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"Shareholder Unfriendly" Provision in Company's IPO Registration Statement Would Have Blocked Access to Litigation

Locked Out

The Carlyle Group Tries to Bar Investors From Court

By Ann M. Lipton

As private equity giant Carlyle Group LP prepared to join rivals Blackstone Group LP and KKR & Co. as a publicly traded company this year, it made headlines with a stunningly "shareholder-unfriendly" proposal to eliminate the litigation rights of its future public owners.

On January 10, Carlyle amended its registration statement in advance of its forthcoming initial public offering ("IPO") to include a provision declaring that any and all investor disputes would be decided in private arbitration proceedings rather than in a court of law.

Although Carlyle ultimately removed the provision after widespread publicity and SEC objections, it is likely only a matter of time before more companies attempt to insert similar provisions in their registration statements and corporate charters. Because class action claims are usually unavailable in arbitrations — Carlyle's clause explicitly prohibited them — and because arbitration proceedings generally disadvantage individual plaintiffs to the benefit of corporate defendants, if such clauses become widespread, it will take away an important check on corporate conduct and deal a tremendous blow to investor rights.

A Closer Look at the Problems Posed by Arbitration

Beginning in the 1980s, arbitration clauses began to proliferate in the small print of consumer, employee, and investor contracts. As a result, when investors and workers seek to challenge corporate defendants for bad behavior arising out of these contracts, they have been forced out of court and into private arbitration. Specifically, federal courts have relied upon the Federal Arbitration Act ("FAA") to require that plaintiffs bring their claims in private arbitration proceedings — as opposed to courts of law — and to strike down all state attempts to regulate arbitration provisions. Passed in 1925, long before the creation of the modern class action, the FAA provides clear guidance that an arbitration provision in a contract "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."

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Further, the Supreme Court has upheld forced arbitration clauses that prevent employees from bringing class actions, including civil rights lawsuits and lawsuits against investment brokers for securities fraud. In addition, in *AT&T Mobility LLC v. Concepcion*, the Supreme Court recently struck down a California law that forbade companies from including waivers of class actions in consumer contracts (in that case, in cellular phone contracts).

This trend favoring mandatory private arbitration over judicial review has long been troubling to consumer advocates, because arbitration proceedings tend to favor corporations over consumers and investors. First and most obviously, to the extent that these provisions forbid class actions, arbitration prevents plaintiffs from taking advantage of the economies of scale that make class actions the only effective way to litigate many types of claims.

Second, arbitrations are usually held in secret, and the decision of the arbitrator does not have to be based on governing law. There is no right to appeal, extremely limited judicial review, and discovery is very limited — making it particularly difficult for claims where most of the relevant evidence is in the defendant's hands (such as in a securities action).

Finally, arbitrators are private entities who are selected and paid for by the parties, and may favor industry defendants, because industry defendants are "repeat players" that appear before them many times. Indeed, the Minnesota Attorney General and the San Francisco City Attorney recently sued one of the biggest players in consumer arbitration, alleging that its arbitrations were biased in favor of credit card company defendants. According to the Minnesota Attorney General, "The company said it was impartial but, behind the scenes, it worked alongside credit card companies to get them to put unfair arbitration clauses in the fine print of their contracts and to appoint the [company] as the arbitrator." The arbitration company denied the allegations, but quietly agreed to bow out of the arbitration business altogether.

When it comes to securities fraud claims, arbitration poses additional concerns. Securities fraud cases are important not just to compensate defrauded investors, but also as a mechanism for deterring fraudulent conduct by punishing bad actors. Just last year, professors at Rutgers University and Emory University conducted a study demonstrating that private securities class actions significantly deter accounting fraud.

These functions simply cannot be served in the context of private arbitration — all but the very largest investors will not be able to bring claims at all, and so long as arbitrations are kept secret, there is no chance for public accountability and deterrence of future misconduct. As Professor Daniel Morrissey of Gonzaga State School of Law stated recently and unequivocally in the *The National Law Journal*, "Arbitration will result in more investment fraud. Removing the deterrent effect that potential shareholder class actions and derivative suits afford would undermine the beneficial purposes of both the federal securities laws and state fiduciary duties. It could very well return us to the pre-Depression 'pump and dump' days."

A Much Deserved Public Outcry — "The Most Shareholder-Unfriendly Corporate Governance Structure in Modern History"

It is no wonder, then, that Carlyle's attempt to impose mandatory arbitration and class action waivers on all public investors attracted such a public outcry. Three senators authored a letter to Chair Schapiro of the SEC protesting the arbitration provision. As they put it, the provision would "delegate out to private companies" the interpretation of federal securities laws, "with no guarantee that federal law would be properly applied. Even in cases of gross misapplication of the law, there is no opportunity for appeal or judicial review....The private arbitration system has been shown to have a repeat-player bias — favoring companies that hire them over and over again, as opposed to the individual shareholders who bring a single claim."

Other commentators agree. Professor and *New York Times* columnist Steven Davidoff described the Carlyle Group's proposal as "the most shareholder-unfriendly corporate governance structure in modern history....The effect of [the arbitration] provisions is to essentially eliminate any ability of shareholders to sue the board for even the most egregious acts." Lynn Turner, the former chief accountant of the SEC, asserted that "the majority of the enforcement of the U.S. securities laws is not done by the SEC but by attorneys for investors. This Carlyle proposal destroys that enforcement mechanism, much to the detriment of 100 million Americans." Former SEC Chair Arthur Levitt — who also serves as an advisor to Carlyle — publicly declared that arbitration "takes away from investors certain rights which it should not do. So I feel fairly strongly about the importance of private rights of action....Yes, we do know who usually wins, and the industry wins the overwhelming number of instances in arbitration cases."

The SEC also agrees. In fact, the SEC — which reviews all registration statements before they go to the public markets — has for 30 years resisted corporate attempts to amend their charters to forbid shareholder suits and require arbitration. In 1990, the SEC blocked the IPO of a Philadelphia savings and loan when it attempted to enforce mandatory arbitration on all investors. The SEC's view and advocacy casts doubt on the enforceability of arbitration provisions in future IPOs.

Under pressure from the SEC and investor activists, the Carlyle Group in February amended its registration statement to remove the mandatory arbitration provisions. However, the issue has not ended with Carlyle. There is no doubt that companies will include similar clauses in their charters and registration statements in the future and, under new SEC Commissioners, they may succeed. In fact, former SEC Chair Harvey Pitt stated publicly that the provision would have been permitted when he was Chair of the SEC. Further, as Professor John Coffee put it, recent Supreme Court decisions "may have initiated a revolution that could end most shareholder litigation involving public corporations....Stay tuned. This story will continue."

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