

Where Arbitration is The Only Game in Town

Mandatory arbitration clauses outside the US severely restrict investors' recovery options

By Jenny Barbosa

In Brazil, arbitration has become the sole means for resolving disputes relating to securities purchased on Brazil's primary stock exchange — the Bovespa.

Foreign companies are increasingly turning to arbitration in an attempt to limit or avoid their liability exposure for securities fraud. This practice is common in Brazil, where public companies are encouraged by regulators to adopt bylaws mandating arbitration, supposedly in an effort to avoid the already overburdened and unreliable Brazilian court system. In fact, arbitration has become the sole means for resolving disputes under Brazilian law relating to securities purchased on the Bovespa, Brazil's primary stock exchange. While arbitration may, in some cases, be preferable to running the gauntlet in foreign courts, mandatory arbitration provisions also drastically restrict investors' recovery options for losses incurred on foreign exchanges.

The Petrobras securities litigation, which arises out of the largest corruption scandal in Brazil's history, serves as a prime example. Petrobras is a multinational state-run energy company headquartered in Rio de Janeiro, and at one time, was one of the largest companies in the world. The securities litigation against Petrobras arises from a decades-long

bribery and kickback scheme in which Petrobras officials conspired with a cartel of company contractors to overcharge Petrobras on construction and service contracts, with billions of dollars in kickbacks and bribes funneled back to Petrobras executives and distributed to Brazil's ruling political parties. The scheme caused Petrobras to overstate the value of its refineries, oil rigs, and other assets by billions of dollars and materially misstate its financial results. As details of the scheme became public, the price of Petrobras securities plummeted.

Investors filed lawsuits in federal court in Manhattan, seeking to recover losses on Petrobras securities purchased on the Bovespa, the New York Stock Exchange, and the over-the-counter bond markets. Shortly thereafter, Petrobras moved to dismiss the Brazilian securities law claims asserted on behalf of investors who purchased their Petrobras securities on the Bovespa, arguing that the claims were subject to mandatory arbitration pursuant to the company's bylaws. The court agreed, and on July 30, 2015, the Honorable Jed Rakoff, applying Brazilian law, held that the company's arbitration clause



was “valid and enforceable against purchasers of Petrobras securities on the Bovespa.” Judge Rakoff held that Article 58 of Petrobras’s bylaws bound all shareholders who purchased Petrobras stock on the Brazilian stock exchange after the bylaws had been adopted.

As a result, the sole recovery option for investors who purchased Brazilian-listed Petrobras securities appears to be mandatory arbitration at the Market Arbitration Chamber of the Bovespa. While at least one mass solicitation for a collective shareholder arbitration in Brazil was circulated as early as September 2015, it appears that to date no arbitration proceeding has actually been filed. As such, there is no pending action or proceeding providing a means for investors who purchased Petrobras securities outside of the United States to obtain compensation for their losses.

In stark contrast, investors who purchased Petrobras American Depositary Receipts (ADRs) on the NYSE and Petrobras bonds in the domestic OTC market continue to enjoy the strong protections of US federal securities laws. Members of the investor class in the Petrobras US

securities litigation, as well as hundreds of investors from the United States and internationally that have chosen to pursue direct action claims, have overcome defendants’ repeated pleading attacks and are set to have their claims for recovery of damages under the US federal securities laws adjudicated in a joint trial scheduled to begin in September 2016.

On June 15, 2016, the Second Circuit Court of Appeals agreed to hear Petrobras’s interlocutory appeal of the district court’s certification of a subset of the class case, namely, concerning purchases of Petrobras US dollar-denominated bonds trading on the OTC corporate bond market. Petrobras argues that individualized proof will be necessary to establish a sufficient domestic nexus under the Supreme Court’s 2010 decision in *Morrison* for these off-exchange transactions in Petrobras bonds. Notably, Petrobras does not argue that such individualized questions prevent certification as to purchasers of the Company’s ADRs on the NYSE.

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While mandatory arbitration may be preferable to running the gauntlet in Brazil’s court system, this development has drastically restricted investors’ recovery options for losses on foreign securities.