

Could the Supreme Court's Enforcement of Arbitration in *Concepcion* Reverberate in the Securities Litigation Sphere?

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A recent U.S. Supreme Court decision may cause corporations to reconsider a possible way to avoid costly and often counter-productive securities class actions. In *AT&T Mobility LLC v. Concepcion*,¹ the Court on April 27 upheld the enforceability of contractual arbitration clauses that waive a consumer's right to bring a class action. This decision has been hyped as both a "dramatic example of judicial activism"² and the "class action shot heard 'round the world"³ because it gives businesses a way to significantly reduce—if not eliminate entirely—consumer class actions.

While the effect of this landmark decision on consumer class actions is evident,

its importance is less clear for shareholder class actions. Can corporations also prevent future securities class actions by adding arbitration and class-action waiver clauses in the company's charter or by-laws? The question has been raised before, most recently in when the Committee on Capital Markets Regulation recommended that shareholders have the right "to adopt alternatives to traditional litigation by instituting alternative dispute resolution mechanisms such as arbitration (with or without class actions)."⁴ The negative reaction from Congress and public investors, however, prevented this recommendation from gaining any traction.

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Now, four years later, the Court’s 5-4 decision in *Concepcion* and other recent developments may make unilateral arbitration clauses more realistic. *Concepcion*’s pro-arbitration holding eliminates one potential hurdle to these clauses: It makes clear that arbitration and class-action waiver clauses can be enforced, even in adhesion contracts that are not negotiated between the parties. This article examines if *Concepcion*’s holding could extend to a corporation’s relationship with its shareholders. It also examines some of the additional challenges a corporation should consider before including these types of clauses in their governing documents.

Concepcion’s Holding

Concepcion was a case of first impression for the Supreme Court which was used to resolve the intersection of two competing policy issues: the policy favoring arbitration embodied in the principal of freedom of contract; and the well-recognized benefit that class actions create for small, similar claims. Both federal and state courts have increasingly recognized the right of contracting parties to agree to arbitration as a means of resolving disputes. The Federal Arbitration Act (FAA), enacted in 1925, embodies both “a liberal federal policy favoring arbitration,” and “the fundamental principle that arbitration is a matter of contract.”⁵ On the other hand, several states—including California, where *Concepcion* originated—have held that certain contract clauses that waive the right to bring a class action are unconscionable and a violation of public policy.⁶

Defendant AT&T Mobility LLC’s underlying contract in *Concepcion* raised these competing

policy concerns. Its standard cellular contract required arbitration of all disputes and also prevented its customers from bringing claims on behalf of a class. The benefit to a company from this type of clause is two-fold. First, it selects the forum, timing, and method for resolving disputes with its customers. Second, and even more importantly, it prevents its customers from bringing large high-dollar class action claims. For the clause requiring arbitration to be beneficial, however, the class-action waiver must also be enforceable. In other words, the biggest concern is not that a court will decline to enforce the arbitration provision in its entirety—but rather that the court will permit arbitration after striking the class waiver on the grounds that it is against public policy.

Before *Concepcion*, several federal and state courts had already disagreed over the enforceability of similar clauses. For example, the California Supreme Court struck down a similar class-waiver clause in 2005 in *Discover Bank v. Superior Court*.⁷ While refusing to hold that class waivers are unconscionable *per se*, the *Discover Bank* court made clear that it would be difficult to enforce an individual arbitration agreement under California law “when the [class action] waiver is found in a consumer contract of adhesion in a setting in which disputes between the contracting parties predictably involve small amounts of damages[.]”⁸ On the other hand, the U.S. Court of Appeals for the Fifth Circuit held that former employees’ claims under the Fair Labor Standards Act were subject to individually executed predispute arbitration agreements that preclude class actions.⁹ Both the district court and the Ninth Circuit in *Concepcion* followed the reasoning in *Discover Bank* and held the arbitration provision was unconscionable.¹⁰

In *Concepcion*, the Supreme Court disagreed with the Ninth Circuit, and reversed and remanded in an opinion written by Justice Antonin Scalia. The Supreme Court acknowledged that the FAA allows arbitration provisions to be invalidated on the basis of generally applicable state contract defenses; however, it noted, “nothing in it suggests an intent to preserve state-law rules that stand as an obstacle to the accomplishment of the FAA’s objectives”—such as the promotion of arbitra-

tion.¹¹ Concluding that the *Discover Bank* rule “stands as an obstacle” to the operation of the FAA,¹² the Court held that the rule was preempted by the FAA. After *Concepcion*, it is clear that companies may enforce individual arbitration clauses against consumers who attempt to bring class actions in state or federal court.

The Benefits of Applying *Concepcion* to Shareholder Class Actions

It is less clear how far *Concepcion*'s holding will extend to other potential groups of plaintiff classes, such as shareholders. Shareholders frequently file putative class actions in state and federal courts, asserting both statutory and common law claims.

To corporations and certain shareholders, the idea of eliminating shareholder class actions in favor of bilateral arbitration is certainly an appealing one. Shareholder litigation has been widely criticized as damaging company value and generating sizeable attorney's fees while having little deterrent effect on corporate wrongdoing.¹³ As one commentator noted:

In the typical secondary market case, the corporation is not selling its securities and thus does not receive any “direct benefit” ... when its managers inflate its earnings and stock price (usually for their own benefit). To punish the corporation and its shareholders in such a case is much like seeking to deter burglary by imposing penalties on the victim for having suffered a burglary.¹⁴

Other commentators have concluded that:

At best, the plaintiff shareholders will settle and recover pennies on the dollar, while 25-30% of the recovery will go to the plaintiffs' attorneys. The cost of the litigation and settlement or recovery is usually borne by the defendant corporation and/

or its insurers even though the corporation may have gained nothing from the fraud.¹⁵

And in many cases, the pressure on corporations to settle is so great that even nonmeritorious claims have a good chance of settling if they survive early motions practice.¹⁶ In contrast, and as the Supreme Court recognized, arbitrations may “allow for efficient, streamlined procedures tailored to the type of dispute,” thus “reducing the cost and increasing the speed of dispute resolution.”¹⁷

Do Corporations Have “Contracts” with Their Shareholders?

While there are several reasons corporations and certain shareholders may want to mandate bilateral arbitration as the means for resolving intra-corporate disputes, it is not clear they have the right to do so.

The first potential roadblock to the enforcement of an arbitral class-action prohibition against shareholders is that the FAA may not apply to such provisions in a company's charter or bylaws. The FAA provides only for the validity of written arbitration provisions *in contracts*, the existence and validity of which is a question of state contract law.¹⁸ While courts and commentators have often described corporate charters as “contracts,”¹⁹ a corporation's ability to create or modify its charter or other documents is a function of a state's corporate law, not of its contract law. As a result, a provision that affects shareholder rights may be binding under corporate law but nevertheless not a literal contract under state law or the FAA.²⁰ The most obvious distinction between contractual and shareholder rights is that only the latter may be altered without consent: Many states allow bylaws and other corporate rules to be altered without shareholder input, and even when a majority vote by shareholders is required, dissenting shareholders have far less recourse than a party to a conventional contract. Because of these and other differences, even courts that liken charters and bylaws to contracts in other

instances may be unwilling to apply the FAA to corporate governance documents.

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There are other indications that courts might declare such agreements governed by the FAA, however. The Delaware Supreme Court—arguably the most influential state court on matters of corporate governance—has stated that “[c]orporate charters and by-laws are contracts among the shareholders of a corporation and the general rules of contract interpretation are held to apply.”²¹ Opinions from the Delaware Court of Chancery and a California federal court on the enforceability of forum-selection clauses in corporate charters recently indicated agreement with this pro-enforceability view, at least for corporate provisions garnering shareholder approval.²² Delaware in particular has shown an increasing awareness of the benefits of arbitration in complex disputes: The state explicitly allows limited liability companies and limited partnerships to create operating agreements mandating arbitration,²³ and as of February 1, 2010, the Delaware Chancery has allowed parties to require arbitration in the Court of Chancery under certain circumstances.²⁴ In addition, courts have upheld arbitration clauses in organizational documents of noncorporate entities, such as private associations and religious groups, on the grounds that such documents bind the organization’s members like any other agreement.²⁵ Finally, where shareholder agreements are formally exchanged, such as for close corporations, such agreements are even more likely to be held covered by the FAA. Indeed, close corporations have used arbitration provisions for years.²⁶

Other Considerations for Enacting Bilateral Arbitration Provisions

A corporation seeking to add an arbitration provision into its governing documents may want to give careful consideration to whether such a provision should be incorporated into its charter or its bylaws. Delaware law provides no clear answer. On the one hand, both the charter and the bylaws would seem equally effective places to incorporate an arbitration provision, since either document may concern shareholder rights.²⁷ On the other hand, “[a]s a matter of corporate law... the bylaws are subordinate to the charter and would have correspondingly less contractual force under the FAA. ... In addition, most corporate statutes provide explicitly that substantial variations from the conventional model of corporate governance be included in the charter, and bylaw provisions are not an adequate substitute under these laws.”²⁸ Corporations may want to take a belt-and-suspenders approach to avoid this problem and add their arbitration provisions to *both* the bylaws and the charter.

If the enforceability of a corporate arbitration provision—whether under the FAA or Delaware corporate law—would require shareholder approval, obtaining such approval may be an additional hurdle. Unlike consumer adhesion contracts, which were the subject of *Concepcion* and are often executed without serious review, corporate provisions would be scrutinized carefully by institutional shareholders with significant corporate ownership interests and by proxy advisory firms. It is easy to imagine that institutional shareholders would fight any provisions denying them redress from the courts in the face of corporate wrongdoing. On the other hand, a shareholder could conclude that an arbitral class action prohibition would ultimately increase shareholder value by reducing strike suits and eliminating the expensive “pocket-shifting” that the award of securities class-action damages usually creates.²⁹

Relatedly, companies should take note of how to obtain shareholder approval under state law and their corporate charter. For example, if an arbitration provision is to be added to a corporate charter,

Delaware law requires that both a majority of the outstanding stock entitled to vote and a majority of each class entitled to vote approves of the addition.³⁰ Charter provisions particular to the corporation may impose additional requirements.

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Another issue is whether an arbitral class-action prohibition would be enforceable in securities-fraud cases, in light of conflicting statutory provisions or common-law antifraud principles. This concern appears to be diminishing. *Concepcion* suggests that such prohibitions are unlikely to be invalidated for unconscionability or public-policy reasons, or for conflicting with state statutes, because the FAA would preempt these on state-law grounds. And the Supreme Court has held that the federal Securities Act and Securities Exchange Act, both of which prohibit the contractual waiver of compliance of their provisions,³¹ do not prohibit arbitration clauses.³²

Concepcion provides good reason for corporations to consider the benefits of arbitral class-action prohibitions as a means to reducing the substantial costs associated with securities class actions. The Supreme Court's decision removed a few roadblocks to such provisions, but companies should keep in mind that it did not clear the path for such prohibitions entirely.

NOTES

1. *AT&T Mobility LLC v. Concepcion*, 131 S. Ct. 1740, 179 L. Ed. 2d 742, 161 Lab. Cas. (CCH) P 10368 (2011).
2. Editorial, *Gutting Class Action*, N.Y. Times, May 12, 2011, available at <http://www.nytimes.com/2011/05/13/opinion/13fri1.html>.
3. Chad Fuller & Megan O'Sullivan, *Class Action Exposure Post-Concepcion*, May 27, 2011, available at <http://www.law360.com/employment/articles/244354/class-action-exposure-post-concepcion>.

4. Interim Report of the Committee on Capital Markets Regulation, Nov. 30, 2006, at xiii, 72, 109-112, available at http://www.capmksreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.
5. *Concepcion*, 131 S. Ct. at 1745 (quoting *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983), and *Rent-A-Center, West, Inc. v. Jackson*, 130 S. Ct. 2772, 2776, 177 L. Ed. 2d 403, 109 Fair Empl. Prac. Cas. (BNA) 897, 93 Empl. Prac. Dec. (CCH) P 43916).
6. *Discover Bank v. Superior Court*, 36 Cal. 4th 148, 30 Cal. Rptr. 3d 76, 113 P.3d 1100 (2005) (abrogated by, *AT&T Mobility LLC v. Concepcion*, 131 S. Ct. 1740, 179 L. Ed. 2d 742, 161 Lab. Cas. (CCH) P 10368 (2011)).
7. *Discover Bank*, 36 Cal. 4th at 148.
8. *Discover Bank*, 36 Cal. 4th at 162.
9. *Carter v. Countrywide Credit Industries, Inc.*, 362 F.3d 294, 9 Wage & Hour Cas. 2d (BNA) 705 (5th Cir. 2004) (interpreting Texas law).
10. See *Laster v. AT&T Mobility LLC*, 584 F.3d 849, 855 (9th Cir. 2009), cert. granted, 130 S. Ct. 3322, 176 L. Ed. 2d 1218 (2010) and rev'd, 131 S. Ct. 1740, 179 L. Ed. 2d 742, 161 Lab. Cas. (CCH) P 10368 (2011); *Laster v. T-Mobile USA, Inc.*, No. 05cv1167 DMS (AJB), 2008 WL 5216255, at *14 (S.D. Cal. 2008), aff'd, 584 F.3d 849 (9th Cir. 2009), cert. granted, 130 S. Ct. 3322, 176 L. Ed. 2d 1218 (2010) and rev'd, 131 S. Ct. 1740, 179 L. Ed. 2d 742, 161 Lab. Cas. (CCH) P 10368 (2011).
11. *Concepcion*, 131 S. Ct. at 1748-49.
12. *Concepcion*, 131 S. Ct. at 1753 (quoting *Hines v. Davidowitz*, 312 U.S. 52, 67, 61 S. Ct. 399, 85 L. Ed. 581 (1941)).
13. See, e.g., Jill E. Fisch, *Class Action Reform, Qui Tam, and the Role of the Plaintiff*, 60 Law & Contemp. Probs. 167, 168 (1997) (discussing disparity between meager recovery of class action members and the healthy fees received by counsel); John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence & Its Implementation*, 106 Colum. L. Rev. 1534, 1536 (2006) ("Deterrence works best when it is focused on the culpable, but there is little evidence that securities class actions today satisfy this standard. Rather, because the costs of securities class actions—both the settlement payments and the litigation expenses of both sides—fall largely on the defendant corporation, its shareholders ultimately bear these costs indirectly and often inequitably.").
14. Coffee, *supra* note 13, at 1537.
15. Jennifer J. Johnson & Edward Brunet, *Critiquing Arbitration of Shareholder Claims: Why Change is Not Always a Measure of Progress* 8 (Lewis & Clark Law School Legal Research Paper No. 2008-11, 2008), available at <http://ssrn.com/abstract=1112826>.
16. Bruce H. Kobayashi & Larry E. Ribstein, *Class Action Lawyers as Lawmakers*, 46 Ariz. L. Rev. 733, 743 (2004) (stating that "many certified class actions settle quickly"); Bryant G. Garth, *Studying Civil Litigation Through the Class Action*, 62 Ind. L.J. 497, 501 (1987) (reporting a 78% settlement rate for certified class actions and only a 15% settlement rate for noncertified cases).
17. *Concepcion*, 131 S. Ct. at 1749.
18. The statute states "[a] written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to

- perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable... ." 9 U.S.C.A. § 2.
19. See, e.g., G. Richard Shell, *Arbitration & Corporate Governance*, 67 N.C. L. Rev. 517, 543 & n.172 (1989) (stating that "[a]s a matter of state corporate law, courts have traditionally viewed the corporate charter as a three-way contract between the corporation and the state, between the shareholders and the corporation, and among the shareholders inter se" and citing cases and statutes).
 20. See generally Shell at 543-46.
 21. *Centaur Partners, IV v. National Intergroup, Inc.*, 582 A.2d 923, 928 (Del. 1990).
 22. See *Galaviz v. Berg*, 763 F. Supp. 2d 1170, 1174-75 (N.D. Cal. 2011) (finding unilateral adoption of forum-selection bylaw unenforceable but suggesting that bilateral adoption would be enforceable); *In re Revlon, Inc. Shareholders Litigation*, 990 A.2d 940, 960 (Del. Ch. 2010) ("[I]f boards of directors and stockholders believe that a particular forum would provide an efficient and value-promoting locus for dispute resolution, then corporations are free to respond with charter provisions selecting an exclusive forum for intra-entity disputes.").
 23. See DEL. CODE ANN. tit. 6, § 17-109(d) (discussing limited partnerships); DEL. CODE ANN. tit. 6, § 18-109(d) (discussing limited liability companies).
 24. The arbitration provision is controlling as long as all parties have consented, the amount in controversy is more than one million dollars, and at least one party is a business entity organized under Delaware law or has its principal place of business in Delaware. See Delaware Court of Chancery, "Order Adopting Court of Chancery Rules 96, 97 and 98" (Jan. 5, 2010), available at http://courts.delaware.gov/Rules/?Chancery96-97-98_020110.pdf; DEL. CODE ANN. tit. 10, § 349.
 25. See Shell, *supra* note 19, at 546-47 (citing *Fox v. Merrill Lynch & Co., Inc.*, 453 F. Supp. 561, 564, 1 Employee Benefits Cas. (BNA) 1976 (S.D. N.Y. 1978) ("A party who agrees to abide by the rules of an organization is bound by its subsequently adopted rule calling for arbitration."); *Brown v. Gilligan, Will & Co.*, 287 F. Supp. 766, 769 (S.D. N.Y. 1968); and *Koppel v. Koppel*, 52 A.D.2d 676, 382 N.Y.S.2d 143 (3d Dep't 1976).
 26. See Shell, *supra* note 19, at 528.
 27. See DEL. CODE ANN. tit. 8, § 242 (recognizing that articles of incorporation may be amended to change "the rights of stockholders"); DEL. CODE ANN. tit. 8 § 109 (stating that the bylaws "may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees").
 28. Shell, *supra* note 19, at 542 n.166 (citing DEL. CODE ANN. tit. 8, § 141(a) and *Datapoint Corp. v. Plaza Sec. Co.*, 496 A.2d 1031 (Del. 1985) (holding that change in statutory "consent" procedure must be contained in charter rather than bylaws)).
 29. Coffee, *supra* note 13, at 1558 ("Often shareholders will belong to both the plaintiff class that sues and the residual shareholder class that bears the cost of the litigation. This can result because they purchased stock at times that are both inside and outside the class period, so that they are on both sides of the litigation. Thus, they are effectively making wealth transfers to themselves, in effect shifting money from one pocket to another, minus the high transaction costs of securities litigation.").
 30. See DEL. CODE ANN. tit. 8, § 242.
 31. Section 14 of the Securities Act of 1933 provides "[a]ny condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void." 15 U.S.C.A. § 77n. Section 29(a) of the Exchange Act of 1934 has a similar provision which states that "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void." 15 U.S.C.A. § 78cc(a).
 32. *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 228, 107 S. Ct. 2332, 96 L. Ed. 2d 185, Fed. Sec. L. Rep. (CCH) P 93265, R.I.C.O. Bus. Disp. Guide (CCH) P 6642 (1987); see also *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 628, 105 S. Ct. 3346, 87 L. Ed. 2d 444, 1985-2 Trade Cas. (CCH) P 66669 (1985) ("By agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial, forum.").

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