wrong and allocate money to help a party recover from a wrong, but through the expenses that accrue through shareholder litigation, shareholders do not receive valuable recoveries but rather come from a reallocation of money internally through “pocket-shifting.”²⁵ Where arbitration can correct the wrong through addressing the wrong and deterring future wrong, while limiting expenses; then arbitration should replace litigation to avoid significant expenses in a setting that subjects corporations to non-meritorious litigation and financial loss.

II. A RESURGENCE OF IPOs

A prosperous “IPO market encourages entrepreneurship, facilitates growth, creates jobs, and fosters innovation, while providing attractive opportunities for investors to increase their wealth and mitigate risk.”²⁶ IPOs create all of these opportunities because of the mutual benefit of giving young, innovative compa-

18. Julie Steinberg, *Do Class Actions Benefit Investors? They May Check Misbehavior, But They Often Don't Compensate for Losses*, WALL ST. J., <https://www.wsj.com/articles/do-class-actions-benefit-investors-1393807214> (last updated Mar. 2, 2014).

19. *Id.*

20. Weitzel, *supra* note 3, at 78.

21. *Id.* at 79.

22. Ann M. Lipton, *Manufactured Consent: The Problem of Arbitration Clauses in Corporate Charters and Bylaws*, CLS BLUE SKY BLOG (Mar. 18, 2015), <http://clsbluesky.law.columbia.edu/2015/03/18/manufactured-consent-the-problem-of-arbitration-clauses-in-corporate-charters-and-bylaws/>.

23. Weitzel, *supra* note 3, at 83.

24. *Id.* at 89.

25. *Id.* at 73.

26. Piwowar, *supra* note 10.

nies the opportunity to gain capital.²⁷ This provides a huge boost from original funding sources, allowing a diverse group of investors the opportunity to profit off a company's success.²⁸ Companies going public create an opportunity to bring in more capital and become more flexible in their operations so, these businesses are much more capable of allocating funds efficiently and making the most of both the employees and the capital on hand, which creates the potential for an IPO to create value leagues higher than the dollar value.²⁹

The benefits of IPOs are clear for both companies considering taking their business public and for potential investors. Despite the benefits that IPOs offer, the number of companies going public has remained consistently low and even having a slight decrease in recent years.³⁰ One major factor has been the huge decrease in the number of smaller IPOs.³¹ A recent U.S. Treasury report cited the risks of class action securities litigation as a potentially significant disincentive for companies to list their shares on the public market.³² The study even suggested that the risks might encourage public companies to remain privately owned rather than undertaking an IPO.³³

Several market booms that occurred in the mid-1980s and mid to late-1990s that skew the numbers must be acknowledged because the numbers may mislead readers to believe class actions have had a much greater effect on IPOs.³⁴ And while, for this reason, the effect of litigation on IPOs may not be as high as some claim, it might still affect IPOs considering that "since 2000 IPO volume has never recovered to anywhere close to the levels observed in the 1990s, despite strong market performance during much of this period."³⁵ If this increase in class action suits has affected directors' decisions in taking their companies public and the low volume of IPOs during strong market performance, then an alternative to these extremely costly proceedings would serve to create value for all parties.³⁶

Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder, allows for investors to sue securities issuers for their misrepresentations and omissions.³⁷ Using these rights, the number of securities class action lawsuits filed has seen a spike in both 2017 and 2018.³⁸ Despite a consistently low number of IPOs over recent years, with a drop in each of the last three, the number of class actions has risen from 151 in 2012 to 412 in 2017; this year the count is at 270 through the first nine months.³⁹ With these rising numbers in class action lawsuits and attendant decline of IPOs, there was a record high 3.9% of exchange-listed compa-

27. *Id.*

28. *Id.*

29. *Id.*

30. Michelle Lowry, Roni Michaely & Ekaterina Volkova, *Initial Public Offerings: A Synthesis of the Literature and Directions for Future Research*, FOUND. & TRENDS IN FIN. 19 (Mar. 20, 2017), <http://leeds-faculty.colorado.edu/bhagat/lowry-michaely-ipos.pdf>.

31. Piwowar, *supra* note 10.

32. U.S. DEP'T OF TREASURY, *supra* note 13.

33. *Id.*

34. Lowry, Michaely & Volkova, *supra* note 30, at 70.

35. *Id.* at 17.

36. *Id.*

37. U.S. DEP'T OF TREASURY, *supra* note 13.

38. *Id.*

39. *Federal Securities Class Action Litigation 1996 – YTD*, STAN. L. SCH., <http://securities.stanford.edu/charts.html> (last visited Apr. 8, 2019).

nies facing these lawsuits in 2016.⁴⁰ With class action litigation so commonplace, it makes the perceived risk of litigation unusually high for companies considering going public.⁴¹ This, paired with the fact that, since 1996, 55% of completed class action security lawsuits have been settled, and those cases settled for the enormous amount of \$90 billion, must weigh heavily on the minds of those considering taking their company public.⁴²

The facts clearly show the prevalence of securities class action lawsuits, and how arbitration could combat the expenses that accrue during those proceedings. The answer revolves around avoiding the fee-setting in securities class actions that significantly rewards lawyers who handle cases.⁴³ These awards result in billions of dollars for plaintiffs' lawyers for fees and reimbursement of expenses.⁴⁴ Because of the huge number of dollars on the line for the defendants, it would be incredibly valuable for them to be able to limit these costs, or even avoid them entirely, and to understand the nature of how these fees are created.⁴⁵ Unfortunately for defendants:

The process by which judges set fee and cost awards remains a black box. Settlements go in; awards come out. Little is known about the mechanism that earmarks dollars for attorneys. Consequently, it is difficult to know why fee awards are sized as they are. Studies have shown that more dollars flow to lawyers when settlements are larger; that, in percentage terms, awards tend to decline as recoveries rise; and that investors get more "bang for the buck" in securities-fraud class actions when public pension funds serve as lead plaintiffs. But the causes of these phenomena remain hidden from view because researchers have not peered inside the fee-setting mechanism.⁴⁶

However, securities litigation has seen improvement since the Private Securities Litigation Reform Act ("PSLRA"), which came into effect in 1995.⁴⁷ The Act "sought to put class actions under the control of sophisticated investors with large financial stakes" and to create proper incentives for attorneys to take these cases. The Act also wanted to create an incentive to deter attorneys from seeking financial gain through abusive behavior.⁴⁸

Without knowing what goes on in the "black box" (that is, the decision of awards), it is uncertain whether improvement in securities class actions are the result of the act or whether it comes from more effective bargaining by the representative plaintiff for the class action.⁴⁹ For this reason, it is impossible to determine the most important factor in the fee-setting in these class actions, and, even

40. U.S. DEP'T OF TREASURY, *supra* note 13.

41. *Id.*

42. *Id.*

43. Lynn A. Baker, Michael A. Perino & Charles Silver, *Is the Price Right? An Empirical Study of the Fee-Setting in Securities Class Actions*, 115 COLUM. L. REV. 1371, 1372 (2015).

44. *Id.*

45. *Id.*

46. *Id.* at 1373-74.

47. *Id.* at 1376.

48. *Id.* at 1373.

49. Baker, Perino & Silver, *supra* note 43, at 1378-79.

more troubling, the attorneys' fees vary between different geographic markets.⁵⁰ This shows evidence of an inconsistent decision-making process that may adversely affect plaintiffs in class actions.⁵¹ It might also encourage attorneys to argue for higher fees in markets that see fewer cases and, therefore, might not be as familiar with reasonable fees.⁵²

In a setting such as arbitration, there would be fewer concerns due to the lack of significant numbers of parties involved and would allow for the plaintiff's only concern to be self-interests rather than all the variables present in a class action suit.⁵³ Parties with significant investments that give need for action would be able to bring their claim.⁵⁴ The other shareholders who lack investments worthy of bringing action would also enjoy several benefits.⁵⁵ These benefits would come in the form of the companies' ability to save money and, therefore, increase the value of the company and its stock price.

As an alternative for investors who would otherwise choose to litigate against a company, investors would enjoy the benefits of the decreased costs of arbitration and reaching a decision quicker. "Scholars generally agree that arbitration is less expensive than litigation because, as Professor David Schwartz explains, arbitration 'offers less room for complexity.'"⁵⁶ A significant portion of these reduced costs comes from the limits of discovery in arbitration.⁵⁷ This creates huge savings because discovery typically accounts for nearly 50% of the average litigation expenses.⁵⁸ However, there is some uncertainty as to how much money is incurred from discovery because the "PSLRA prevents discovery while there is a pending motion to dismiss."⁵⁹ Because of this pause in discovery, there would likely be little to no discovery cost for non-meritorious claims that do not make it through a motion to dismiss.⁶⁰ Examining securities class actions from 2014, where only 10% of cases are ongoing helps to paint a picture of how many cases actually incur discovery expenses.⁶¹ In 2014, 41% of the cases were dismissed meaning no discovery expenses were paid and 48% of cases were settled.⁶² Because the most opportune time to settle is following a denied motion to dismiss, it cannot be determined the exact amount of money that is incurred during discovery, but it is possible that this number is limited because of the few number of cases that reach a ruling.⁶³

50. *Id.* at 1381.

51. *Id.* at 1423.

52. *Id.* at 1381.

53. *Id.*

54. *Id.*

55. Baker, Perino & Silver, *supra* note 43.

56. Weitzel, *supra* note 3, at 83.

57. *Id.* at 84.

58. *Id.*

59. Tom Baker & Sean J. Griffith, *How the Merits Matter: Directors' and Officers' Insurance and Securities Settlements*, 157 U. PA. L. REV. 755, 778 n.98 (2009), <https://www.law.upenn.edu/live/files/102-bakergriffith157upalrev7552009pdf>.

60. *Id.* at 779.

61. *Securities Class Action Filings-2018 Midyear Assessment*, CORNERSTONE RES. 17 (2018), <http://www.cornerstone.com/Publications/Reports/Securities-Securities-Class-Action-Filings%E2%80%942018-Midyear-Assessment>.

62. *Id.*

63. *Id.*

Litigation expenses are somewhat uncertain because, as mentioned previously, under the PSRLA, decisions are very discreet, making it uncertain what the exact value of savings would be enjoyed through arbitration.⁶⁴ Although the discretion used in the fee setting of securities prevents a complete breakdown of expenses, the electronic discovery setup for securities class actions costs between one and three million dollars, which makes it certain that significant savings could be earned for the companies and its shareholders.⁶⁵

Considering all of these facts, it is easy to come to the conclusion that these risks of litigation have at the very least some effect upon the decision of whether to take a company public.⁶⁶ If arbitration were able to effectively govern publicly traded corporations, business owners would be able to offset these tremendous costs of litigation by creating a drastically more appealing market to enter when undertaking IPOs.⁶⁷ This would allow businesses to reap the benefits created by their relationship with investors, while creating value for these investors by simply reestablishing the desirability of this once dominant form of funding.⁶⁸

In addition to making companies more comfortable creating offering shares to the public, shareholders may gain benefits by reducing litigation that negatively affects the price of the shares they own.⁶⁹ While eliminating action by individuals whose claims would be insufficient to justify litigation, the nominal gains they would have earned will be passed back to them in the form of increased value of shares.⁷⁰ Future plaintiffs who have already invested money in companies may feel savings by allowing such arbitration through the potential millions of dollars companies may save.⁷¹ Many of these arguments may seem counterintuitive because of the relationship between shareholders and companies, which may require disciplinary action.⁷² In the end, it is in the best interest of shareholders for the companies' losses to be limited.⁷³ The most important aspect of the argument for mandatory arbitration clauses now is whether shareholders may be properly protected from corporate misconduct if their sole venue to bring a complaint is through arbitration.⁷⁴

III. CAN ARBITRATION DETER CORPORATE MISCONDUCT?

The number one policy issue when considering whether arbitration could effectively replace the function of a courtroom is whether companies are more likely to engage in misconduct when being arbitrated rather than adjudicated.⁷⁵ Jennifer Arlen, New York University Professor, believes that replacing the public forum of

64. Baker, Perino & Silver, *supra* note 43.

65. Weitzel, *supra* note 3, at 84 (citing 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)).

66. *Id.*

67. *Id.* at 74.

68. *Id.* at 93.

69. *Id.* at 71-72.

70. *Id.* at 78.

71. U.S. DEP'T OF TREASURY, *supra* note 13.

72. Weitzel, *supra* note 3, at 73.

73. *Id.*

74. *Id.* at 75.

75. Frankel, *supra* note 6.

the courtroom with the private forum of arbitration will cause more misconduct.⁷⁶ In support of this belief she said, “If you take shareholder suits out of the light of day and put them in a dark closet, you lose the deterrent effect.”⁷⁷ While this reasoning has some merit, it cannot be read without taking into account the economic inefficiencies of class actions for securities violations that companies would have a huge incentive to avoid.⁷⁸

In opposition to Jennifer Arlen, Michigan’s Adam Pritchard stated that big investors would have the money to cover upfront costs of arbitration, and would have sufficient losses to make the proceedings worth their while.⁷⁹ So here, if big investors are willing to pursue claims against corporations, the risk of these individual arbitrations would be sufficient to deter corporate misconduct.⁸⁰ However, some, including Boston University’s David Webber who said “[the SEC] should not be fostering policies that harm certain investors . . . [t]he SEC is supposed to level the playing field,” still have issue with the fact that this form of recovery would leave some shareholders unprotected despite potential deterrent effects.⁸¹

Regarding shareholders who may be left unprotected, their “protection” could come in the form of the profits that were previously lost through the reductions in payments to shareholders due to expenses of litigation.⁸² Judgments and settlements create significant expenses totaling in the billions over the last 20 years.⁸³ Decisions resulting from class actions indirectly take from shareholders because expenses accrue while corporations’ assets and insurance policies pay for litigation.⁸⁴ The sum of these costs works up a sizeable bill in all cases and create a deterrent effect for corporations through the money paid for damages, but they also take an indirect cut from shareholders.⁸⁵ However, proponents of class action litigation argue that, in addition to the deterrent effect of bringing actions, compensation to the shareholders is a very important justification for class actions.⁸⁶

The compensation justification is widely rejected by scholars. Because settlements to shareholders are paid from the company’s treasury, which already belongs to the shareholders, the payments are mere pocket-shifting. This means shareholder settlements are little more than a court-enforced dividend with heavy transaction costs.⁸⁷

A greater problem in this compensation justification is that plaintiffs eligible for recovery do not make up all shareholders; so all shareholders will bear the cost of litigation or settlement, while only select plaintiffs receive any recovery.⁸⁸ The mean length of the class period in securities litigation was 358 days, with a medi-

76. *Id.*

77. *Id.*

78. U.S. DEP’T OF TREASURY, *supra* note 13.

79. Frankel, *supra* note 6.

80. *Id.*

81. *Id.*

82. U.S. DEP’T OF TREASURY, *supra* note 13.

83. *Id.*

84. *Id.*

85. *Id.*

86. Weitzel, *supra* note 3, at 73.

87. *Id.*

88. Willard T. Carleton et al., *Securities Class Action Lawsuits: A Descriptive Study*, 38 ARIZ. L. REV. 491, 496 (1996).

an length of 257 days.⁸⁹ Therefore, unless investors bought the majority of their stock interest in the company during this period of less than a year, they will, on average, bear the proportionate cost of the recovery and the litigation, but not share in any portion of the recovery.⁹⁰ These indirect losses to shareholders could be restored to them through transaction costs saved by arbitration entered into by larger investors or affected parties, and arbitration pursued by large investors could create a sufficient deterrent effect.⁹¹ Following this approach, it could reasonably be concluded that mandatory arbitration clauses could put each of the parties involved in their best possible position.⁹²

Clearly, many of the arguments against mandatory arbitration clauses cite concerns of this forum's ability to deter corporate misconduct by punishing those guilty of fraud and misrepresentation, but shareholder litigation itself often fails to punish these managers and directors anyway.⁹³ In ninety-six percent of shareholder securities class actions, insurance policies cover the expenses that result from class action litigation.⁹⁴ An even greater harm to shareholders occurs when corporations choose to settle at a less than optimal time to remove the lawsuit, but then agree to pay an inflated insurance premium at the next renewal.⁹⁵ Even when these policies fail to cover the entire amount of expenses that added up, individuals who created the issue rarely if ever make up the difference.⁹⁶

The argument in support of mandatory arbitration clauses for shareholders often relies on its potential to provide a more efficient outcome for shareholders, and the argument in opposition to arbitration generally cites its inability to properly deter misconduct.⁹⁷ Countering this argument can come from both the fact that it can be reasonably argued that there is a deterrent effect, and that if this deterrent effect is questioned, the deterrent effect of shareholder litigation is as questionable as that of arbitration.⁹⁸ The likely deterrent effect of arbitration is the fact that although a lawsuit will not reach court, the companies may be held liable through arbitration.⁹⁹

Corporations accused of wrongdoing would likely be pursued in arbitration by the more sophisticated investors who would have been attractive for the position of lead plaintiffs in a class action suit.¹⁰⁰ Just because a lawsuit will not reach the public forum does not mean that the deterrent effect goes away with the courts. It simply means they will be liable in a different setting that will reach a decision on the same matters, while avoiding many of the procedural and transactional costs that would be accrued in the court system.¹⁰¹ These reduced costs will also be joined by reduced liability costs.¹⁰² The more predictable outcomes seen in arbitration will increase the clarity of a future settlement, which will promote

89. *Id.*

90. *Id.*

91. Weitzel, *supra* note 3, at 79.

92. *Id.*

93. *Id.* at 75.

94. *Id.*

95. Baker & Griffith, *supra* note 59, at 818.

96. Weitzel, *supra* note 3, at 75.

97. *Id.* at 74-75.

98. *Id.* at 76.

99. *Id.* at 85.

100. *Id.* at 78.

101. *Id.* at 85.

102. Weitzel, *supra* note 3, at 85.

reaching this settlement more quickly.¹⁰³ This result would reject the argument that loss of money should be considered a deterrent and promote efficiency between both parties.

IV. INSIGNIFICANT CLASS ACTION REWARDS

One of the greatest inefficiencies of securities' class action lawsuits, and even class action lawsuits in general, is the fact the rewards to small investors (or small plaintiffs) are so small that they often do not bother to collect them.¹⁰⁴ These small payouts largely result due to the high percent of recoveries of between 25-35% going to the plaintiffs' attorneys.¹⁰⁵ In 2016, securities class actions saw a jump in both settlements and payouts, which to some suggested a more efficient and more favorable system to shareholders.¹⁰⁶ However, this jump would still have the same inefficient effect on small investors.¹⁰⁷

An even greater injustice occurs in the many cases where attorneys along with a select few of the plaintiffs are paid to dismiss the case.¹⁰⁸ In this situation, potential plaintiffs with smaller claims receive nothing.¹⁰⁹ In consumer class actions, the consumer plaintiffs are comparable to the low-dollar investors who have small claims in proportion to all the claimants but together create the class action.¹¹⁰ Here, these small plaintiffs receive incredibly small amounts despite the fact that the lawsuit was filed with the supposed purpose of defending those very people.¹¹¹ In a study of commercial class actions, it was found that "the percentage of class members who actually got money ranged from a high of 12% down to a low of 0.00006%."¹¹² These numbers in no way suggest that class actions have sufficiently rewarded plaintiffs, and even suggests that it is unjustifiable to reward attorneys with such high payouts when they haven't earned proper recoveries.¹¹³

Shareholders' compensations in class action lawsuits are consistent with the recoveries in class actions in other areas such as consumers' class actions.¹¹⁴ While the check-ins on corporate misconduct help to keep corporations honest, when it comes down to compensating investors for their losses, class actions are still entirely inefficient.¹¹⁵ "Generally, aggrieved investors get only pennies on the dollar. The average settlement amounts to 1% to 5% of shareholder losses, according to the Stanford Securities Litigation Analytics database, which tracks

103. *Id.*

104. *Id.* at 78.

105. *Id.*

106. Meaghan Kilroy, *Securities Class-Action Settlements, Payouts Jump in 2016—Report*, PENSIONS & INV. (Mar. 15, 2017), <https://www.pionline.com/article/20170315/ONLINE/170319915/securities-class-action-settlements-payouts-jump-in-2016-8212-report>.

107. *Id.*

108. Daniel Fisher, *Study Shows Consumer Class-Action Lawyers Earn Millions, Clients Little*, FORBES (Dec. 11, 2013), <https://www.forbes.com/sites/danielfisher/2013/12/11/with-consumer-class-actions-lawyers-are-mostly-paid-to-do-nothing/#762ee1fb1472>.

109. *Id.*

110. *Id.*

111. *Id.*

112. *Id.*

113. *Id.*

114. Steinberg, *supra* note 18.

115. *Id.*

securities litigation since 2000.”¹¹⁶ To further harshen the blow to investors, studies estimate that these lawsuits cost investors approximately \$39 billion per year while only providing \$5 billion per year.¹¹⁷

Where payouts to plaintiffs in class action lawsuits are so low that they have no incentive to collect their rewards and compensation for loss, there is no reason that investors would be harmed by the implementation of mandatory arbitration clauses if corporate misconduct were effectively deterred.¹¹⁸ Elimination of securities class actions would allow for the savings by corporations to positively affect the share prices, which should be the number one concern of investors when payouts do not adequately compensate shareholders.¹¹⁹

V. IMPLEMENTATION OF ARBITRATION CLAUSES THROUGH CORPORATE CHARTERS AND BYLAWS

Mandatory arbitration clauses by corporations have been adopted for nearly every issue under the Federal Arbitration Act (FAA) and continue to increase in prominence, bringing up the question of how they do it.¹²⁰ Corporations routinely include these provisions in consumer contracts, employment agreements, and other legal documents.¹²¹ More recently, inclusion of arbitration provisions in corporate charters and bylaws has been an area of concern.¹²² “Although it has not issued more general policy guidance, the [SEC] has long indicated its opposition to the inclusion of mandatory arbitration clauses in corporate charters and bylaws. It has refused, for example, to accelerate registration statements with charters that contain such a clause. In the context of shareholder proposals, SEC staff have suggested that mandatory arbitration charter provisions might violate securities laws.”¹²³ However, this concern is rejected by past rulings such as *Shearson/American Express Inc. v. McMahon*, which “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.’”¹²⁴

While it might seem odd to reference the Supreme Court because the rights among shareholders and corporations are ordinarily governed by State law, the Supreme Court’s upholding of enforceability of these provisions FAA is relevant because the Federal Arbitration Act (FAA) “preempts any state rule that discriminates on its face against arbitration or that covertly accomplishes the same objective by disfavoring contracts that have the defining features of arbitration agree-

116. *Id.*

117. *Id.*

118. Weitzel, *supra* note 3, at 78.

119. *Id.*

120. Zachary D. Clopton & Verity Winship, *A Cooperative Federalism Approach to Shareholder Arbitration*, YALE L.J. (July 9, 2018), <https://www.yalelawjournal.org/forum/cooperative-federalism-shareholder-arbitration>.

121. *Id.*

122. *Id.*

123. *Id.*

124. Weitzel, *supra* note 3, at 102 (quoting *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220, 223 (1987)).

ments.¹²⁵ Considering this ruling on the FAA along with Supreme Court ruling on the FAA allowing arbitration of statutory rights unless challengers show otherwise, leaves the major decision of whether to allow mandatory arbitration clauses in corporate charters or bylaws to the discretion of the SEC.¹²⁶ For this reason, the inclusion of these provisions in corporate governance documents may subject shareholders to mandatory arbitration for securities claims if the SEC began to accept corporate governance documents with these provisions along with a favorable interpretation of securities laws.¹²⁷

If included in these documents, shareholders would have absolutely no bargaining power and no available negotiation to alter the terms regarding arbitration.¹²⁸ This has been incredibly concerning to opponents of mandatory arbitration clauses, and their concerns about the future seem to be relevant as foreign entities have begun to include arbitration language in their governance documents.¹²⁹ Statements by SEC Commissioner Michael Piwowar about potentially allowing shareholders to be bound to mandatory arbitration makes it almost certain that this issue will be faced sooner or later.¹³⁰

The Federal Arbitration Act requires that arbitration clauses in contracts be enforced according to their terms.¹³¹ As charters and bylaws are considered to be contracts among shareholders, the question of whether these shareholders should be bound to a contract and thought of as consenting to the provisions is brought forth.¹³² “In a series of decisions involving a single Maryland-based REIT, two courts separately held that corporate bylaws are akin to ordinary contracts and equally subject to FAA analysis.”¹³³ The FAA states that arbitration provisions in contracts “shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.”¹³⁴ Following this logic, the conclusion can be easily reached that if the SEC allowed mandatory arbitration, then the corporate governance documents would stand in place of an additional contract.¹³⁵

If courts will continue to follow this reasoning, as well as past rulings confirming that governance documents should be treated as contracts, corporations will have the ability to carefully craft contractual terms to meet the parties’ needs.¹³⁶ “For example, a corporation could draft a provision so that it only applied to certain disputes above or below a given monetary threshold, as some corporations have done. Additionally, arbitration provisions may be written to require individual arbitration, thereby preventing class resolution.”¹³⁷ Outcomes such as these can be favorable to both parties because it presents the possibility to set very

125. *Kindred Nursing Ctrs. Ltd. P’ship v. Clark*, 137 S. Ct. 1421, 1423 (2017).

126. Weitzel, *supra* note 3, at 104.

127. *Id.*

128. *Id.*

129. *See id.*

130. Posner, *supra* note 1.

131. Lipton, *supra* note 22.

132. *Id.*

133. *Id.*; *see Del. Cty. Emps. Ret. Fund v. Portnoy*, 2014 WL 1271528 (D. Mass. 2014); *Corvex Management LP v. Commonwealth REIT*, 2013 WL 1915769 (Cir. Ct. Md. 2013).

134. Lipton, *supra* note 22.

135. *Id.*

136. *See generally* Garry D. Hartlieb, *Enforceability of Mandatory Arbitration Clauses for Shareholder-Corporation Disputes*, 4 MICH. BUS. & ENTREPRENEURIAL L. REV. 131 (2014).

137. *Id.* at 132-33.

clear definitions of what can and cannot be arbitrated.¹³⁸ They also dive deeper into more precise issues such as known issues and other company-specific details.¹³⁹ By the nature of bylaws, they will be able to prepare for a wide array of potential disputes through a proactive approach of setting up potential resolutions to disagreements, making it more time and cost efficient.¹⁴⁰ Preparation like this may take place by “address[ing] issues such as discovery, motions, arbitrator qualifications, experts, fee awards, confidentiality, duration of proceedings, and any applicable third party provider rules.”¹⁴¹

Although opponents of arbitration believe and argue that shareholders will lose their day in court, the corporations are best situated to determine what might come and how to handle the issue, so allowing them to prepare rules will be a potentially advantageous for shareholders.¹⁴² If the SEC decided to allow mandatory arbitration provisions to further protect shareholders, the SEC would carefully define what would be allowed to be arbitrated.¹⁴³ It would also be the last group to review corporate governance documents, giving them the ability to control what is and is allowed to be decided by arbitration.¹⁴⁴ An important consideration that should not be forgotten is that “mandatory arbitration is not necessarily an all-or-nothing game.”¹⁴⁵ While many will take the idea of mandatory arbitration as undesirable in general, there will be many specific areas that both parties will benefit by skipping over several of the time consuming and expensive processes of the court system.¹⁴⁶

Proponents of mandatory arbitration have recently argued that arbitration is “nothing more than a ‘specialized kind of forum-selection clause.’”¹⁴⁷ This argument is compelling because it concisely argues why corporations may be so attracted to arbitration rather than highlighting why arbitration is harmful for public policy reasons.¹⁴⁸ Like a forum-selection clause, arbitration is attractive because it allows for the corporation to prepare for arguments in a similar fashion for each hearing.¹⁴⁹ Arbitration goes a step further by significantly reducing the costs to both parties, which here have a common bank account and, therefore, a shared goal in each side settling the matter with as few expenses as possible.¹⁵⁰

The expertise that would, similar to forum-selection clauses, follow would be a huge draw to corporations’ interests in choosing to use arbitration rather than go straight to court.¹⁵¹ Similar to the issue of the “black box” of the formation of awards for damages, corporations may avoid the uncertainty of what lies ahead through more predictable decisions.¹⁵²

138. Weitzel, *supra* note 3.

139. *Id.*

140. Claudia H. Allen, *Bylaws Mandating Arbitration of Stockholder Disputes?*, 39 DEL. J. CORP. L. 751, 761 (2015).

141. *Id.* at 798.

142. *Id.* at 795.

143. *Id.*

144. *Id.*

145. Clopton & Winship, *supra* note 119.

146. *Id.*

147. Weitzel, *supra* note 3, at 81.

148. *Id.* at 83.

149. *Id.* (quoting *Allied-Bruce Terminix Cos., Inc. v. Dobson*, 513 U.S. 265, 280 (1995)).

150. *Id.*

151. *Id.* at 88.

152. *Id.*

“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. For 133 of those judges (83%) it was the first time ever handling summary judgment in a securities class action. 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.”¹⁵³

Dealing with such large numbers, corporations can clearly see that there is much room for error when there is so much unfamiliarity with the topic in the decision maker.¹⁵⁴ Many of the scholars and commentators are quick to point out that corporations that might include arbitration provisions in their charter do so only to hide wrongdoing behind the secrecy of arbitration.¹⁵⁵ However, another conclusion may point to the expertise and consistency that corporations will face.¹⁵⁶

The implementation of arbitration clauses through corporate charters and by-laws would effectively create a binding contract between shareholders and corporations in the event that the SEC approves the validity of these provisions.¹⁵⁷ Once corporations begin implementing these provisions, the SEC would review the arbitration clauses to determine whether they are acceptable. This would be done in order to ensure that they were created in good faith, and for purposes to benefit both themselves and the shareholders, rather than to take advantage of a less sophisticated parties.¹⁵⁸ In this scenario, through careful analysis in very limited areas, corporations would be able to enjoy less expensive proceedings with more appropriate decision maker.

VI. CONCLUSION

The inefficiencies for shareholders in securities class actions imposes significant costs to both the corporation itself and its shareholders.¹⁵⁹ At its roots, the inefficiencies are a simple matter of dollar and cents that can be resolved by looking towards the creation of value rather than individuals’ rights to their “day in court.”¹⁶⁰

Not only do the tremendous expenses of litigation harm shareholders from direct losses to the corporations’ checkbooks, but also the decreases in IPOs have eliminated a valuable source of funding for corporations and eliminate an option for potential shareholders to diversify their investments.¹⁶¹ Although these inefficiencies seem to be an incurable result of the litigation system, it may be countered by the introduction of arbitration, a cheaper alternative.¹⁶²

In class actions, the lead plaintiffs have a very important role of representing this class, and they take this role because they are the party with the most at stake

153. Weitzel, *supra* note 3, at 88.

154. *Id.* at 88-89.

155. *Id.* at 95.

156. *Id.* at 88.

157. Clopton & Winship, *supra* note 119.

158. *Id.*

159. Weitzel, *supra* note 3, at 73.

160. *Id.* at 92-93.

161. *Id.* at 74.

162. *Id.* at 83.

in the lawsuit.¹⁶³ These same plaintiffs would still bring action against corporations and, through these actions, would bring the necessary deterrent function to help prevent corporate misconduct.¹⁶⁴

While opponents of mandatory arbitration have great concern for plaintiffs losing their day in court due to the introduction of mandatory arbitration, this argument ignores the fact that these same plaintiffs already have such a small position in the argument that they rarely collect their payouts.¹⁶⁵ This aspect of class actions alone is a major inefficiency of the system and should be eliminated.¹⁶⁶ The additional members of the class create more expenses and where their reward is insignificant, no justice is served.¹⁶⁷ Rather than participating in the pocket-shifting of these derivative suits, the goal should be to protect the value of the shareholders' investment as well as their stock price.¹⁶⁸

To implement a more efficient system, corporations could amend their charters and bylaws in order to create a system that fits their company-specific details.¹⁶⁹ This practice would need to be carefully monitored by the SEC to prevent any prejudicial clauses, but in a system of good faith, a mutually beneficial system could be put in place for shareholders and their corporations.¹⁷⁰

In the end, corporations form with the goal of creating value and investors put money into these corporations in order to promote growth and create value for themselves. Keeping this in mind, the simplification of securities litigation with the goal of creating more value for both parties would result in a more favorable system for all parties involved.

163. Richard D. McCune et al., *What to Know If You Sign up to Be a Lead Plaintiff for a Class Action*, MCCUNE WRIGHT AREVALO ATTORNEYS AT LAW, (Jul. 7, 2016), <https://www.mccunewright.com/blog/2016/july/what-to-know-if-you-sign-up-to-be-a-lead-plaintiff/>.

164. Weitzel, *supra* note 3, at 75.

165. *Id.* at 78.

166. *Id.*

167. *Id.*

168. *Id.* at 74.

169. Clopton & Winship, *supra* note 119.

170. *Id.*