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Eliminating Securities Fraud Class Actions Under the Radar

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ELIMINATING SECURITIES FRAUD CLASS ACTIONS UNDER THE RADAR

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At least since Basic, Inc. v. Levinson, *the business community and many influential scholars have challenged the existence of the securities fraud class action on a variety of grounds. Recently, two proposals have been advanced to "fix" the problem of "abusive" securities fraud class actions. One proposal requires arbitration of all securities fraud actions; the other eliminates the corporate defendant in most actions. Proponents assert that shareholders should have the right to adopt these proposals through amendment of the company's certificate of incorporation. Both these proposals have attracted more than academic interest. In reality, adoption of either proposal would substantially curtail, if not eliminate, the securities fraud class action.*

Part II of this paper first reviews the two rationales – compensation and deterrence— for the federal securities class action, sets forth the critics' principal arguments as to why these goals are not achieved, and argues that the post-PSLRA securities fraud class action is reasonably effective in achieving both compensatory and deterrence goals. Part III then describes the two proposals. Part IV explains why these proposals are impermissible under the anti-waiver clause, Section 29(a) of the Securities Exchange Act of 1934. Part V explains why these proposals are also, under state law, illegal, unfair to shareholders that do not vote in favor of them, and unenforceable as to future stock purchasers. Part VI concludes by calling for a national debate on the future of the securities fraud class action. The arguments for and

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against the securities fraud class action involve complexities and uncertainties that make "quick and dirty" solutions like these two proposals inappropriate.

I. INTRODUCTION

The attacks on the securities fraud class action never end. At least since *Basic, Inc. v. Levinson*,[1] the business

[1] 485 U.S. 224 (1988). Indeed, the attacks on the class action generally, and the securities fraud class action specifically, go back to the 1966 amendments to rule 23 of the Federal Rules of Civil Procedure that expanded the scope of the federal class action. *See, e.g.*, AMERICAN COLLEGE OF TRIAL LAWYERS, *Report and Recommendations of the Special Committee on Rule 23 of the Federal Rules of Civil Procedure* III (1972) (quoting a trial judge who referred to the class action device as "an engine of destruction" and a law professor who described it as "legalized

community and many influential scholars have challenged its continued existence on a variety of grounds. Even substantial congressional reform to cure perceived abuses, in the Private Securities Litigation Reform Act of 1995 (PSLRA)[2] and again in the Securities Litigation Uniform Standards Act of 1998 (SLUSA),[3] did not satisfy its critics who assert that "the system is broken."[4] Recently, two proposals have been advanced to "fix" the problem of "abusive" securities fraud class actions; in reality, adoption of either proposal would substantially curtail, if not eliminate, the securities fraud class action. One proposal requires arbitration of all securities fraud actions (the "arbitration proposal");[5] the other eliminates the corporate defendant in most actions (the "proposal to eliminate the corporate defendant").[6] Proponents assert that shareholders should have the right to adopt these proposals through amendment of the company's certificate of incorporation.

Both these proposals have attracted more than academic interest. Prior to the financial meltdown and Madoff scandal that currently command the agency's attention, it was rumored that the Securities and Exchange Commission (SEC) was considering a change in its policy that would

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blackmail"). For an early defense of rule 23, *see* Arthur R. Miller, *Of Frankenstein Monsters and Shining Knights: Myth, Reality, and the "Class Action Problem,"* 92 HARV. L. REV. 664 (1979).

[2] Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified at 15 U.S.C. §§ 78(a) et seq. (2006)).

[3] Pub. L. No. 105-353, 112 Stat. 3227 (1998).

[4] *See, e.g.,* U.S. CHAMBER INSTITUTE FOR LEGAL REFORM, SECURITIES CLASS ACTION LITIGATION i (July 2008) (calling for congressional reform of private securities class actions).

[5] *See infra* notes 87–93 and accompanying text.

[6] *See infra* notes 96–102 and A.C. Pritchard, Stoneridge Investment Partners v. Scientific-Atlanta*: The Political Economy of Securities Class Action Reform,* 2007–2008 CATO SUPREME COURT REVIEW 217, 248–55. Professor Pritchard describes the proposal as a "partial waiver of the fraud on the market (FOTM) presumption;" this technical description, however, masks its wide-ranging effect.

permit companies to require arbitration of investors' claims.[7] More recently, a shareholder of a public corporation submitted a preliminary proxy statement to the SEC to solicit fellow shareholders for adoption of the proposal to eliminate the corporate defendant.[8]

Debate about the securities fraud class action is healthy. Radical change of an important investor protection mechanism, however, is such an important policy matter affecting our securities markets that the debate should take place in the national spotlight. Congress, the courts, and the SEC are all important participants that should be in the forefront of this debate. The SEC is the "investor's advocate,"[9] charged with the responsibility to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.[10] The Supreme Court and Congress have, over the years, engaged in an ongoing

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[7] Kara Scannell, *SEC Explores A Wider Role for Arbitration – Agency May Consider Letting Firms Head Off Lawsuits by Investors,* WALL ST. J. Apr. 16, 2007, at A1. Although then Chairman Cox testified before Congress that no such policy was pending before the Commission, rumors persisted. *See* Nicholas Rummell, *SEC and Congress gang up on arbitration,* FIN. WEEK, (July 23, 2007) *available at* http://www.financialweek.com/apps/pbcs.dll/article?AID=/20070723/REG/70720028/-1/FWIssueAlert01&template=printart.

[8] A shareholder of Alaska Air Group, Inc. submitted a shareholder proposal under SEC Rule 14a-9 to adopt Professor Pritchard's proposal. Management refused to include the proposal in the management's proxy statement, and the SEC issued a no-action letter that management could exclude the proposal for noncompliance with Rule 14a-8(c). *See* Alaska Air Group, Inc., SEC No-Action Letter, 2009 WL 829060, at *1 (Mar. 5, 2009).

[9] *See* SEC, http://www.sec.gov/about/whatwedo.shtml (last visited Oct. 3, 2009) (describing the SEC's role).

[10] SEC, *supra* note 9. In August 2007, a group of influential law professors called on the SEC to take a leadership role on these issues. Letter to SEC Chairman Christopher Cox from Professor Donald C. Langevoort et alia (Aug. 2, 2007), *available at* http://www.the10b-5daily.com/archives/Chairman%20Cox%20SEC%20Letter.pdf. Chairman Cox announced the SEC would hold roundtable discussions, but it has not yet done so. *See* Kara Scannell, *SEC to Study Revamp on Shareholder Suits,* WALL ST. J., Sept. 24, 2007, at C2.

dialogue over the scope of the securities fraud class action.[11] Recently, the Court expressed the view that Congress is the dominant voice in this exchange in light of its recent extensive legislative involvement in this area;[12] nevertheless, the Court maintains a significant role in interpreting and implementing Congressional policy. While the policymakers certainly should solicit and take into account investors' views on the benefits and costs of securities fraud class actions, curtailment of the federal securities class action is not an issue of shareholder rights that should be decided through the e-proxies of individual corporations.[13]

Part II of this paper first reviews the two rationales – compensation and deterrence – for the federal securities class action, sets forth the critics' principal arguments as to why these goals are not achieved, and argues that the post-PSLRA securities fraud class action is reasonably effective in achieving both compensatory and deterrence goals. Part III then describes the two "self-help" proposals[14] to curtail securities fraud class actions. Part IV explains why these

[11] *See* Jill E. Fisch, *The Scope of Private Securities Litigation: In Search of Liability Standards for Secondary Defendants*, 99 COLUM. L. REV. 1293 (1999) (advocating a judicial approach that weighs policy objectives identified by Congress).

[12] *See* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148 (2008); Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 321-22 (2007).

[13] Shareholder voting, particularly voting by retail investors, has dropped significantly at corporations that have adopted the notice and access model that dispenses with the requirement that corporations mail proxy statements to all investors. *See* Luis A. Aguilar, SEC Commissioner, Speech on Increasing Accountability and Transparency to Investors (Feb. 6, 2009), *available at* http://www.sec.gov/news/speech/2009/spch020609laa.htm.

[14] Professor Jean Sternlight calls provisions in consumer contracts that bar class actions the "do it yourself" approach to law reform. *As Mandatory Binding Arbitration Meets the Class Action, Will the Class Action Survive?*, 42 WM. & MARY L. REV. 1, 11 (2000). *See also* Richard A. Nagareda, *Aggregation and its Discontents: Class Settlement Pressure, Class-Wide Arbitration,* 106 COLUM. L. REV. 1872, 1902 (2006) (identifying the problem of class arbitration waivers that operate to repeal private enforcement).

proposals are impermissible under the anti-waiver clause, Section 29(a) of the Securities Exchange Act of 1934 (the Exchange Act).[15] Part V explains why these proposals are also, under state law, illegal and may also be unfair to shareholders that do not vote in favor of them and unenforceable as to future stock purchasers. Part VI concludes by calling for a national debate on the future of the securities fraud class action. There is no easy answer to the future of the federal securities fraud class action. The arguments for and against it involve complexities and uncertainties that make "quick and dirty" solutions like these two proposals inappropriate.

II. THE DEBATE OVER SECURITIES FRAUD CLASS ACTIONS

In the typical secondary market securities fraud claim, the corporation introduces intentional misstatements into the market that artificially inflate the stock price, so that purchasers of the stock during the period of the fraud pay an inflated price for the stock.[16] The corporation's fraud thus causes injury to purchasers when the corrective information reaches the market and the stock price drops.[17] In the typical case, where the corporate defendant does not sell the securities during the period of the fraud, the corporation causes harm, but does not benefit directly from it, since the fraud does not increase the corporation's assets (although corporations benefit in many real ways from their stock's increased market value).[18]

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[15] 15 U.S.C. § 78cc(a) (2006).

[16] The situation where the corporation makes misstatements that depress the stock price and result in sellers during the period of the fraud receiving less than they otherwise would have, is far less common, although it was the fact pattern in *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

[17] *See* Dura Pharms., Inc. v. Broudo, 544 U.S. 336 (2005).

[18] As one example, corporations with a certain amount of market capitalization benefit from streamlined registration requirements under the Securities Act of 1933. Form S-3, General Instructions I.B.1 (Form S-3

Because "[t]he overriding purpose of our Nation's securities laws is to protect investors and to maintain confidence in the securities markets,"[19] Congress, the Court and the SEC have long recognized that the securities fraud class action is "an indispensable tool"[20] that allows defrauded investors to recover at least some portion of their losses. Moreover, because securities fraud undermines overall investor confidence in the securities market, Congress, the Court, and the SEC have also acknowledged the importance of the securities fraud class action as a necessary supplement to the SEC's enforcement efforts.[21] Thus, as described by Professor James Cox, the class action has a "quasi-public character."[22]

In order to facilitate securities fraud class actions, the Supreme Court, in *Basic, Inc. v. Levinson*,[23] adopted the "fraud on the market" (FOTM) presumption of reliance in efficient markets so that plaintiffs did not have to establish

can be used in primary offerings by registrants with $75 million float), *available at* http://www.sec.gov/about/forms/forms-3.pdf.

[19] Joint Explanatory Statement of the Committee of Conference on H.R. 1058 (Joint Explanatory Statement) at 31, reprinted in 2 U.S.C.C.A.N. 730 (104th Cong., 1st Sess. 1995).

[20] *Id. See* Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 345 (2005) (stating that private actions are available to protect investors against losses caused by fraud). *See also* Edward Labaton, *Consequences, Intended and Unintended, of Securities Law Reform,* 29 STETSON L. REV. 395, 401 n.43 (1999) (setting forth testimony of SEC Chair Richard C. Breeden that private actions are necessary to compensate defrauded investors).

[21] *See Dura*, 544 U.S. at 345 (stating that private securities fraud actions serve to deter fraud); *Basic*, 485 U.S. at 231 (1988) (stating that the Rule 10b-5 private claim constitutes an essential tool for enforcement of the 1934 Act). *See also* J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964) (stating that private enforcement of proxy rules is a necessary supplement to SEC action); Joint Explanatory Statement at 31 (stating that private suits "help to deter wrongdoing"); Labaton, *supra* note 20 at 401 n.43 (setting forth testimony of SEC Chair Richard C. Breedon that private actions augment SEC enforcement resources and provide additional deterrence).

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

[23] 485 U.S. 224 (1988).

their own reliance on the fraudulent statement; rather, in efficient markets "all information known to the public affects the price and thus affects every investor."[24] As a result of the *Basic* presumption, individual issues of reliance do not defeat class action certification so long as the securities are traded in an efficient market, and securities fraud class actions increased in number.[25]

After *Basic,* the business community and many scholars charged that plaintiffs' attorneys brought too many unmeritorious securities fraud class action suits in pursuit of quick settlements and substantial attorneys' fees.[26] In response, Congress enacted PSLRA in 1995.[27] Business interests urged Congress to eliminate the FOTM presumption of reliance,[28] without which securities fraud class actions would be difficult if not impossible to maintain. The SEC opposed the elimination of the FOTM presumption,[29] however, and Congress decided not to do so.

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[24] Asher v. Baxter Int'l Inc., 377 F.3d 727, 731 (7th Cir. 2004). Belief in the efficiency of markets is also a core aspect of the SEC's regulation of disclosure. Seasoned issuers, for example, can use Form S-3 to register securities and incorporate by reference information contained in Exchange Act filings, Item 12 (Incorporation of Certain Information by Reference), Form S-3, *available at* http://www.sec.gov/about/forms/forms-3.pdf.

[25] Securities class actions have averaged between 47% and 48% of all class actions in recent years. *See* John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implication,* 106 COLUM. L. REV. 1534, 1539–40 (2006).

[26] Professor Alexander wrote an influential law review article on this issue. Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497 (1991). Two leading securities professors rejected Professor Alexander's thesis because of the small size of her sample (6 settlements) and her calculation of allowable damages. *See* Joel Seligman, *The Merits Do Matter*, 108 HARV. L. REV. 438, 453 (1994); Cox, *supra* note 22, at 503–04.

[27] Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified at 15 U.S.C. §§ 78(a) et seq. (2006)).

[28] *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 664–65 (3d ed. 2003).

[29] *Common Sense Legal Reform Act: Hearing on H.R. 10 Before the Subcomm. on Telecommunications and Fin. of the H. Comm. on Commerce,*

Instead, PSLRA sought to weed out frivolous suits through a variety of procedural and other measures.[30] Congress chose not to eliminate the securities fraud class action, but to cure it and thus confirmed its importance to the integrity of the U.S. capital markets.[31] Consistent with the Congressional purpose, the Supreme Court identified PSLRA's twin goals: "to curb frivolous, lawyer-driven litigation, while preserving investors' ability to recover on meritorious claims."[32] In 1998, Congress reaffirmed the national importance of the reformed federal securities fraud class action and enacted SLUSA, which preempted most class actions filed under state common law and state securities statutes.[33]

The business community's campaign against the securities fraud class action has not abated since the enactment of PSLRA and SLUSA, even in the face of persistent widespread corporate fraud, including the Enron-era accounting frauds that led to the enactment of the Sarbanes-Oxley Act of 2002 (SOX) and the stock options backdating scandals of 2005-06. They make the same pre-PSLRA warnings that securities class actions present "a serious threat to the health of the U.S. economy" and the same pre-PSLRA arguments that "the culture of abusive class actions" is "driven by a multibillion-dollar plaintiffs'

104th Cong. 203 (1995) (statement of Arthur Levitt, Chairman, Securities and Exchange Commission) (opposing proposal to eliminate the FOTM presumption both because it would be contrary to SEC's disclosure regulation and because it would make it "virtually impossible" for investors to assert claims as part of a class action).

[30] Among its procedural hurdles, PSLRA imposes heightened pleading requirements for scienter and a stay on discovery pending resolution of a defendant's motion to dismiss. The statute also requires court appointment of a "lead plaintiff," presumptively the largest shareholder willing to serve. For a brief description of the key provisions, see DONNA M. NAGY, RICHARD W. PAINTER & MARGARET V. SACHS, SECURITIES LITIGATION AND ENFORCEMENT CASES AND MATERIALS 9–10 (2d ed. 2008).

[31] H.R. Rep. No. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730730.

[32] Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 309 (1997).

[33] Pub. L. No. 105-353, 112 Stat. 3227 (1998).

lawyer industry."[34] In addition, the business community asserts that the prevalence of private securities litigation places U.S. businesses at a competitive disadvantage and deters foreign businesses from entering the U.S. securities markets.[35] Finally, according to its critics, there is no need for private litigation; the SEC and other regulators have the power not only to enforce the securities laws but also to recover compensation for investors.[36] The business community's concerns have found a receptive audience in the Court; the majority opinion in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*[37] recited all of them as reasons to restrict the scope of liability in private Rule 10b-5 suits.

Many scholars also challenge the continued existence of the securities fraud class action on a related series of arguments grounded in finance theory that call into question both the class action's compensatory and deterrence functions.[38] They assert that the securities fraud class action does not perform its compensatory function well because investors do not receive very much compensation. Cases

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[34] *See, e.g.,* U.S. CHAMBER INST. FOR LEGAL REFORM, SECURITIES CLASS ACTION LITIGATION, at i (2008).

[35] *See id.*; U.S. CHAMBER OF COMMERCE, COMMISSION ON THE REGULATION OF U.S. CAPITAL MARKETS IN THE 21ST CENTURY: REPORT AND RECOMMENDATIONS 28–31 (2007); Michael R. Bloomberg, City of New York, and Charles E. Schumer, U.S. Senate, SUSTAINING NEW YORK'S AND THE U.S. GLOBAL FINANCIAL SERVICES LEADERSHIP 73-77 (Jan. 23, 2007) (hereinafter Bloomberg-Schumer Report); COMMITTEE ON CAPITAL MARKETS REGULATION, INTERIM REPORT 72, 74–84 (Nov. 30, 2006) (hereinafter Interim Report).

[36] *See* U.S. CHAMBER INST. FOR LEGAL REFORM, *supra* note 34, at iii. For a description of the Fair Fund provision and a critique of the business community's arguments, *see* Barbara Black, *Should the SEC Be A Collection Agency for Defrauded Investors?*, 63 BUS. LAW. 317, 325–27, 337–39 (2008).

[37] 128 S. Ct. 761, 772–73 (2008).

[38] While the following discussion is abbreviated and does not attempt to explore all the nuances of these complex and interrelated arguments, I believe it fairly sets forth the positions of those who doubt the compensatory and deterrence rationales.

typically settle for a small percentage of investors' losses, and a significant portion of the settlement goes to payment of costs, including attorneys' fees;[39] accordingly, they believe that it is not worth the high cost to produce such paltry returns to the investor. If this is a serious concern, then increases in the amounts of settlements should be evidence of the success of the securities fraud class action rather than of its failure, as critics view it.[40] Moreover, this argument has general applicability to all class actions.[41]

Other arguments discounting the compensation rationale focus specifically on the securities fraud class action. Unlike, for example, a defective product class action in which the corporation pays damages to users of the product for harm caused by the product, in a securities fraud class action the corporation pays damages to some of its current shareholders who purchased the stock at the inflated price. Thus, they argue, to the extent there is shareholder identity, paying plaintiffs for their damages is simply an expensive "pocket-shifting."[42] While this is true, the cost to the current shareholders may be less than the benefit to those same shareholders if a significant amount of the settlement is funded by insurance (which is usually the case)[43] or by

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[39] *See* Coffee, Jr., *supra* note 25, at 1545 (stating that "from a compensatory perspective, the conclusion seems inescapable that the securities class action performs poorly"). *See also* Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions,* 48 STAN. L. REV. 1487, 1500 (1996) (arguing the current system fails to effectively compensate class members).

[40] U.S. CHAMBER INST. FOR LEGAL REFORM, *supra* note 4. at ii (noting that, excluding billion dollar-plus settlements, the average 2007 settlement increased approximately 43% from 2006). The average value of settlements fell in 2008, from $62.7 million to $31.2 million. Stephen Taub & Roy Harris, *Class-action Values Plunging, but Not for Long,* CFO.com, Mar. 11, 2009, http://www.cfo.com/printable/article.cfm/13277439.

[41] Congress gave many examples of class action settlements that did not give class members meaningful compensation in the legislative history of the Class Action Fairness Act. *See* S. Rep. No. 109-14 (2005), *reprinted in* 2005 U.S.C.C.A.N. 3, 15–20 (109th Cong., 1st Sess. 2005).

[42] Coffee, Jr., *supra* note 25, at 1556.

[43] The vast majority of securities claims settle within or just above the limits of the corporation's D&O coverage. *See* Tom Baker & Sean J.

payments from individual or third-party defendants (which is usually not the case).[44]

Finally, the critics argue that investors have a less costly method of protecting themselves against losses caused by securities fraud. If investors have a diversified portfolio, over the long term, they will be on both sides of a securities fraud – buyers who have suffered a loss and sellers who reaped a benefit, because of a corporate fraud.[45] Indeed, under this theory, a diversified investor will be overcompensated if it gets a recovery in a class action for its losses and does not have to account for its gains in other instances. The power of a diversified portfolio to net losses and gains over time has become an article of faith among academics, despite the fact there is little empirical evidence to support it.[46] Under this view, taking money from the corporation, and ultimately its current shareholders, and giving it to another group of investors (some of whom may be one and the same), with the attendant "waste" of a

Griffith, *How the Merits Matter: Directors' and Officers' Insurance and Securities Settlements,* 157 U. PA. L. REV. 755, 761 (2009).

[44] Why defendants other than the issuer seldom pay is discussed *infra* notes 69–70 and accompanying text.

[45] Early expression of this point was made in Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases,* 52 U. CHI. L. REV. 611, 641 (1985). Later expressions include Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets,* 78 VA. L. REV. 623, 639–40 (1992); Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud,* 38 ARIZ. L. REV. 639, 646–47 (1996). *See also* Coffee, Jr., *supra* note 25, at 1545.

[46] One empirical study, funded by the U.S. Chamber Institute for Legal Reform, found that large institutional investors generally break even from their investments in common stock impacted by fraud allegations and are often overcompensated as a result of litigation. Anjan V. Thakor, THE ECONOMIC REALITY OF SECURITIES CLASS ACTION LITIGATION 20 (2005). Another study points out limitations in the U.S. Chamber study and finds that many diversified institutional investors suffer significant net losses from securities fraud over a ten-year period. Alicia Davis Evans, *Are Investors' Gains and Losses from Securities Fraud Equal Over Time? Some Preliminary Evidence* (Jan. 27 2009), *available at* http://ssrn.com/abstract=1121198.

significant portion being paid in attorneys' fees and other costs, is unnecessary to compensate shareholders for their losses. Some scholars even argue that, just as contract law requires victims of contract breaches to take reasonable efforts to mitigate their losses, so too the securities laws should not protect unreasonable investors who fail to diversify.[47] Indeed, some influential academics routinely dismiss compensation as a rationale for the securities fraud class action.[48]

Academic dismissal of the compensatory function contrasts sharply with the attitude of Congress and SEC, who have advanced compensation as a value in SEC enforcement actions since the inclusion in SOX of the Fair Fund provision that gives the SEC the authority to distribute civil penalties to fraud victims.[49] With the exception of attorneys' fees, the arguments against the compensation rationale apply equally to Fair Fund distributions, yet the amount of publicity that the agency generates for its distribution of Fair Funds reflects its judgment that compensation remains important to many investors. Should Congress and the SEC simply explain to investors that compensation is not a worthy goal of securities regulation?

Deterrence has been an equally important rationale for the securities fraud class action in recognition of the limited resources of the SEC and other regulators to enforce the securities laws.[50] Indeed, the Court has more frequently

[47] *See* Richard A. Booth, *The End of the Securities Fraud Class Action as We Know It*, 4 BERKELEY BUS. L.J. 1, 10 (2007).

[48] *See* Donald C. Langevoort, Basic *at Twenty*: *Rethinking Fraud on the Market,* 2009 WIS. L. REV. 151, 165 (referring to critical scholars). *See also* Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237, 280–81 (2009) (arguing that the issuer of securities should not be liable to losing shareholders for securities fraud).

[49] *See* Black, *supra* note 36, at 341.

[50] *See* Labaton, *supra* note 20 and accompanying text. The deterrence function of class actions generally came under attack in the enactment of the Class Action Fairness Act of 2005 (CAFA), most prominently in the Senate Report, which states that the "concept of class actions serving as private attorney general is illegal." S. Rep. 109-14, at 59 (2005), *reprinted*

identified deterrence than compensation as the rationale.[51] Scholars debate how effectively securities fraud class actions deter corporate fraud.[52] Some scholars worry about over-deterrence.[53] Judge Easterbrook and Professor Fischel were the first to articulate this concern.[54] They build on the observation that, in every transaction where the stock price is inflated by fraud, there is a purchaser that suffered a loss and a corresponding seller who profited from the fraud.[55] In the typical case, moreover, where the corporate defendant is not selling shares during the period of the fraud, the securities fraud does not increase the corporation's assets, although corporations benefit in many real, if indirect, ways from an increased market capitalization. Thus, they argue, requiring the corporation to pay the total out-of-pocket (OOP) losses[56] of the buyers makes the defendant pay for

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in 2005 U.S.C.C.A.N. 3, 55. For a post-CAFA defense of the deterrence value of class actions, see Myriam Gilles & Gary B. Friedman, *Expanding the Class Action Agency Costs Myth: The Social Utility of Entrepreneurial Lawyers,* 155 U. PA. L. REV. 103 (2006).

[51] *See supra* note 21 and accompanying text.

[52] Scholars who have recognized the deterrence value include Langevoort, *supra* note 45, at 651–52; Cox, *supra* note 22, at 513; and Alexander, *supra* note 39, at 1510–11. Professor Coffee believes significant reform is required to achieve deterrence. *See* Coffee, Jr., *supra* note 25, at 1536–37. Professors Arlen and Carney argue that the goal of optimal deterrence is not achieved. *See* Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Cases: Theory and Evidence,* 1992 U. ILL. L. REV. 691 (1992). Professors Tom Baker and Sean J. Griffith argue that the practices of D&O insurers diminish deterrence. *See* Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' and Officers' Liability Insurer,* 95 GEO. L.J. 1795, 1817–18 (2007).

[53] *See, e.g.,* Langevoort, *supra* note 45, at 646 (describing OOP damages as "excessive and dysfunctional"); Alexander, *supra* note 39, at 1496 (arguing that aggregate amount by which class members overpaid does not represent the true social cost of the violation).

[54] *See* Easterbrook & Fischel, *supra* note 45, at 612, 640.

[55] *See id.* at 635. The assumption is that it would be both unfair and impracticable to require innocent sellers to disgorge their profits.

[56] OOP losses is the standard measure of damages in securities fraud class actions. *See* Langevoort, supra note 45, at 646.

more harm that it caused; indeed, *focusing solely on trading losses*,[57] the fraud has caused no damage. Significantly, Easterbrook and Fischel do not say that damages are zero; they recognize that there are other losses such as confidence in the trading markets.[58]

Is it truly possible that fraud can be overdeterred? Rule 10b-5 claims require proof of scienter,[59] and, since PSLRA, plaintiffs must "state with particularity facts giving rise to a strong inference that the defendant acted with [scienter]"[60] to survive a motion to dismiss, and they must do so without the benefit of discovery.[61] Indeed, Easterbrook and Fischel concluded that so long as liability was confined to truly egregious acts, OOP damages were acceptable.[62] Later scholars doubt that liability is sufficiently limited[63] and argue that less voluntary corporate disclosure, and other adverse effects, may be a consequence of securities fraud class actions.[64]

I believe, however, that after PSLRA, under-deterrence is a more serious concern than over-deterrence. PSLRA's tightened pleading standards and bar on discovery prior to a motion to dismiss[65] mean that, combined with the short statute of limitations the Court legislated in *Lampf, Pleva,*

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[57] Easterbrook & Fischel, *supra* note 45, at 639.

[58] *Id.* at 641.

[59] Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

[60] 15 U.S.C. § 78u-4(b)(2) (2006); Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 308 (2007).

[61] 15 U.S.C. § 78u-4(b)(3)(B) (2006). In addition, to plead scienter against a corporate defendant, a plaintiff must raise a strong inference that someone whose intent can be imputed to the corporation acted with scienter. Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc., 531 F.3d 190 (2d Cir. 2008).

[62] Easterbrook & Fischel, *supra* note 45, at 644.

[63] *See, e.g.*, Langevoort, *supra* note 45, at 644 (stating that scienter and materiality are too indeterminate). *See also* Alexander, *supra* note 39, at 1489 (arguing that compensatory damages are not an efficient deterrent because, among other reasons, there is too much uncertainty associated with the measure of damages).

[64] *See, e.g.*, Langevoort, *supra* note 45, at 652–53.

[65] *See* NAGY ET AL. *supra* note 30 and accompanying text.

Lipkind, Prupis & Petigrow v. Gilbertson[66] and Congress only slightly expanded in SOX,[67] plaintiffs' attorneys may lack sufficient time to uncover enough evidence to persuade a court that fraud has occurred. Moreover, both supporters and detractors of the securities fraud class action agree that under the current system (where the corporate defendant generally pays all of the settlement through insurance while individual defendants rarely pay anything), there is insufficient deterrence for corporate managers and outside participants to refrain from committing securities fraud.[68] Unfortunately, imposing personal liability on the perpetrators of the fraud, although it would enhance deterrence, is unlikely to become a common practice both for reasons of legal theory[69] and expediency.[70] Is the solution to eliminate corporate liability? While some think yes,[71] liability on non-corporate defendants should not be advocated as an alternative to corporate liability, but as a supplement.[72] Otherwise, there is a great danger that no one will be held accountable for securities fraud.

In short, the securities fraud class action, while by no means perfect, is a reasonably effective system, particularly

[66] 501 U.S. 350 (1991).

[67] The limitations period is two years from discovery of fraud but not more than five years from the violation. 28 U.S.C. § 1658 (2006).

[68] *See* Coffee, Jr., *supra* note 25, at 1567–68.

[69] *See* Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994) (abolishing aiding and abetting liability in Rule 10b-5 actions) and Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148 (2008) (limiting primary liability against third-party defendants).

[70] *See* Coffee, Jr., *supra* note 25, at 1566–72 (describing the dynamics of settlement between plaintiffs' counsel and the corporate defendant).

[71] *See infra* notes 96–102 and accompanying text (substance of Pritchard's proposal). *See also* Fox, *supra* note 48, at 279–81.

[72] Coffee first states this proposition arguing that "the radical reform of abolishing corporate liability for second market securities fraud seems an overly risky step." Coffee, Jr., *supra* note 25, at 1566. He then contradicts himself by proposing that the SEC exempt the non-trading corporate issuer from private liability for money damages under Rule 10b-5. *Id.* at 1582–84.

after the PSLRA reforms, that achieves both compensatory and deterrence goals.

Finally, some scholars also advance an argument based on fairness. They again emphasize that, in most cases, the securities fraud does not increase the corporation's tangible assets. Accordingly, making the corporate defendant pay for harms from which it did not profit diminishes corporate assets and harms the current shareholders. (Again, advocates of this view tend to overstate the extent of the harm since most settlements are funded by insurance.) Shareholders who purchased shares before the class period[73] thus bear the cost of the fraud perpetrated by the managers.[74] As with some of the previous arguments, this argument against enterprise liability has broader applicability than the securities fraud class action.[75]

Professor Mitchell traces the history of this concern for the "innocent shareholder" and demonstrates that it has been a "rallying cry . . . against corporate regulation."[76] He argues that the view of the "innocent shareholder" as a passive shareholder in need of protection is at odds with a model of shareholder activism that treats shareholders as important players in corporate governance reform.[77] Professor Cox also points out that imposing on the

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[73] Coffee argues that these shareholders are likely to be retail investors pursuing a buy-and-hold strategy, including the company's employees who invest through their 401(k) plans. Since they are less likely to have diversified portfolios, the losses occasioned by the fraud cause more harm to them. *Id.* at 1559–61.

[74] *See also* Fox, *supra* note 48, at 280 (stating that current shareholders are victims of managers' fraud). Some of the current shareholders may also be members of the plaintiff class, in which case this is, as discussed *supra* in notes 42–44 and accompanying text, "pocket-shifting."

[75] *See generally* Leonard Orland, *The Transformation of Corporate Criminal Law*, 1 BROOK. J. CORP. FIN. & COM. L. 45 (2006).

[76] Lawrence E. Mitchell, *The "Innocent Shareholder": An Essay on Compensation and Deterrence in Securities "Class-Action" Lawsuits*, 2009 WIS. L. REV. 243, 248 (2009).

[77] There are, of course, arguments that shareholders are rationally apathetic because of the "collective action" problem.

shareholders the cost of managers' misconduct is an accepted attribute of share ownership and provides them with incentives to scrutinize the integrity of management in corporations in which they invest.[78] Similarly, Professor Harvey Goldschmid argues that we want long-term shareholders to be concerned about the quality of management.[79]

Professor Coffee in contrast, while acknowledging that enterprise liability might enhance monitoring by the shareholders, believes that it "offends social norms" in this context.[80] Tellingly, Professor Coffee apparently disagrees with himself on whether the corporation should continue to be a defendant. In the same article, he asserts that "the radical reform of abolishing corporate liability for secondary market securities fraud seems an overly risky step"[81] and then goes on to propose precisely that![82]

As the preceding discussion should make clear, the arguments for and against the federal securities fraud class action involve complexities and uncertainties that defy "quick and dirty" solutions. The future of the federal securities class action raises important policy questions that call for national debate. If, as many argue, compensation should not be recognized as a rationale for the securities fraud class action, what impact will that have on the confidence of the investor, so critical to the operation of an efficient and fair trading market?[83] How do we square the dismissal of compensation as a rationale with the SEC's recent authorization to distribute corporate penalties to compensate injured investors?[84] If over-deterrence is a problem even after PSLRA, a less drastic solution may be to

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[78] Cox, *supra* note 22, at 511.

[79] Harvey J. Goldschmid, *Capping Securities Fraud Damages: An Unwise Proposal in an Imperfect World*, 38 ARIZ. L. REV. 665, 666 (1996).

[80] Coffee, Jr., *supra* note 25, at 1562.

[81] *Id.* at 1566.

[82] *Id.* at 1582–84.

[83] Goldschmid, *supra* note 79, at 666.

[84] *See* Black, *supra* note 36.

reduce the amount of liability.[85] If the problem is insufficient deterrence on corporate managers, then the solution may be to impose more liability on managers in addition to the corporation. In assessing enterprise liability, how effective can shareholders be in monitoring the corporate managers against fraud, and how concerned should we be for passive shareholders?

We now turn to examine the two proposals that would allow shareholders to curtail or even eliminate the securities fraud class action.

III. THE "SHAREHOLDERS' RIGHTS" PROPOSALS

A. The Arbitration Proposal

In late 2006 to early 2007, three influential reports were issued addressing concerns about the declining prominence of the U.S. capital markets in the face of increasing competition from overseas markets.[86] While the reports identified many factors contributing to this perceived decline, each identified the costs of regulation and private enforcement of federal securities laws as significant anti-competitive factors. Two of them[87] specifically recommended

[85] Professor Langevoort previously called for caps on damages. *See* Langevoort, *supra* note 45, at 639. Professor Alexander proposed a penalties-based approach. *See* Alexander, *supra* note 39, at 1487.

[86] Interim Report, *supra* note 35 (an independent, bipartisan committee composed of twenty-two corporate and financial leaders); Commission on the Regulation of U.S. Capital Markets in the 21st Century Report and Recommendations (Mar. 2007) (an independent, bipartisan commission established by the U.S. Chamber of Commerce); Bloomberg-Schumer Report, *supra* note 35 (commissioned by New York City Mayor Michael R. Bloomberg and New York Senator Charles E. Schumer).

[87] Interim Report, *supra* note 35, at 17–18; Bloomberg-Schumer Report, *supra* note 35, at 102–03. *See also* Cyril Moscow, *Arbitration Bylaws to Bar Shareholder Class Actions*, 20 INSIGHTS 8 (2006) (arbitration of shareholders' derivative claims has been previously proposed). *See* G. Richard Shell, *Arbitration and Corporate Governance*, 67 N.C. L. REV. 517 (1989); John C. Coffee, Jr., *No Exit?: Opting Out, The Contractual Theory*

that corporations be permitted to amend their certificates of incorporation to require arbitration of securities fraud claims. They presented arbitration as an issue of shareholders' rights: "shareholders should have the right to choose, particularly given the high cost to shareholders of litigation."[88] Further, "the [SEC] should not force shareholders to accept the costs that go with class action securities litigation . . . where these shareholders choose to forgo these rights."[89] It was widely reported that, in response to these proposals, the SEC planned to publish for public comment a proposal to permit arbitration. The SEC Chairman Christopher Cox denied that the agency was drafting such a proposal, and no such proposal was publicly released.[90]

Neither report developed the substance or implementation of the recommendation in any depth. Their analysis of several critical issues is superficial. First, they express indifference as to whether plaintiffs could bring their federal securities claims as class action arbitrations or would be limited to individual arbitrations, although this indifference is likely disingenuous.[91] Second, they assume that Section 29(a) of the Exchange Act presents no obstacle to shareholders' waiving their right to bring their securities

of the Corporation, and the Special Case of Remedies, 53 BROOK. L. REV. 919 (1988).

[88] Interim Report, *supra* note 35, at 18; *See also* Bloomberg-Schumer Report, *supra* note 35, at 103.

[89] Interim Report, *supra* note 35, at 109–110. For an exchange of views on the SEC's refusal to allow acceleration of a registration statement because it contained a charter provision mandating arbitration of shareholder claims, see Carl Schneider, *Arbitration in Corporate Governance Documents: An Idea the SEC Refuses to Accelerate*, 8 INSIGHTS 21 (1990) and Thomas L. Riesenberg, *Arbitration and Corporate Governance: A Reply to Carl Schneider*, 8 INSIGHTS 2 (1990).

[90] *See supra* note 7 and accompanying text.

[91] *See infra* note 145 and accompanying text.

claims in federal court.[92] Finally, they assert that notice of the arbitration provision is sufficient to bind subsequent purchasers.[93]

B. The Proposal to Eliminate the Corporate Defendant

Although not the first to make the proposal, Professor Coffee received much attention when he floated the idea of eliminating the corporate defendant in secondary market securities fraud class actions.[94] He advocated that the SEC use its statutory exemptive authority to accomplish this change.[95] Recently, Professor Adam Pritchard advanced a proposal that, although he phrases it in more technical terms ("partial waiver of the FOTM presumption"), would effectively accomplish the same result.[96] Because he does not believe that the SEC (or Congress or the Court) would take this action, Professor Pritchard proposes a self-help measure. Asserting that *Basic's* recognition of the FOTM presumption is the problem, he argues that shareholders can "fix" the problem themselves through amending the certificate of incorporation to specify disgorgement as the measure of damages if plaintiffs invoke the FOTM presumption.[97] In his view, disgorgement is the appropriate measure of damages in FOTM cases because deterrence is the principal justification for allowing securities fraud class actions.[98] As a result, in the typical secondary market case, defendants would be limited to corporate managers who participated in the fraud and who received a direct financial gain from the fraud, as by selling their shares at the inflated price. Only

[92] Interim Report, *supra* note 35, at 110 (asserting there is "little chance that securities law claims involving the corporate issuer would be held to be beyond arbitration").

[93] Interim Report, *supra* note 35, at 110–11 (notice of arbitration provision in corporation's SEC filings and on its website); Bloomberg-Schumer Report, *supra* note 35, at 103 (notice provided by broker-dealers).

[94] *See supra* notes 80–82 and accompanying text.

[95] Coffee, Jr., *supra* note 25, at 1582–83.

[96] Pritchard, *supra* note 6, at 248–55.

[97] *Id.* at 255.

[98] *Id.* at 249.

investors that could establish their own reliance on the fraudulent misstatements would be able to bring individual actions against the corporation and recover OOP damages; presumably only a few institutional investors would be able to establish reliance and would have a sufficiently large investment to make maintaining their own actions financially feasible.[99] Professor Pritchard would allow successful plaintiffs to recover attorneys' fees.[100]

Professor Pritchard provides a more extended analysis of the legal issues than do the proponents of the arbitration proposal. Like them, Professor Pritchard asserts that § 29(a) of the Exchange Act does not prohibit shareholders from waiving the FOTM presumption[101] and that notice of the waiver is sufficient to bind subsequent purchasers.[102]

Contrary to the assertions of the proponents of both proposals, I argue (in Part IV) that § 29(a) of the Exchange Act makes both proposals impermissible under federal securities law. I make (in Part V) three arguments based on state law. First, although the proponents of both proposals apparently did not recognize this, these certificate provisions are not permitted under state corporate law because they are "inconsistent" with law. Second, these proposals may be unfair to current shareholders that do not vote in favor of the proposals. Third, these proposals may be unenforceable as to subsequent stock purchasers.

IV. SECTION 29(a) OF THE EXCHANGE ACT (THE ANTI-WAIVER CLAUSE)

This Part first addresses the legislative history and case law interpreting § 29(a) as background. It then addresses

99 *Id.* at 224. Pritchard would allow institutional investors to recover OOP damages if they could prove actual reliance, even though, under his theory, investors would be overcompensated if they have diversified portfolios. *Id.* at 250.

100 *Id.*

101 *Id.* at 252–54.

102 *Id.* at 252.

specific objections under § 29(a) relating to the arbitration proposal and the proposal to eliminate the corporate defendant and concludes that neither proposal is permissible.

Section 29(a) of the Exchange Act states that "any condition, stipulation, or provision binding any person to waive compliance with any provision of this Chapter or of any rule or regulation thereunder . . . shall be void."[103] In 1934 Congress took this section verbatim from Section 14 of the Securities Act of 1933 (the Securities Act),[104] which in turn was derived from Section 10(5) of Great Britain's The Companies Act.[105] The legislative history is scant,[106] but this is not surprising. Congress drafted the provision broadly and plainly and must have thought it required no explanation. The investor protections afforded by the statute and its rules are so important that Congress would not permit parties to negotiate deals that weakened the statutory framework. While the congressional purpose may have been at least partly protective, reflecting a concern that the more sophisticated party might persuade the less sophisticated party to give up his rights, Congress also must have been concerned about the national interest and the importance of federal regulation for the overall fairness and effectiveness of the securities market—the fundamental purpose of the Exchange Act.

[103] 15 U.S.C. § 78cc (2006).

[104] 15 U.S.C. § 77n (2006).

[105] That the Securities Act was modeled after The Companies Act is well-documented. *See* Seligman, *supra* note 28, at 46, 53 (1995).

[106] Section 29(a) "was taken verbatim out of the Securities Act," *Stock Exchange Practices: Hearings on S. Res. 84, 72d Cong., S. Res. 56 and S. Res. 97, 73d Cong., Before Senate Banking and Currency Comm.*, 73d Cong., 2d Sess. 6578 (1934), *reprinted in* 6 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (J. S. Ellenberger & Ellen. Mahar eds. 2001). The legislative history of Section 14 of the Securities Act, 15 U.S.C. § 77n, is silent as to the statute's scope. *See* Margaret V. Sachs, *The Relevance of Tort Law Doctrines to Rule 10b-5: Should Careless Plaintiffs Be Denied Recovery?*, 71 CORNELL L. REV. 96, 127 n.237 (1985).

Wilko v. Swan,[107] *Shearson/American Express, Inc. v. McMahon*,[108] and *Rodriguez de Quijas v. Shearson/American Express, Inc.*[109] are the only Supreme Court opinions that analyze the anti-waiver provisions in any depth. In these cases the Court considered whether a provision in a customer's brokerage agreement that required arbitration of all disputes was unenforceable with respect to federal securities claims because of the anti-waiver provision. In *Wilko* the Court held that "[a]s the protective provisions of the Securities Act require the exercise of judicial direction to fairly assure their effectiveness, it seems to us that Congress must have intended § 14 to apply to waiver of judicial trial and review."[110] Over thirty years later, however, in *McMahon*, the Court changed its mind.[111] In doing so, the Court's statutory analysis focuses initially on the language and states that what the statute prohibits is waivers of the statute's "*substantive* obligations," which does not include the provision conferring exclusive jurisdiction over Exchange Act claims on the district courts.[112] The Court, however, goes beyond this cramped reading and identifies the statute's central purpose: "§ 29(a) is concerned . . . with whether the agreement 'weakens [customers'] ability to recover under the Exchange Act.'"[113] The balance of the opinion and *Rodriguez*[114] make clear that this is the judicial concern. After examining the current state of securities arbitration, the Court concludes that, contrary to the *Wilko* court's

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[107] 346 U.S. 427 (1953).

[108] 482 U.S. 220 (1987).

[109] 490 U.S. 477 (1989).

[110] *Wilko*, 346 U.S. at 437.

[111] Since *McMahon* involved § 29(a), the technical overruling did not occur until *Rodriguez*, 490 U.S. 477 (1989).

[112] *McMahon*, 482 U.S. at 228 (emphasis added).

[113] *Id.* at 230 (quoting from *Wilko*).

[114] For an insightful comparison of the Court's approaches in *McMahon* and *Rodriguez* see Margaret V. Sachs, *Freedom of Contract: The Trojan Horse of Rule 10b-5*, 51 WASH. & LEE L. REV. 879, 892–895 (1994).

"mistrust of arbitration,"[115] the process adequately vindicates customers' rights, principally because of SEC oversight over the SRO arbitration forums.[116]

In the 1990s several circuit courts had occasion to consider the applicability of § 29(a) to contracts for underwriting capital between Lloyd's of London and U.S. residents.[117] According to the plaintiffs, Lloyd's solicited U.S. investors to raise capital and concealed the underwriting risks and massive liabilities relating to asbestos litigation. The contracts specified English choice of law and an English forum for investors' claims, and Lloyd's insisted that execution of the contracts take place on British soil. While the choice of forum clause would likely pass muster under *McMahon*[118] and *Scherk v. Alberto-Culver Co.*,[119] the plain meaning of the statute prohibits a clause mandating application of English law, because such a clause is a "provision binding any person . . . to waive compliance with any provision of [the] Act."[120] The circuit courts, however, uniformly upheld both the choice of law and choice of forum clauses on the ground that these were international transactions among sophisticated investors. The opinions emphasized the importance of certainty and predictability in international transactions,[121] as well as respect for international law. The circuit courts also worried that

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[115] *Id.* at 233.

[116] *Id.* at 238; *Rodriguez,* 490 U.S. at 483.

[117] Richards v. Lloyd's of London, 135 F.3d 1289 (9th Cir. 1998) (en banc); Lipcon v. Underwriters at Lloyd's, London, 148 F.3d 1285 (11th Cir. 1998) (recognizing it is a "close question," but following the "weight of circuit authority"); Roby v. Corp. of Lloyd's, 996 F.2d 1353 (2d Cir. 1993); Bonny v. Soc'y of Lloyd's, 3 F.3d 156 (7th Cir. 1993).

[118] *See supra* notes 111–16 and accompanying text.

[119] 417 U.S. 506 (1974) (upholding an arbitration clause in an international transaction that the Court assumed involved securities).

[120] *See Richards*, 135 F.3d at 1297–98 (Thomas, J. dissenting) (quoting section 14 of the Securities Act)

[121] *Lipcon* emphasized the narrowness of its holding by noting that international agreements were "sui generis," 148 F.3d at 1293. Similarly, *Richards* emphasized the importance of certainty and predictability in international agreements, 135 F.3d at 1293.

banning the use of these clauses in international contracts would be an over-extension of U.S. securities laws[122]—policy concerns more properly left to Congress. Importantly, however, the courts recognized that the available English remedies must be "adequate substitutes" for federal securities laws.[123] Thus, while these opinions carve out a questionable exception for international securities contracts among sophisticated investors, they do not detract from the *McMahon* principle that § 29(a) forbids agreements that weaken investors' protections under federal securities (or equivalent) laws.

Finally, it is well established that § 29(a) does not permit provisions that weaken investors' ability to recover under the federal securities laws, no matter what form they take: "non-reliance" clauses in stock purchase agreements,[124] "no-action" clauses in indentures,[125] clauses that provide for an alternative remedy,[126] or clauses that specify indemnification as the sole remedy.[127] The only situation where some courts have enforced non-reliance clauses is in negotiated contracts among sophisticated investors or corporate insiders where the written agreement contains specific representations and the non-reliance clause serves the purpose of barring

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[122] *Lipcon*, 148 F.3d at 1294–95; *Richards*, 135 F.3d at 1293.

[123] *Richards*, 135 F.3d. at 1296; Stamm v. Barclays Bank of New York, 153 F.3d 30, 33 (2d Cir. 1998).

[124] *See, e.g.*, AES Corp. v. Dow Chemical Co., 325 F.3d 174 (3d Cir. 2003); Caiola v. Citibank, N.A., 295 F.3d 312 (2d Cir. 2002) (synthetic trading relationship); Rogen v. Illikon Corp., 361 F.2d 260 (1st Cir. 1966); Roll v. Singh, 2008 U.S. Dist. LEXIS 50125 (D.N.J. June 26, 2008); MBI Acquisition Partners, L.P. v. Chronicle Publ'g. Co., 2001 WL 1478812 (W.D. Wis. Sept. 6, 2001).

[125] *See, e.g.*, McMahan & Co. v. Wherehouse Entm't, Inc., 65 F.3d 1044 (2d Cir. 1995); Kusner v. First Penn. Corp., 531 F.2d 1234 (3d Cir. 1976).

[126] *See, e.g.*, Special Transp. Servs., Inc. v. Balto, 325 F. Supp. 1185 (D. Minn. 1971).

[127] Citibank v. Itochu Int'l, Inc., 2003 WL 1797847 (S.D.N.Y. Apr. 4, 2003).

representations not contained in the agreement.[128] While the judiciary's creation of a parole evidence rule exception to § 29(a) is questionable, it is of limited scope.[129]

A. The Arbitration Proposal

Some commentators, like the proponents of this proposal, have mistakenly assumed that *McMahon*[130] answers in the affirmative the question of whether § 29(a) permits contracts that require arbitration of federal securities fraud claims against the issuer.[131] Arbitration of a purchaser or seller's securities fraud claims against the issuer, however, is very different from arbitration of securities fraud claims between a customer and his broker or even arbitration of shareholders' derivative claims.

As an initial matter, Section 2 of the Federal Arbitration Act (FAA) requires an agreement to arbitrate.[132] In the customer/broker setting, there is privity of contract in the traditional contract sense, because brokerage firms require customers to sign brokerage agreements that contain an arbitration clause. In contrast, there is no privity of contract between the issuer and the purchaser of its stock in the secondary market, and it is doubtful that a certificate of incorporation containing an arbitration provision is the required arbitration agreement for purposes of Section 2 of the FAA. We defer this discussion, however, to Part V and

[128] Rissman v. Rissman, 213 F.3d 381 (7th Cir. 2000) (no discussion of § 29(a)); Harsco Corp. v. Segui, 91 F.3d 337 (2d Cir. 1996).

[129] *See Harsco*, 91 F.3d at 343 (recognizing that plaintiff's remedies were weakened, but emphasizing that this was a detailed written agreement negotiated among sophisticated parties). *Harsco* was distinguished in MBI Acquisition Partners, L.P. v. Chronicle Publ'g Co., 2001 WL 1478812 (W.D. Wisc. Sept. 6, 2001) (distinguishing *Harsco* because plaintiffs alleged that they attempted to confirm truth of agreement's representations, but were "duped" by false answers).

[130] *See supra* notes 111–116 and accompanying text.

[131] *See* John C. Coffee, Jr., *Arbitration and Corporate Governance*, 90 N.Y.L.J. 5 (May 31, 1990) (stating that the argument distinguishing *McMahon* and *Rodriguez* as limited to broker-dealer disputes "approaches the frivolous").

[132] 9 U.S.C. § 2 (2006).

assume there is a contract for purposes of the § 29(a) analysis.

Apart from the issue of privity, customer/broker claims are fundamentally different from purchaser/issuer claims. A customer's dispute with his broker is a private dispute focusing on the individual broker's alleged failure to live up to his duties owed to the individual customer, usually under state securities or common law, but occasionally under federal securities law as well.[133] Moreover, the customer generally possesses much of the information necessary to present his claim, both in his account statements and in the broker's statements (both written and oral) made to the customer. Whatever additional information the customer needs can be obtained from the broker through a relatively uncomplicated discovery process. In this setting, the traditional advantages of arbitration – lower cost, greater speed, informality, and confidentiality – may offer value to the participants. In contrast, securities fraud class actions allege a fraud on the marketplace, a matter of national significance that preempts state claims arising from the same set of facts.[134] The purchaser is not likely to possess the necessary information to establish a securities fraud claim. Instead, there is need for a structured discovery process to balance the purchaser's need for information with the issuer's need for protection from an abusive "fishing expedition." Finally, the *McMahon* court upheld the arbitration agreement in the customer/broker setting principally because it had assurance that the customer's rights would be adequately protected; customer/broker claims are generally arbitrated in SRO forums whose procedural rules must be approved by the SEC upon a finding that they are protective of investors.[135] In contrast, purchaser/issuer claims would be arbitrated before one of the

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[133] For development of the issues discussed in this paragraph, see Barbara Black & Jill I. Gross, *Making It Up As They Go Along: The Role of Law in Securities Arbitration,* 23 CARDOZO L. REV. 991 (2002).

[134] *See supra* note 3 and accompanying text.

[135] *Supra* note 116.

commercial arbitration forums where the SEC has no power or influence over the adequacy or fairness of its procedures.[136]

In short, the traditional advantages of arbitration have little applicability to purchaser/issuer claims. To the contrary, there is a need for formality and transparency in order to meet the goals of the participants and the national interest. Adjudications, unlike arbitrations, fulfill functions of deterrence and development of legal standards and satisfy investors' right to know the laws are being enforced.[137] In addition, the significant procedural advantages under PSLRA that Congress constructed for defendants, in order to achieve the twin goals "to curb frivolous, lawyer-driven litigation while preserving investors' ability to recover on meritorious claims,"[138] are not readily transferable to the arbitration forum.[139] Finally, arbitration cures none of the deficiencies in the class action about which its critics complain. For similar reasons, FINRA, the arbitration forum for customer disputes with brokers, will not accept class arbitrations against broker-dealers and requires class actions to be heard in court.[140]

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[136] Many consumer groups believe that the consumer arbitration process and forums are biased against consumers. Recently, the National Arbitration Forum agreed to stop arbitrating credit card disputes after being sued by the Minnesota Attorney-General. Press Release, National Arbitration Forum, National Arbitration Forum to Cease Administering All Consumer Arbitrations in Response to Mounting Legal and Legislative Challenges (July 19, 2009), *available at* http://www.adrforum.com /print.aspx?itemID=1528. The American Arbitration Association announced it would stop arbitrating consumer debt collection claims until the process was reformed. Press Release, American Arbitration Association, AAA Announces Moratorium on Consumer Debt Collection Arbitration Cases (July 27, 2009), *available at* http://www.adr.org/sp.asp?i d=36432&printable=true.

[137] Jennifer J. Johnson & Edward Brunet, *Critiquing Arbitration of Shareholder Claims*, 36 SEC. REG. L.J. 181, 193–96 (2008).

[138] Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308 (2007).

[139] *See* Johnson & Brunet, *supra* note 137, at 197.

[140] FINRA CODE OF ARBITRATION PROCEDURES FOR CUSTOMER DISPUTES RULE 12204(a), *available at* http://finra.complinet.com/en/display/display_

Do these significant distinctions between customer/broker and purchaser/issuer claims mean that the Court would not apply *McMahon* in the latter setting? Although securities fraud class arbitration is the antithesis of the fast, simple and inexpensive alternative to litigation that arbitration was originally intended to provide, it is unlikely that courts would preclude securities fraud class arbitrations because of the complexity of the claims.[141] The Court, with its pro-arbitration policy and zeal to remove cases from the federal dockets,[142] consistently rejects objections that federal statutory claims involving questions of national importance are not suitable for arbitration.[143] Similarly, the arguments that Congress legislated specific judicial procedures for securities fraud actions or that *McMahon* should be limited to claims filed in an SRO forum are unlikely to persuade courts that the purchaser/issuer claims cannot be brought in arbitration. If there is an agreement to arbitrate,[144] the Court's approach is to enforce it; it is indifferent if the parties select the less optimal forum. Accordingly, as to the broad question of whether § 29(a) bars agreements to

main.html?rbid=2403&element_id=4110. FINRA does not permit class arbitrations because they are incompatible with the virtue of arbitration as a relatively quick and inexpensive dispute resolution process.

[141] *See* JLM Indus., Inc. v. Stolt-Nielsen SA, 387 F.3d 163, 181 (2d Cir. 2004) (rejecting argument that antitrust claims were beyond the capabilities of an arbitral panel). *But see In re* Am. Express Merchants'. Litig., 554 F.3d 300, 310 n.7 (2d Cir. 2009) (observing that the argument that class arbitrations are incompatible with the FAA was "intriguing").

[142] *See* Barbara Black, *The Irony of Securities Arbitration Today: Why Do Brokerage Firms Need Judicial Protection?*, 72 U. CIN. L. REV. 415, 415 (2003) (describing *McMahon* as the perfect alignment of two strong Supreme Court policies: support for arbitration and antipathy toward investors' claims in federal court).

[143] Besides *McMahon*, which approved arbitration of both securities and RICO claims, *see, e.g.*, Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614 (1985) (approving arbitration in antitrust claim) and Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. 20 (1991) (approving arbitration in age discrimination claim).

[144] Just a reminder that we have not answered this question yet.

arbitrate federal securities claims against issuers, the answer may be no, not necessarily.

The analysis of the § 29(a) issue, however, does not end here. Despite the proponents' professed agnosticism on the class arbitration issue, I suspect that defeating class actions is a primary motivating factor in the arbitration proposal. PSLRA's legal procedures are so advantageous to defendants that it is bizarre that defendants would prefer arbitration where legal requirements may not be so strictly enforced[145] unless their objective is to eliminate class proceedings. Eliminating class arbitration would be a significant advantage for corporate defendants because if investors could not aggregate their claims, few investors would suffer losses of sufficient magnitude to make arbitration cost-effective. Eliminating class arbitration would both seriously weaken investors' ability to recover and reduce the deterrent effect of the private remedy. Thus, the proponents' professed indifference to this question appears disingenuous. If my suspicions are correct, the issue under § 29(a) can be more precisely framed as whether an arbitration agreement that does not permit class arbitration is enforceable.

Some corporate defendants have asserted that the nature of arbitration is antithetical to class action, that arbitration, by definition, is an informal dispute resolution process to resolve individual disputes, and that this notion of arbitration is embedded in the FAA.[146] Under this view, an arbitration clause that does not explicitly allow class arbitration bars it. This view of arbitration, and its reliance on the consensual model of the FAA, strikes me as at odds with the widespread acceptance of arbitration clauses in

[145] *See* Johnson & Brunet, *supra* note 137, at 197 (stating that the procedural protections against vexatious lawsuits would not apply in arbitration).

[146] The Supreme Court will hear a case this term which presents the question of whether imposing class arbitration on parties whose arbitration clauses are silent on that issue is consistent with the Federal Arbitration Act. Stolt-Nielsen SA v. AnimalFeeds Int'l Corp., 548 F.3d 85 (2d Cir. 2008), *cert. granted*, 77 U.S.L.W. 3678 (U.S. June 15, 2009) (No. 08-1198).

standard-form contracts.[147] If this argument has any persuasive power, however, it might be good strategy for a corporation seeking to include an arbitration provision in its certificate of incorporation to draft a simple arbitration clause that does not address class arbitration, with the hope that shareholders may not recognize the full implications of the provision until the corporation later seeks to prevent a class arbitration.

Alternatively, a corporation seeking to include an arbitration provision in its certificate of incorporation may prefer lack of ambiguity and draft the provision explicitly to bar class arbitration. Today, many sellers of products and services include arbitration provisions that preclude class arbitrations.[148] Plaintiffs have challenged these bans on collective action under a number of theories, and "the wisdom and utility of these provisions have become the subject of intense debate."[149] While, initially, most courts upheld class arbitration waivers,[150] recently the highest courts of some states and some federal appellate courts (applying state law) have declared that class arbitration waivers in consumer contracts may be unenforceable, either because they are contrary to public policy[151] or because they

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[147] *See* Feeney v. Dell, Inc., 908 N.E.2d 753, 765 (Mass. 2009) (rejecting defendants' argument that a prohibition on class arbitration is "inherent" in an agreement to arbitrate). Petitioners in *JLM Industries, Inc. v. Stolt-Nielsen SA,* 387 F.3d 163 (2d Cir. 2004), distinguish their case, an agreement among commercial parties operating in the same industry, from consumer contracts of adhesion. Petitioner's Brief, Stolt-Nielsen SA, at 14.

[148] *See generally* Myriam Gilles, *Opting Out of Liability: The Forthcoming, Near-Total Demise of the Modern Class Action,* 104 MICH. L. REV. 373 (2005).

[149] *In re* Am. Express Merchants' Litig., 554 F.3d 300, 303 (2d Cir. 2009).

[150] For a compilation of cases rejecting the unconscionability analysis, *see* Gilles *supra* note 148, at 400 n.139.

[151] *Feeney,* 908 N.E.2d at 761; Discover Bank v. Superior Court, 113 P.3d 1100, 1100 (Cal. 2005).

are unconscionable.[152] These courts focus on whether enforcing the class arbitration waiver will operate, as a practical matter, to prevent small claimants from vindicating their statutory rights.

Green Tree Financial Corp. v. Randolph[153] provides a basis for challenging class action waivers under the FAA. In that case, the Court stated that "[i]t may well be that the existence of large arbitration costs could preclude a litigant . . . from effectively vindicating her federal statutory rights in the arbitral forum."[154] Subsequent courts have acknowledged that excessive costs can make the arbitration remedy, in fact, illusory and prevent plaintiffs from vindicating their rights, so that arbitration is no longer "a valid alternative to traditional litigation."[155] In *In re American Express Merchants' Litigation,*[156] the Second Circuit held that, in the context of the particular dispute before the court, the class action waiver clause was unenforceable because it would effectively preclude individual plaintiffs, merchants that accepted defendant's credit cards, from vindicating their statutory rights under federal antitrust law.[157] Plaintiffs were able to prevail because of a financial consulting firm's affidavit that estimated the cost of an expert study concerning liability and damages relating to an antitrust tie-in claim and compared it with the potential recovery by an individual plaintiff. The

[152] Homa v. Am. Express Co., 558 F.3d 225, 233 (3d Cir. 2009) (applying New Jersey law); Chalk v. T-Mobile USA, 560 F.3d 1087, 1097 (9th Cir. 2009) (applying Oregon law).

[153] 531 U.S. 79 (2000).

[154] *Id.* at 90.

[155] *See, e.g.*, Awuah v. Coverall N. Am., Inc., 554 F.3d 7, 12 (1st Cir. 2009) (quoting Kristian v. Comcast Corp., 446 F.3d 25, 27 (1st Cir. 2006)). *See also* Faber v. Menard, Inc., 367 F.3d 1048, 1053 (8th Cir. 2004) (recognizing that excessive fees may prevent vindication of statutory rights); Musnick v. King Motor Co., 325 F.3d 1255, 1259–60 (11th Cir. 2003).

[156] 554 F.3d 300 (2d Cir. 2009), *petition for cert. filed,* 77 U.S.L.W. 3670 (U.S. May 29, 2009) (No. 08-1473).

[157] The court recognized the issue, but did not address whether class arbitrations are ever incompatible with the FAA.

economist concluded that "it would not be worthwhile" for a plaintiff to pursue an individual claim in light of these high costs and the small amount of individual damages.[158] In addition, the court found that the statutory trebling of damages and payment of costs, including attorneys' fees, did not solve the problem of a potential small recovery relative to certain large costs.[159] Accordingly, the court agreed with plaintiffs that the class action waiver "flatly ensures that no small merchant may challenge American Express's tying arrangements under the federal antitrust laws,"[160] a troubling outcome because "private suits provide a significant supplement to the limited resources available to the Department of Justice for enforcing the antitrust laws and deterring violations."[161]

In the context of securities fraud class arbitration, the Second Circuit's analysis in *In Re American Express Merchants' Litigation* is even more compelling because of § 29(a). The costs of proving a federal securities fraud claim in arbitration—including falsity, materiality, efficient market, scienter, causation and OOP damages[162]—would be so large as to make pursuing an individual claim infeasible except possibly for large investors that have suffered significant losses. Accordingly, unless the claims could be brought as class arbitrations, there is, as a practical matter, no remedy for investors with small holdings. A class action waiver in this context is the equivalent of a waiver of investor protections prohibited by § 29(a).

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[158] *In re* Am. Express Merchants' Litig., 554 F.3d 300, 317 (2d Cir. 2009).

[159] *Id.* at 318. *See also* Feeny v. Dell, Inc., 908 N.E.2d 753, 764 (Mass. 2009) (rejecting defendant's argument that the statutory availability of attorneys' fees, damages and multiple damages would provide sufficient incentives to pursue small claims individually).

[160] In re *Am. Express Merchants' Litig.*, 554 F.3d at 319.

[161] *Id.*

[162] Dura Pharmas., Inc. v. Broudo, 544 U.S. 336, 341–42 (2005).

B. The Proposal to Eliminate the Corporate Defendant

Recall that Professor Pritchard's proposal limits recovery to disgorgement if plaintiffs invoke the FOTM presumption of reliance in securities fraud class actions.[163] His proposal is not only, as he labels it, a partial waiver of the FOTM presumption of reliance that limits plaintiffs' recovery, but also operates to eliminate the corporate defendant in most instances. There can be no doubt that this waiver of reliance is impermissible under § 29(a). As the earlier discussion explains, both the Securities and Exchange Acts, from their initial enactment, have forbidden private parties to adopt measures that weaken investors' protections, especially their ability to recover damages, under the federal statutory framework.[164] There is no ambiguity or uncertainty in the statutory language, and courts have consistently struck down non-reliance clauses in securities contracts[165] as violative of § 29(a). Congress made the decision that the statutory protections are so important to individual investors and the marketplace as a whole that there is no place for "self-help" measures that curtail the statutory remedies.

Professor Pritchard offers two arguments as to why § 29(a) should not render his partial waiver of the FOTM presumption proposal unenforceable. Both are unconvincing. First, he argues that his proposal does not excuse compliance with the antifraud provision, but merely alters the remedy.[166] This argument is disingenuous; the purpose and effect of his proposal are to eliminate, in most cases, the principal defendant in securities fraud class actions and the only defendant likely to be able to pay substantial damages.

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[163] *See supra* notes 97–98 and accompanying text.

[164] *See supra* notes 103–129 and accompanying text.

[165] *See supra* notes 124–127 and accompanying text.

[166] Pritchard, *supra* note 6, at 253. *See also* Adam Pritchard, *Can Shareholders Waive the Fraud-on-the-market Presumption of Reliance?*, SECURITIES DOCKET, Nov. 17, 2008, *available at* http://www.securitiesdocket.com/2008/11/17/guest-column-can-shareholders-waive-the-fraud-on-the-market-presumption-of-reliance (expanding on his analysis in a blog column).

Moreover, even as to other defendants, his proposal limits recovery to disgorgement of gains, an amount that may, in many cases, be insufficient to make bringing these cases worthwhile. As discussed earlier, waivers of class actions should be impermissible under § 29(a) because the costs of bringing securities fraud actions make claims brought by small investors financially infeasible.[167] Similarly, in instances where plaintiffs cannot establish that individual defendants directly benefited from their fraud, the likely recovery may not be large enough to make pursuing the remedy cost-effective. In both these situations, the award of attorneys' fees does not cure this problem.[168] As a result, the practical effect will be to excuse compliance with the antifraud provisions. Perpetrators of securities fraud should not have a free pass because, although they may have caused considerable losses to investors, they themselves did not receive much direct benefit from their fraud.

Second, Professor Pritchard argues that his proposal does not violate § 29(a) because the FOTM presumption of reliance is merely a "procedural device, created by the courts, not Congress."[169] The caselaw establishes that waivers of reliance present precisely the kind of danger that concerned Congress when it initially enacted the statute.[170] Finally, Professor Pritchard's dismissive treatment of the FOTM presumption ignores the fact that Congress itself recognized the FOTM presumption and its importance when it reformed the securities fraud class action in PSLRA.[171]

This Part IV demonstrates that both "self-help" proposals violate § 29(a) and thus are impermissible as a matter of federal securities law. Part V explains why these proposals are also impermissible under state law.

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[167] *See supra* note 162 and accompanying text.

[168] *See supra* note 159 and accompanying text.

[169] Pritchard, *supra* note 6, at 253–54.

[170] *See supra* notes 124–127 and accompanying text.

[171] *See supra* notes 27–31 and accompanying text.

V. LEGALITY, FAIRNESS, AND ENFORCEABILITY UNDER STATE LAW

A. Legality

Proponents of these proposals assume that state law permits inclusion of these provisions in a corporation's certificate of incorporation. However, while modern corporation statutes allow great flexibility and private ordering, the discretion of corporate managers and shareholders to modify the corporation to include any provision that serves their needs is not unlimited.[172] A corporation's certificate of incorporation may contain provisions that limit the stockholders' powers only so long as they are "not inconsistent" with law.[173] As stated by the Delaware Supreme Court, the "broad powers conferred by [the statute] do not authorize the stockholders to contract with each other or with the corporation to achieve a result forbidden by settled rules of public policy."[174] Thus, for example, courts have invalidated charter provisions that gave the board of directors the power to deny a stockholder the right to examine books and records,[175] that conferred lifetime appointments on directors and officers,[176] and that permitted a majority of shares to ratify the issuance of stock options without consideration.[177] The Delaware Supreme

[172] For example, would anyone seriously argue that a public corporation's charter provision could prohibit public shareholders from owning stock in a competitor?

[173] MODEL BUS. CORP. ACT § 2.02(b)(2)(iii) (2002). *See also* DEL. CODE ANN. tit. 8, § 102(b)(1) (2009) ("not contrary to the laws of this State"). Fletcher, CORPORATIONS § 150 (2009). ("All optional provisions must be lawful and cannot be contrary to public policy")

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

[175] State *ex rel.* Cochran v. Penn-Beaver Oil Co., 143 A. 257, 259 (Del. 1926).

[176] State *ex rel.* Ross v. Anderson, 67 N.E. 207, 211 (Ind. Ct. App. 1903). *Cf.* Union Trust Co. v. Carter, 139 F. 717, 725 (C.C.W.D. V.A. 1905) (upholding charter provision that shareholders could not vote for a specified "start-up" time).

[177] Frankel v. Donovan, 120 A.2d 311, 316 (Del. Ch. 1956).

Court recognized the necessarily amorphous quality of this standard,[178] but rather than attempt a definition of "public policy," it explained that charter provisions could not "transgress a statutory enactment or a public policy settled by the common law or implicit in the General Corporation Law itself."[179] While none of the reported cases involves a clash between a federal statute and a charter provision,[180] there is nothing in the Delaware opinions to suggest that considerations of public policy are limited to state law, as Professor Pritchard believes.[181] Indeed, under preemption principles, charter provisions that violate the anti-waiver clause of the federal securities laws must be violative of public policy and impermissible under state law.

B. Fairness

Even if the charter provisions were legal under state law, there is a serious question of fairness about taking away rights from current shareholders that do not assent to the provision. If the managers and controlling shareholders include such a provision in the corporate charter prior to the company's initial public offering, it is likely that all current shareholders have agreed to the provision.[182] With respect to established public corporations, however, proponents assume that both proposals can be adopted through amendment of

[178] *Sterling*, 93 A.2d at 118 (stating that "the limits of 'public policy' are ill-defined and changing").

[179] *Id.* For a recent example following *Sterling*, see Jones Apparel Group, Inc. v. Maxwell Shoe Co., 883 A.2d 837, 853 (Del. Ch. 2004) (upholding a charter provision that established the record date for consent solicitations).

[180] While *Maxwell Shoe* states that a charter provision should be set aside only for transgressions of "a mandatory rule of our corporate code or common law," 883 A.2d at 846, the analysis should be equally applicable to transgressions of a preemptive federal statute.

[181] Pritchard, *supra* note 6, at 252.

[182] Coffee, Jr., *supra* note 87, at 924 (distinguishing between initial and midstream changes in corporate governance rules).

the certificate of incorporation by majority vote.[183] What about current shareholders that do not vote in favor of the amendment? Can their rights to bring federal securities class actions be substantially restricted without their assent? If they object to giving up their rights, are they relegated to selling their shares in the open market, perhaps at a reduced price reflecting the diminishment of their rights?[184]

It is true that modern corporate law, with its emphasis on flexibility and adaptability to change, allows substantial alteration, even elimination, of shareholder rights without their consent, as exemplified by the demise of the "vested rights" doctrine.[185] However, the power of the shareholders holding a majority of the vote to alter corporate governance and stock ownership rules is not absolute. Thus, for example, majority shareholders will not be able to adopt a provision that eliminates the board of directors,[186] because minority shareholders cannot be deprived of the protections afforded by a board of directors with fiduciary responsibilities to the corporation.

Some legislatures recognize the harshness that results from the flexibility afforded by modern corporate law and grant appraisal rights to shareholders whose rights are

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[183] It may be a majority of the outstanding shares, *see* DEL. CODE ANN. tit. 8, § 242(b)(1) (2009), or as few shares as a majority of a majority of shares, *see* MODEL BUS. CORP. ACT § 10.03(e) (1984), depending on state law requirements.

[184] Proponents will argue that it is more likely that share prices will go up, reflecting the savings achieved through limiting litigation. How the market will react is a matter of speculation, but at least for the first corporations that adopt one of these provisions we might expect a price decline reflecting market uncertainty because of the novelty.

[185] *See* Barbara Black, CORPORATE DIVIDENDS AND STOCK REPURCHASES § 5:4 (Supp. 2008) (reviewing demise of "vested rights" doctrine relating to defeasance of shareholders' preferential rights).

[186] In Delaware a statutorily defined "close corporation" may provide for management by the shareholders if all the incorporators or shareholders agree to it and notice of the provision is conspicuously noted on the stock certificates. DEL. CODE ANN. tit. 8, § 351 (2009). *See also* MODEL BUS. CORP. ACT § 7.32 (1984) (a similar provision under which the agreement ceases to be effective when the corporation becomes public).

adversely affected by changes they vote against.[187] In addition, courts may provide protection on fairness or fiduciary duty grounds,[188] particularly where the alteration is not a "plain-vanilla" corporate governance provision, but goes to personal attributes of stock ownership.[189]

The proponents have not satisfactorily addressed this fairness issue. One proponent of the arbitration proposal, at least, recognized that the rights of dissenting shareholders need to be addressed;[190] another proponent of arbitration suggests an unworkable solution of prospective application.[191] Professor Pritchard does not address the impact on current shareholders of the proposal to eliminate the corporate defendant. Fairness requires that, *at a minimum,* current shareholders should have appraisal rights if they dissent from the adoption of these proposals.

C. Enforceability

Assuming that these charter provisions are legal and current shareholders that dissent from the provision are treated fairly, is either provision enforceable as to subsequent stock owners? Proponents assert that notice on the corporate website and in its SEC filings is sufficient to bind future shareholders.[192] This is, however, a questionable assertion under both contract and corporate law. The

[187] *See, e.g.,* NEW YORK BUS. CORP. LAW § 806(b)(6) (2009) (providing appraisal rights to shares adversely affected by certain charter amendments).

[188] *See, e.g.,* Dental v. Fidelity Sav. & Loan Ass'n, 539 P.2d 649, 651 (Or. 1975) (recognizing that even with decline of vested rights, courts have not held that shareholders can lose all rights).

[189] *See* Black v. Glass, 438 So. 2d 1359, 1371 (Ala. 1983) (striking down a bylaw that did not simply regulate the conduct of internal affairs, but instead allocated property rights among shareholders).

[190] Bloomberg-Schumer Report, *supra* note 35, at 103.

[191] Moscow, *supra* note 87, at 9.

[192] Interim Report, *supra* note 35, at 111. *See also* Pritchard, *supra* note 6, at 252. *Cf.* Bloomberg-Schumer Report, *supra* note 35, at 103 (proposing that brokers provide notice to their customers).

following discussion focuses first on the arbitration proposal and the requirement of an agreement under the Federal Arbitration Act (FAA). It then addresses the proposal to eliminate the corporate defendant under corporate law. Finally, the issue of notice is specifically addressed.

1. The Arbitration Proposal

The Congressional purpose in enacting the FAA was to remove the anti-arbitration bias in federal courts.[193] Accordingly, FAA § 2 states that arbitration agreements are enforceable to the same extent as other contracts.[194] Over the years, the Court has transformed the FAA into an expression of "pro-arbitration" policy,[195] but, even so, by definition, an arbitration agreement between the corporation and all its current and future shareholders is required. Is the corporate charter containing an arbitration provision a contract for purposes of FAA § 2?

Corporate law theory does repeatedly refer to the corporate charter as a contract among the corporation and its shareholders.[196] Indeed, many corporate law scholars view the corporation as nothing more than a variety of contractual relationships between the various stakeholders.[197] For these scholars, the question of whether the certificate of incorporation is a contract for purposes of FAA § 2 is easily answered in the affirmative. A corporate law metaphor, however, does not make the certificate of incorporation the equivalent of the commercial contract

[193] *See* Jean R. Sternlight, *Panacea or Corporate Tool?: Debunking the Supreme Court's Preference for Arbitration,* 74 WASH. U. L.Q. 637, 660–62 (1996) (explaining how the Court created the myth of favoritism for arbitration).

[194] 9 U.S.C. § 2 (2006).

[195] Sternlight, *supra* note 193, at 660–62.

[196] Shell, *supra* note 87, at 543 n.172 (citing sources).

[197] "[The firm] is simply a legal fiction that encompasses a set of contractual relations." STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS § 1.5, at 26 (2002).

contemplated by the FAA,[198] and the demise of the "vested rights" doctrine[199] established that contract law principles are not grafted onto corporate law with full force and effect.

Arbitration of shareholders' disputes in closely held corporations has long been generally accepted,[200] but in those instances the arbitration clause is typically found in an actual agreement entered into by all the shareholders.[201] To extend the concept of an agreement under FAA § 2 to include the certificate of incorporation of a corporation with a small number of shareholders, all of whom are actively engaged in the business, may not stretch the definition of a commercial contract very far, although a recent federal appellate court, applying Pennsylvania law, refused to enforce an arbitration provision contained in a professional corporation's bylaws against a shareholder who did not assent to it.[202] In the context of public corporations, treating the certificate of incorporation as an actual contract among all current and future shareholders is pressing the metaphor too far.[203]

Professor G. Richard Shell, in his careful examination of the legality of arbitration clauses in the context of shareholders' derivative actions,[204] thought a better analogy

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[198] *See* Shell, *supra* note 87, at 543 n.170 (reviewing the legislative history).

[199] *See* Black, *supra* note 185 and accompanying text.

[200] *See* Shell, *supra* note 87, at 528–33 (discussing the New York experience).

[201] *Id.* at 528 n.80.

[202] Kirleis v. Dickie, McCamey & Chilcote, P.C., 560 F.3d 156, 161 (3d Cir. 2009). The Third Circuit petitioned the Pennsylvania Supreme Court to certify the question, because "it exposed tension between corporate law principles and arbitration contract principles"; the state court denied the petition.

[203] A recent survey found a small number of foreign issuers whose stock is traded in the U.S. markets with clauses in their certificates of incorporation mandating arbitration of intracorporate disputes; *see* Christos Ravanides, *Arbitration Clauses in Public Company Charters: An Expansion of ADR Elysian Fields or a Descent into Hades?*, 18 AM. REV. INT'L ARB. 371, 389–90 (2007).

[204] Shell, *supra* note 87, at 528 (1989). It should be noted that the arguments in favor of arbitration in shareholders' derivative actions are

is found in cases where members of an association, such as a stock exchange,[205] are bound by an arbitration clause in the association's governing documents which serve as a constitution.[206] However, as Professor Shell acknowledges, consent to the terms contained in the association's governing document is more naturally implied where the participants are members of a common trade or profession and the document sets forth norms by which the members agree to abide. In contrast, shareholders in publicly held corporations "share no common ground other than their investment preference."[207] Accordingly, the presence of an arbitration provision in the certificate of incorporation alone does not constitute an "arbitration agreement" for purposes of FAA § 2.

2. The Proposal to Eliminate the Corporate Defendant

As discussed earlier,[208] unlike contract law, which requires a party's assent to be bound to the terms, modern corporate law promotes flexibility and adaptability by permitting most changes to corporate governance rules, and even changes in the attributes of stock ownership, by less than unanimous consent of the current shareholders. In addition, the changes are binding on subsequent purchasers; the cases routinely state that purchasers of stock take with

stronger than in securities fraud class actions, since in the former plaintiffs must be shareholders at the time of bringing the suit and the complaint is based on a breach of fiduciary duty owed to the corporation and its shareholders, while in the latter plaintiffs need only be purchasers or sellers during the period that the fraud tainted the stock price and the fraud is inflicted on the traders in the market. *See* Ralph C. Ferrara & Danny Ertel, BEYOND ARBITRATION: DESIGNING ALTERNATIVES TO SECURITIES LITIGATION 184–88 (1991).

[205] *See, e.g.*, Perry v. Thomas, 482 U.S. 483, 485 (1987).

[206] Shell, *supra* note 87, at 546–547.

[207] *Id.* at 547.

[208] *See supra* note 172 and accompanying text.

notice of the contents of the certificate of incorporation.[209] Although his discussion on this point is abbreviated, Professor Pritchard appears to rely on this principle.[210]

The power of the current majority to bind all subsequent holders, however, has its limits; some alterations require the consent of, or at least notice to, subsequent shareholders to bind them. Courts are generally more likely to see the value of flexibility in alterations of corporate governance provisions, but to be more protective of subsequent shareholders in alterations to personal attributes of stock ownership.[211] Accordingly, corporate governance provisions affecting the allocation of powers among the corporation's board of directors, officers and shareholders are the types of provisions where, in most instances, changes will bind future shareholders who do not have notice of the change. Bylaw amendments requiring a majority vote to elect directors in uncontested elections[212] or limiting the term of any director who receives more votes against than for his election[213] are popular and recent examples of alterations of corporate governance rules that will bind all shareholders when adopted by the requisite percentage of shareholder votes. More generally, supermajority voting requirements for both board and shareholder action can be adopted by less than

[209] *See, e.g.,* Goldbloss v. Reiman, 55 F. Supp. 811, 819 (S.D.N.Y. 1943), Mason v. Mallard Tel. Co., 240 N.W. 671, 674 (Iowa 1932).

[210] *See* Pritchard, *supra* note 6, at 252 n.126 (citing *In re* Appraisal of Ford Holdings, Inc. Preferred Stock, 698 A.2d 973 (Del. Ch. 1977), where the court enforced a provision in the certificate of incorporation stipulating the fair value of preferred stock in an appraisal proceeding, even though there was no evidence that the current holders agreed to the provision or even knew of it).

[211] I recognize that the distinction is a blurred one – e.g., dividend arrearages on preferred shares that fueled the "vested rights" debate. *See supra* note 185 and accompanying text.

[212] DEL. CODE ANN. tit. 8, § 216 (2009).

[213] MODEL BUS. CORP. ACT § 10.22.

unanimous vote and are binding on all current and future shareholders.[214]

However, the power of the shareholders holding a majority of the vote to bind subsequent holders to corporate governance rules is not unlimited. Some changes so fundamentally alter the corporate governance structure as to require special protections for subsequent shareholders. As discussed previously, an example is a provision that eliminates the board of directors and replaces it with management by the shareholders.[215] This provision requires not only the unanimous approval of the current shareholders, but also conspicuous notice on the stock certificate to bind all future shareholders. In addition, only non-public corporations can adopt this radical change, in recognition of the fact that a corporation whose corporate governance structure lies so far outside the customary norm may mislead subsequent shareholders and a notice requirement is not sufficient warning.

Like corporate governance changes, many charter provisions relating to the terms of shares, including rights, qualifications, limitations, and restrictions,[216] are binding on all current shareholders,[217] and no notice is required to bind subsequent owners.[218] Some alterations to attributes of stock ownership, however, are so contrary to the customary understanding of property rights that they cannot bind future shareholders unless they either agree or at least take the stock with notice. A restriction on transferability is the

[214] DEL. CODE ANN. tit. 8, § 216 (2009) (shareholder quorum and vote); *Id.* at § 141(b) (board quorum and vote); MODEL BUS. CORP. ACT § 7.27 (shareholder quorum and vote); *Id.* at § 8.24 (board quorum and vote).

[215] *See supra* note 186 and accompanying text.

[216] DEL. CODE ANN. tit. 8, § 151(a) (2009); MODEL BUS. CORP. ACT § 6.01.

[217] DEL. CODE ANN. tit. 8, § 242(b)(1) (2009); MODEL BUS. CORP. ACT § 10.03(e).

[218] *See, e.g, In re* Appraisal of Ford Holdings, Inc. Preferred Stock, 698 A.2d 973, 975–76 (Del. Ch. 1997) (stating that preferred shares can stipulate the fair value of the shares for appraisal, while Chancellor Allen speaks of the preferred shareholders' "contracting away" their rights, the plaintiffs purchased the shares on the secondary market).

most common example.[219] The power to transfer stock ownership is considered a traditional property right; while perhaps the corporation statute could define stock ownership differently from other types of personal property and include prohibitions on transfer among the limitations and restrictions permitted in the certificate of incorporation's statement of the stock terms, no state has chosen to do so. Thus, while the statutes do not limit restrictions on transferability to closely held corporations, it is unlikely that restrictions on transferability applicable to all shareholders would either be feasible or upheld by the courts once the corporation's shareholder base reached a certain size.

Admittedly, the distinction between corporate governance rules and rules relating to attributes of stock ownership is blurred. Nevertheless, provisions that purport to restrict a current or former shareholder's right to bring federal securities fraud class actions do not have much bearing on the allocation of power between shareholders and directors, except to the extent that current shareholders' power to sue management may strengthen their position within the corporation. A provision that requires a majority vote to elect directors in uncontested elections does not have much in common with a provision that restricts the power of a former shareholder to sue the corporation and its managers for lying to the marketplace. Rather, the right to sue is more closely related to an attribute of stock ownership, particularly in securities fraud class actions, where (unlike shareholders' derivative actions)[220] standing is conferred not on shareholders, but on purchasers or sellers.[221]

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[219] DEL. CODE ANN. tit. 8, § 202 (Supp. 2009), MODEL BUS. CORP. ACT § 6.27. Moreover, the statutes require a legitimate corporate purpose for the restriction.

[220] Indeed, since a derivative claim involves the corporation's right to sue, it may have already agreed to arbitrate certain disputes, and such an agreement may be binding on the shareholders. *See* Jerry A. Sanborn, *The Rise of "Shareholder Derivative Arbitration" in Public Corporations: In re Salomon Inc. Shareholders' Derivative Litigation*, 31 WAKE FOREST L. REV. 337 (1996) (discussing a derivative suit involving alleged malfeasance committed by corporate employees of a securities firm, where defendants

Indeed, proponents of both the arbitration proposal and the proposal to eliminate the corporate defendant acknowledge that fairness requires some kind of public notice,[222] indicating that they do not believe that the reliance on corporate law principles is compelling. Accordingly, we address now the question of notice.

3. Notice

Even though we have shown that there is serious doubt that either proposal could be enforced under contract or corporate law principles, it is true that, in an era of standardized form contracts and internet transactions, modern commercial law has moved, in the name of efficiency, from an assent model to a notice model of contract formation.[223] In the law governing commercial transactions, there are many decisions holding that where the purchaser of a product or service receives notice of the seller's terms and has an opportunity to reject the product or service, a contract is created on the seller's terms.[224] In addition, the trading markets bear some similarity to auctions, and the longstanding law regarding auctions establishes the principle that bids at an auction embody terms made by advertisement, posting or other publication, whether or not the bidder is aware of them.[225] Finally, since the plaintiffs rely on the FOTM presumption to maintain these class actions, it may be inconsistent for them to argue that a public notice cannot bind them. Accordingly, it may be that

moved to compel arbitration pursuant to agreements with the New York Stock Exchange).

[221] Corporate statutes authorize charter amendments to eliminate directors' liability for duty of care breaches. DEL. CODE ANN. tit. 8, § 102(b)(7) (2009). Otherwise, it is doubtful that a majority of shareholders could take this action.

[222] *See supra* notes 93, 102 and accompanying text.

[223] *See, e.g.*, Hill v. Gateway 2000, Inc., 105 F.3d 1147 (7th Cir. 1997).

[224] *See, e.g.*, Register.com, Inc. v. Verio, Inc., 356 F.3d 393 (2d Cir. 2004) (citing Jones v. Brisbin, 41 Wn.2d 167 (Wash. 1952)); *Gateway 2000*, 105 F.3d 1147; ProCD Inc. v. Zeidenberg, 86 F.3d 1447 (7th Cir. 1996).

[225] RESTATEMENT (SECOND) OF CONTRACTS § 28(2) (1981).

the ultimate issue as to the enforceability of both proposals is what kind of notice is required so that it is fair to bind subsequent stock purchasers.

It would be difficult to provide actual notice at the time of the sale. In an earlier era of corporate law, where shareholders typically received stock certificates, notice requirements were easily met; the provisions could be printed on the certificate, as is still the case with respect to closely held corporations. Purchasers do receive confirmations that could contain notice of the provisions, but requiring the broker-dealer to ascertain the existence of the terms and include the notice on the confirmation would impose a considerable burden on them. A generic statement on brokerage statements that some issuers may include such provisions should not be sufficient to constitute fair notice.

Proponents assert that, in lieu of actual notice at the time of sale, notice on the corporate website or in the corporation's SEC filings (which, in many instances, the corporation no longer has to deliver to the shareholders)[226] is sufficient to bind subsequent purchasers.[227] Commercial law, however, does not support this assertion. Of critical importance in the commercial cases is that the purchaser, at a minimum, receives actual notice of the existence of the terms, either in a physical document or online, in sufficient time to renounce the transaction;[228] "clarity and conspicuousness . . . are important in securing informed assent."[229] Thus, in *Specht v. Netscape Communications Corp.*,[230] the Second Circuit said it would not enforce an arbitration clause where individuals could download a plug-in program from defendant's website without first viewing defendant's license agreement containing the arbitration agreement. Importantly, "inquiry

[226] SEC, Internet Availability of Proxy Materials, 72 Fed. Reg. 4148 (Jan. 29, 2007).

[227] *See supra* notes 93, 102 and accompanying text.

[228] Specht v. Netscape Commc'ns. Corp., 306 F.3d 17, 31 (2d Cir. 2002).

[229] *Id.* at 32.

[230] 306 F.3d 17 (2d Cir. 2002).

notice" was not created even though plaintiffs would only have to scroll down to a screen located below the download button. Notice in the corporation's SEC filings and its corporate website is not sufficient notice under *Specht*, because the purchaser would have to engage in more of a search to determine the existence of the provision than the website visitors in *Specht* had to do.

Proponents do have better support for their notice argument in the auction cases. Because of the special nature of auctions, the law imposes a greater responsibility on bidders to ascertain the terms of the sale, and they will be bound by publicized terms of which they should be aware,[231] in recognition of the fact that auctions are "cost-saving device[s] in which face-to-face negotiations, except as to price, are not engaged in by the parties."[232] Thus, the court in *Hessel v. Christie's, Inc.*[233] thought it likely that the bidder would be bound by the terms contained in the auction house's catalog even if he did not receive it, because he should have inquired into the terms of the sale. In that case, the court noted that (1) the auction house's customary practice was to post on its website, below the description of the items up for auction, the words "important notice;" (2) when the viewer clicked on those words, a notice appeared stating that the terms and conditions of the sale were set forth in the catalogue and that it was the viewer's responsibility to inform himself of the terms; (3) the bidder had visited the website prior to the auction; and (4) the bidder was an experienced art purchaser who had purchased art many times before from the auction house.[234] In short, courts assume that participants in auctions should know the rules of the game.

The proponents essentially argue that, like bidders at an auction, stock traders should know the rules of the game and be familiar with information posted on the corporation's

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[231] Hessel v. Christie's, Inc., 399 F. Supp. 2d 506 (S.D.N.Y. 2005).

[232] Travis v. Washington Horse Breeders Ass'n, 759 P.2d 418, 422 (Wash. 1988).

[233] 399 F. Supp. 2d 506, 516 (S.D.N.Y. 2005).

[234] *Id.* at 515–16.

website and in its SEC filings. Unlike auctions, however, there is no expectation that purchasers review the corporate information before making stock purchases. For most investors, this is simply a waste of time; they should either rely on the market to price the stock or rely on the recommendation of their broker or investment adviser.[235] Furthermore, unless and until adoption of these provisions becomes widespread, it would be unfair to charge even sophisticated traders with knowledge of these provisions.[236] It is true, however, that the FOTM theory presumes that all public information about the corporation is embedded in the stock price. Thus, to the extent the limitation is impacted in the stock price, the purchasers may be bound by the provision. To challenge it may undermine their reliance argument.

To summarize: Even if the arbitration proposal and the proposal to eliminate the corporate defendant were not impermissible under § 29(a), they are certainly illegal, and may also be unfair and unenforceable, under state law.

VI. CONCLUSION

Securities fraud class actions play an important role in compensating investors and deterring corporate fraud. When Congress reformed the securities class action in PSLRA and decided not to eliminate the FOTM presumption, it reaffirmed their importance. This is not to say that there is no place for further reform. The critics of the federal securities class action raise important policy questions that have serious consequences for the U.S. securities markets. The nation is currently debating what may possibly be the most significant regulatory reform to our financial markets

[235] *See* Stephen J. Choi, *Regulating Investors Not Issuers: A Market-Based Approach,* 88 CAL. L. REV. 279 (2000) (arguing that unsophisticated investors should be permitted only to purchase index funds).

[236] *See* Register.com v. Verio, Inc., 356 F.3d 393 (2d Cir. 2004) (holding that daily user of website who admitted to knowing the terms of its use could be bound by them even though he never manifested his assent to the terms).

since the 1930s. The SEC should exercise a leadership role in considering whether further reform to the securities fraud class action is advisable and convene a broadly inclusive national discussion on this subject.[237] There is no place for self-help measures advanced in the name of shareholders' rights.

[237] *See supra* note 10.