Keeping Investors out of Court

The Looming Threat of Mandatory Arbitration

By Robert Trisotto

Investors must remain vigilant as companies attempt to evade securities laws and block investor access to court through mandatory arbitration provisions.

Over eighty years ago, federal securities laws were enacted to safeguard investments on national securities markets. These securities laws — premised on the notion that investors should receive accurate and thorough information regarding the public companies that they own — have transformed United States stock exchanges into the most prominent and trusted exchanges in the world.

Despite this impressive history, the management of some publicly-traded companies have increasingly sought to evade federal securities laws by altering their charters or bylaws in ways that the drafters of securities laws likely never imagined. For instance, companies have attempted to deter shareholders from filing lawsuits against corporate management by adopting fee-shifting provisions in their charters or bylaws. Such provisions would place a losing shareholder on the hook for the company's attorney's fees and expenses in disputes over management's actions on behalf of investors.

Companies have also tried to restrict shareholders' access to certain forums to enforce the securities laws. For example, after the US Supreme Court held that state courts are open to investors to file class actions alleging claims under the Securities Act of 1933 in *Cyan, Inc. v. Beaver County Employees' Retirement Fund*, companies such as Blue Apron Holdings, Inc., Stitch Fix, Inc., and Roku, Inc. adopted clauses in their charters aimed at requiring shareholders to file Securities Act claims in what management viewed to be a more favorable forum: federal court.

Perhaps most troubling, companies have tried, albeit unsuccessfully, to adopt mandatory arbitration provisions in their charters or bylaws to completely shut off the courtroom to investors. Companies' past efforts to force arbitration on investors were rejected by the SEC. But, recent commentary from the SEC suggests it may revisit its policy against mandatory arbitration provisions. This has sparked a vigorous discussion about


DETOUR
AHEAD

Forced arbitration raises serious concerns about depriving investors of important federal rights to litigate securities fraud violations in court.

the practical effects that mandatory arbitration provisions would have on investors' ability to adequately vindicate their rights under the securities laws. As detailed further below, forced arbitration raises serious concerns about depriving investors of important federal rights to litigate securities fraud violations in court. Although arbitration may offer benefits to companies and their management, many scholars and advocates have concluded that the potential harm to investors of being forced to arbitrate securities violations significantly outweighs such benefits.

The SEC has historically protected investors from forced arbitration

The SEC has long protected investors from companies' efforts to force them into mandatory arbitration instead of litigation in federal courts. For instance, in 1988, Franklin First Financial Corporation declared its intention to include a mandatory arbitration provision in its charter and bylaws in advance of its planned IPO. Similarly, in 2012, The Carlyle Group LP filed a draft registration statement with the SEC that would have required investors to arbitrate disputes. In both cases, the SEC refused to accelerate the effective date of the companies' registration statements, thereby effectively blocking the companies' ability to proceed with their planned IPOs. The result: Both companies abandoned their plan to prohibit shareholders from filing class-action lawsuits.

The SEC has also prevented public companies from modifying their existing bylaws to provide for mandatory shareholder arbitration. For example, when a proposal was made to amend the bylaws of Gannett Co., Inc. to require investor disputes to be submitted to arbitration, the SEC encouraged Gannett to omit the proposal from its proxy materials (by stating that it would "not recommend enforcement action to the Commission" if it was indeed omitted) as there was support for the view that "implementation of the proposal would cause the company to violate the federal securities laws." The SEC has also supported other companies' (Alaska Air Group, Inc. and Pfizer Inc., for example) decisions to exclude similar pro-arbitration proposals.

SEC officials have signaled potential policy shift towards arbitration

Despite repeatedly rejecting companies' attempts to force arbitration on investors for the past three decades, the SEC has recently suggested that it may reconsider its position on mandatory arbitration provisions. In a July 2017 speech to the Heritage Foundation, former SEC Commissioner Michael Piwowar supported changing the SEC's policy to allow companies to force shareholders to resolve claims through arbitration rather than in court. Piwowar stated that "[f]or shareholder lawsuits, companies can come to us to ask for relief to put in mandatory arbitration into their charters…I would encourage companies to come and talk to us about that." Additionally, the US Department of the Treasury issued a report in October 2017 suggesting that mandatory arbitration be used as a tool to reduce the costs of shareholder litigation and recommended that "the SEC continue to investigate the various means to reduce costs of securities litigation for issuers in a way that protects investors' rights and interests, including allowing companies and shareholders to settle disputes through arbitration." More recently, in August 2018, SEC Commissioner Hester Peirce stated in a public interview that she "absolutely" thinks that public companies should have the option to require investors to resolve shareholder disputes through arbitration.

This is not the view of all SEC officials. For example, in February 2018, SEC Commissioner Robert J. Jackson, Jr. expressed his "concern" about mandatory arbitration provisions because of the important role shareholder litigation plays in policing corporate misconduct and given the SEC's limited resources. Also in February 2018, SEC Investor Advocate Rick Fleming called mandatory arbitration "draconian" because it would "strip[] away the right of shareholders to bring a class action lawsuit," which is vital in "helping to protect investors and deter wrongdoing." But the fact remains that certain SEC officials appear to be inclined to open the door for mandatory arbitration.

Mandatory arbitration provisions may significantly erode investor rights

Mandatory arbitration provisions have the potential to undermine investors' ability to prosecute securities claims in court and hold companies accountable for their misconduct. Under the Federal Rules of Civil Procedure, investors can institute a class action to hold companies liable for their violations of securities laws in federal court. But, if limited to arbitration and subjected to class action waivers, individual investors may not be able to afford to pursue their claims unless they have very large losses.

In a class action, a plaintiff seeks relief for a company's securities violations on behalf of itself and the class, allowing it to share the cost of litigating with all investors. In contrast, in arbitration subject to class action waiver provisions, the claimant can only seek relief for its own claims and thus must bear the costs of the arbitration alone. Securities fraud cases are often complex cases, requiring multi-million-dollar capital expenditures before trial. If the case goes to trial, litigation expenses could be much more. By preventing investors from asserting their claims in a class action in the federal courts, mandatory arbitration provisions could force countless investors to forego meritorious claims.

Mandatory arbitration provisions could also eliminate shareholder litigation's ability to deter violations of securities laws. Arbitration generally takes place in a private setting and arbitration clauses typically prohibit the disclosure of any information about the proceedings. Absent public accountability, companies can keep their misconduct a secret, hiding it from the public in perpetuity.

Arbitration and class action waiver provisions could also stifle critical enforcement of the securities laws. Shareholder litigation serves as an essential tool to enforce securities violations, along with enforcement by the SEC and the Department of Justice. Each year, private litigants hold public companies accountable for billions of dollars of securities fraud violations. Their results compare well to governmental enforcement actions. SEC Commissioner Jackson noted earlier this year that, following securities fraud scandals at WorldCom, Enron, Tyco, Bank of America, and Global Crossing, the SEC recovered only about $1.75 billion while investors in private class action suits recovered more than ten times that amount, or about $19.4 billion. Without shareholder class actions to seek relief for securities violations, companies' misconduct could get a free pass, investors could be undercompensated, and there would be far fewer factors deterring fraud and other corporate misconduct. With a reduced probability of being caught, corporate managers could commit fraud without fear of serious consequence.

The way forward — institutional investors must proactively address managerial overreach and fraud

Institutional investors should remain vigilant in monitoring and combating efforts by corporate management to strip them of their valuable rights to litigate securities fraud claims in court. With companies, the business lobby, and other anti-shareholder special interests ready to reignite the fight over mandatory arbitration provisions, investors must voice their concerns about forced arbitration to legislators and the SEC, and be prepared to pursue available legal remedies to challenge the attempted use of mandatory arbitration provisions. Investors should stand together against these renewed attacks on fundamental shareholder rights.

Robert Trisotto is an Associate in BLB&G's California office. He can be reached at robert.trisotto@blbglaw.com.