TORT REFORM IN THE SECURITIES SECTOR

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The IPO Flight From the U.S.[1]

Attached is a sampling of recent commentaries, concerned about the outflow of IPOs from the traditional U.S. trading platforms … the New York Stock Exchange and NASDAQ … to offshore, non-U.S. exchanges, including principally the AIM. As reported in *The Economist*:

> In 2000 nine out of every ten dollars in the world's initial public offerings were raised in America. Last year nine out of every ten dollars were raised outside America.[2]

Granted, there are factors which can influence the flow of IPO business having nothing to do with perceived overregulation in the U.S.: the numbers cited above are, for example, significantly influenced by a plethora of Chinese issuers going public in Hong Kong during the period.[3] Nonetheless, the IPO window for venture-backed companies in the U.S. with market caps under, say, $700 million, is very narrow. Over 40 U.S. companies have floated IPOs on the AIM, six this year alone.[4] And, if the traditional IPO exit for U.S. venture funds is closed, the effect ripples back up the entire economic chain … impacting the environment for new business formation, from the "embryo to the IPO" as I describe it: Less appetite for risk; fewer entrepreneurs finding seed capital; therefore, inexorably, fewer Microsofts, Genetechs, Ciscos and Dells.[5] If there is any doubt on the immediacy and severity of the problem, one need only review the recent public announcement by the manager of one of the oldest and most successful venture funds in this country's history, Sevin Rosen. Because the traditional venture capital model is broken, "by reason of a terribly weak exit environment" … *i.e.* the IPO window is effectively closed for

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[1] This memo was prepared with the invaluable help of Brian Doyle, a summer law clerk at Fish & Richardson and a 3L at Rutgers Law School, with input as well from David Hammer, an experienced New York securities litigator.

[2] "Battle of the Bourses," *The Economist* (May 27, 2006). *See* Ramirez, "Arbitration and Reform in Private Securities Litigation," 40 *Wm. & Mary L. Rev.* 1055 (April 1999):

> American fortunes ride upon the success of our financial markets as never before because of increased international economic competition and important demographic trends.

[3] Loss of the IPO business is not the only U.S. asset at risk. As the *Economist* has pointed out:

> … the competitive threat to America is real – as the Big Apple's hoarier financiers know only too well. They still sigh when recalling restrictions introduced in the 1960s that drove lenders and borrowers to London, where the Eurobond market promptly took off. The American government loosened the rules a decade later, but by then it was too late and London ran off with the business.

[4] *See* Book 19 of *The Encyclopedia of Private Equity and Venture Capital*, which contains a large quantity of AIM data and metrics. *The Encyclopedia* is available to subscribers at www.vcexperts.com. According to a survey by the National Venture Capital Association, 57 percent of 200 investors surveyed say there will be a growing propensity in the industry to take American companies public in overseas markets in 2007.

[5] Indeed, one of the oddities in today's climate is that U.S. initial public offerings are increasingly rare while private companies are "going public" at accelerated rates … through the increased use of SPACs and reverse mergers into public shells. There are a number of factors at work, one of which deserves special mention in this context … liability concerns stemming from the paucity of defenses to a claim brought on the basis of Section 11 of the `33 Act. In the SPAC and shell games, the securities involved are already registered publicly and the threat of near-absolute liability imposed on, *e.g.,* board members under Section 11, is substantially less menacing under Rule 14a-9. The SPAC's, and shells constitute a flight away from quality, often driven by (my phrase) Boca Raton underwriters under the spell of "casino capitalism." Not illegal or immoral, to be sure, but bad for the economy. For a survey on SPACs and Shells, including the all important tracking of after-market performance once the acquisition closes, see www.vcexperts.com, *The Encyclopedia of Private Equity and Venture Capital*, Book 20.

mid-cap, venture-backed companies … companies which in an earlier era would qualify as 'portfolio makers' … the general partners are returning commitments for $250 to $300 million. When rational VCs give that kind of money back (even if they never make an investment, that's $6 million a year for 10 years), something is radically wrong.[6]

Next, by way of an explanation of where I am coming from, I am concerned that the diminishment of opportunities for venture-backed IPOs in the U.S. can have significant negative effects on the venture business in the country generally … and our economy in both the short and long run.[7] Thus, research published in April by the British Venture Capital Association (BVCA) showed the importance of healthy stock markets for the venture capital and private equity community: about one-fifth of the divestments in the UK since 1998, measured by acquisition cost, have been by way of an IPO. And that figure would be even higher if measured by realized value, since IPOs tend to be reserved for the better performing investments.[8] In fact, studies around the globe show that venture capital funding levels are especially sensitive to the health and size of a given country's IPO market.[9]

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[6] Reported in The *NYTimes*, C1 (Oct. 7, 2006): Helft, "A Kink in Venture Capital's Gold Chain."

[7] The importance of venture capital in this country to our overall economic health is beyond argument. According to The Kauffman Foundation

> Few people realize how many Americans today still make their living in entrepreneurial settings. More than 500,000 'employer firms' (businesses with employees) are started in the United States every year. The latest Global Entrepreneurship Monitor (GEM) survey, funded by the Ewing Marion Kauffman Foundation, found that in 2003, approximately 11 of every 100 working adults in the United States were engaged in entrepreneurial activity, either starting a business or playing a lead role in one less than three and a half years old. That rate is higher than any in Europe and roughly twice that of Germany or the United Kingdom.
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> The United States is also unusual in that many of its big, strategically important corporations were created very recently. Dell and Cisco Systems, for example, were started in 1985 and 1984, respectively.
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> Overall, new firms play two essential roles in the U.S. economy. First, they are engines of innovation. Although large, established firms innovate, they tend to do so only in certain ways, wary of straying too far from their existing lines of business. Compare the birth of two industries: nuclear power and software. Innovation in the first was driven mainly by big companies such as Westinghouse Electric that were already in the power-generation business. By contrast, there was no software industry in the early days of computing. Computer programs were either custom-written or sold along with the machinery; writing and selling them separately, for wide-spread use, was not seen as a viable business strategy. Thanks to the efforts of thousands of similar entrepreneurs, the software industry has done what nuclear power was once expected to do: benefited every sector of the economy and spurred tremendous growth.
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> The second essential role that new firms play in the U.S. economy is smoothing the exigencies of the business cycle. Time and again, the breeding of new companies, new jobs, and new industries has helped pull the economy out of a slump and fuel a rebound – as occurred after the recession in the early 1990s. Japan, in contrast, has many innovative large firms but the lowest per-capital rate of entrepreneurial activity of 37 countries studied by GEM – a possible explanation for its prolonged stagnation."

[8] EU Private Equity Highlights – from SJBerwin, 10/19/2006.

[9] Jeng & Wells, "The Determinants of Venture Capital Funding: Evidence Across Countries," 6 *Journal of Corporate Finance* (Sep. 2000), pp 241-289; *see also* .Mauro, "Stock Returns and Output Growth in Emerging and

SOX Can Be Balanced: However, Strike Suits Are Deemed An Insoluble Problem.

My sense, from conversations with my clients and others, is that, despite the popular and conventional wisdom, the main problem is not Sarbanes-Oxley per se.[10] I am convinced that, over time, the wasted effort and money currently experienced by U.S. public companies seeking to comply with SOX can work itself out. That is to say, as and when the SEC Staff formalizes a window for legitimate queries on the appropriate interpretation of ambiguous SOX rules, particularly vis-à-vis Section 404, I am convinced that a body of interpretation can be built up which will accord with the practical necessities facing the industry and its regulators. By trial and error (if you like), sorting through issues of overkill and ambiguity one by one, the Agency can craft the equivalent of a how-to-do-it manual which is sensible, practical and, sooner or later, comprehensive. Assuming the accounting profession, the lawyers, the chief financial officers, board committees, etc. can get questions answered in real time and profit from the experiences of others facing similar problems, we should shortly reach a point where the burdens of compliance are counterbalanced by the benefits of investor comfort in financial transparency. The SEC's willingness to open up the hood, so to speak … to craft safe harbors for well intentioned but confused fiduciaries and their advisers … will go a long way towards providing potential IPO customers the comfort they need vis-à-vis running afoul of SEC and the DOJ. The problem with SOX is that, given Draconian penalties for a misstep (even if only negligent or inadvertent), we are all compelled to err on the side of super-caution … and, therefore, excessive expense. This is a *bête noire*, if you like, which the Agency can address without altering its normal procedures; it need only enhance its readiness to keep the window open for queries, and accelerate the response time, as we feel our way to equilibrium.

SOX Is Not the Biggest Hindrance to U.S. IPO's

Advanced Economics," *J.of Development Economics*, 129: "… the empirical association between output growth and lagged stock returns … is significantly stronger in countries that have … a large number of listed domestic companies and initial public offerings … ." *Id* at 131-132; and see NVCA Survey, Dec. 18, 2006, where the survey indicates:

> Alternatives to the traditional VC exit routes are expected to be a prevalent factor in 2007. More than half of VCs surveyed (57 percent) believe there will be a greater propensity for U.S. venture-backed companies to consider overseas IPOs next year. More interesting perhaps is the fact that 71 ercent of the venture capitalists surveyed believe the purchase of portfolio companies by private equity firms will become a more attractive option in 2007.

[10] As Chairman Cox remarked in a speech to the AICPA, much of the excess SOX expense, the tribute, if you will, is traceable to the "unfriendly legal environment." Final Report of the Advisory Committee on Smaller Public Companies, (April 23, 2006) (hereafter the "Report") 109. See also Chairman Cox remarks quoted in "SEC Looks To Cut Costs of Meeting Audit Rule," N.Y. Times, July 12, 2006, at C3, where he is quoted as saying: "Our goal is to develop practical guidance for companies to help improve the reliability of financial reporting and to make Section 404 implementation more efficient and cost effective for investors, … ." That being true, leveling the legal playing field is not only a plus in and of itself but will serve to take unnecessary SOX expense out of the equation. Moreover, one positive function of experienced arbitration panels, and the Agency would do well to suggest the panel include at least one senior member of the accounting profession, will be to sort through the ambiguities and gaps in SOX and separate out culpable conduct from honest mistakes. Precedent built up on the basis of decided cases, coupled with Staff omnibus guidance, can neutralize the principal § 404 excess …the overkill in the review and documentation functions, referred in the trade jargon as the Ostrich Contingency, meaning a due diligence process so over the top that the professionals check to see if the issuer has protection in place in case an ostrich bursts into the CEO's office and attempts to kick her to death.

SOX to the contrary notwithstanding, the root cause[11] of IPO capital flight from the U.S. has to do, in my opinion, with failures in the administration of civil justice in the United States. Despite the efforts of Congress and the Supreme Court, clever plaintiffs counsel have been able to use (at little risk) class actions as bounty hunts;[12] the way the dice are loaded, U.S. public companies are routinely compelled to pay out extraordinary numbers (with consequent press criticism and public vilification) in settlement of litigation, regardless of merit, brought by resourceful plaintiffs counsel. In the *WorldCom* case, an individual independent director/defendant faced 35 separate trials around the country … and the necessity of winning each one on the merits, in front of a local jury. Can you blame those scarred by this experience, and their friends and peers, if they ask: "Who needs it?" The fact is that, if a public company stock takes a hit, the right to a civil jury trial for corporate boards and managers has effectively disappeared. The chances are close to 100 percent that a hiccup, particularly if the same occasions critical media comment, will be followed by a class action.[13] As Prof. Coffee has pointed out:

One risk-minimizing course of action for the plaintiff's attorney is logical, but not socially desirable: rather than invest significant amounts of time in a single action, the plaintiff's attorney can spread his risk by litigating a large number of actions, devoting little time or energy to any one, in the hope of settling a reasonable percentage of them for a modest amount per case. In effect, he hedges his bets and invests in a broad portfolio of actions. Of course, this description is also the classic profile of the strike suit: a slapdash action, inadequately researched as to either the facts or the law, brought by an attorney who is currently the attorney of record in a large number of similar pending actions.

It is this specter … one pronounced dip in the stock price resulting in a cavalcade of lawsuits (contingent fee lawyers representing multiple opt outs) … that is spooking Corporate America. In the UK, the Law Society bans contingent fees and imposes a "loser pays" system. The introduction of the Loser Rays system in this or any other sector triggers a controversial reform which is well beyond the scope of the Proposal. See, for example, Polinsky & Rubinfeld, "Does the English Rule Discourage Low-Probability

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[11] Apparent agreement on this point is found, courtesy of David Hammer, in an interview in the *Wall Street Journal* "The Journal Report Online," with Prof. Hal Scott, from which I excerpt:

> **WSJ.COM**: Is Sarbanes-Oxley the reason foreign IPOs seem to be drying up on Wall Street?
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> **Mr. Scott:** That's something I'll be better able to answer in November. That's something we're looking very carefully at.
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> By the way, everybody refers to SOX when they really mean a lot of other things, such as the litigation system, which I regard as much more important then SOX in terms of this question.

WSJ, R2 (Oct. 9, 2006).

[12] The standard theory of the 'strike suit' was succinctly stated by Justice Black when he characterized the 'strike suit' as one brought 'by people who might be interested in getting quick dollars by making charges without regard to their truth so as to coerce corporate managers to settle worthless claims in order to get rid of them.' The assumption is that it is cheaper to settle than to fight so long as a cheap, quick settlement is possible. …" John C. Coffee, "The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation," L. & Contemp. Problems 5 (Summer 1985) (hereinafter cited as "Coffee").

[13] It is part and parcel of the business of professional plaintiffs' counsel to 'spray and play' multiple companies. [Thus], "a second basic explanation for the strike suit is a differential in risk aversion between plaintiffs and defendants. If we examine first the plaintiff's attorney as the real party in interest, persuasive arguments suggest that he is more likely to be risk neutral than the defendant. By definition, he is a professional, a repeat player who is accustomed to facing litigation risks and who probably has a portfolio of other actions that diversify his risks.

Coffee, n. 8, *supra* at p.19.

of Prevailing Plaintiffs?"[14] Why not, my clients say, go there? From personal experience (I have participated in, so far, three AIM events in the U.S.), this is the <u>major</u> talking point advanced by our U.K. competitors, as well it should be.

Given the power and influence of the trial bar, it is foolish to attempt to force down the throat of Congress a system patterned after the British.[15] In fact, each time the Congress has legislated in order to restrain

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[14] 27 *Journal of Legal Studies*, 141 (Jan. 1998):

> One of the principal results in the economic theory of litigation is that the English rule of fee allocation (in which the loser pays the winner's litigation costs) is better at discouraging suits by low-probability-of-prevailing plaintiffs than the American rule (in which each side bears its own costs). This result has been demonstrated under the assumption that all suits that are filed go to trial. Using a standard asymmetric-information model of litigation, we show that when the settlement process is taken into account the English rule results in more low-probability-of-prevailing plaintiffs going to trial than the American rule. In this sense, the English rule encourages low-probability plaintiffs more than the American rule. … It is important to point out that the conventional result concerns the incentives of parties to file suits, whereas our focus is on the decisions of parties whether to go to trial or to settle. Our conclusion does not contradict the conventional result. Although we show that the English rule leads to more trials involving low-probability plaintiffs, our analysis does not imply that the English rule also causes more suits to be filed by low-probability plaintiffs. In the model we employ, the same suits are filed under the two rules. More generally, it could be the case that the English rule discourages the filing of suits by some low-probability plaintiffs while encouraging other low-probability plaintiffs to go to trial.

See also Smith, "Note: The Role of the Attorney in Protecting (and Impairing) Shareholder Interests: Incentives and Disincentives to Maximize Corporate Wealth," 47 *Duke L.J.* 161 (Oct. 1997), where the author submits:

> The English Solution: Making the Loser Pay. The proposal put forth in Part III.A.I. would give an incentive to plaintiffs' attorneys to act in an efficient, wealth-maximizing way. However, there is an equally important need for a disincentive to deter these attorneys from acting in wealth-destroying ways. Attorneys act destructively when they bring "strike suits" – shareholder suits which would not win in court on their merits, and which have no potential to benefit the corporation – for the purpose of inducing the corporation to settle in order to avoid the costs and disruptions of litigation. Unfortunately, the strike suit is a common occurrence. Although strike suits are meritless, corporations and their officers have powerful incentives to settle them. The corporation must bear the litigation expenses to fight the suit, and, perhaps more significantly, the existence of a pending lawsuit may have a substantial deleterious effect on the defendant's normal business activity. These incentives to settle make meritless strike suits profitable for attorneys.
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> The proper disincentive for these meritless suits is to require a plaintiff who loses on the merits to reimburse the defendant for a portion of its litigation expenses. this rule is fair because a shareholder who files a meritless lawsuit unilaterally thrusts costs upon the corporation and its shareholders. This rule is efficient because it would encourage corporations to fight meritless lawsuits rather than settle them, providing a powerful deterrent to these destructive suits. Finally, this rule is necessary because other attempts to deter frivolous shareholder litigation, such as the contemporaneous ownership rule and security-for-expense statutes, are inadequate; those fee-shifting provisions are not related to the merits of the case and thus affect meritorious as well as nonmeritorious suits.

[15] It would, perhaps will, be ironic if, as some predict, the regulations and law matters overseas react to some of the benefits of Sarbanes-Oxley by stiffening their own requirements. See SJBerwin, Private Equity Comment, Sept. 22, 2006:

> Next month in the British Parliament the long, slow process will finally come to an end, and a new Companies Act will make its way onto the statute books shortly after. It will probably be another year before it comes to force, but when it does it will certainly herald significant change – and most of it for the better. …The process (although disappointingly slow) has, by and large, been a

excesses, the wily trial bar has found a way to maneuver around the rules.[16] As Judge Cote noted in WorldCom, the Lerach firm, in an attempt to avoid removal to her court, crafted complaints filed in 10 Mississippi counties, each time representing 49 (one fewer than a "class" for removal purposes) plaintiffs … complaints identical, as she noted, "down to the typographical errors." In that sense, the U.S. government does not appear to have a workable solution … at least by legislation or administrative rule making. Once a reform is passed, the trial lawyers parse the language and figure a way around it. The good news, however, is that the solution I am advancing requires very little in the way of groundbreaking Agency action; my suggestion levels the playing field by bringing the private sector into the act … by authorizing potential registrants to insert binding arbitration clauses in their charters. The current … and as far as I am aware the only … obstacle to my proposal is an informal policy of the SEC, advanced publicly in 1990 in a trade journal piece authored by Assistant GC Riesenberg who was responding to a published assault on the policy by Carl Schneider, the latter aggrieved by the fact that the SEC would not accelerate (*i.e.*, had a *de facto* ban on) registration statements if the charter contained what is often called a "collective action waiver [17] … *i.e.*, a provision binding shareholders to arbitration." [18]

> good one so far – wide consultation, and a genuinely responsive approach from the government. The remaining issues, though, are of great importance to the business community and there are many who hold legitimate concerns.
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> Perhaps the most concerning proposal is the attempt to write the duties of directors into the law, and to clarify very complicated rules about when directors can be sued. Both of those aims are laudable. The problem is that the way that the new rules are drafted will make the duties more onerous, and could make it easier for shareholders to sue. Whether that is what the government intends is not entirely clear, but lawyers say that is the result.

[16] *See* Cyril Moscow, "Arbitration Bylaws to Bar Shareholder Class Actions," 20 *Insights* 8 (April 2006). Concededly, securities class actions are declining in the U.S. See the mid-year report released by the Stanford Law School Class Action Clearinghouse in cooperation with Cornerstone Research, reported in *The Business Forum Online*. While the reasons are not susceptible to precise cause and effect analysis, the factors certainly include increased attention to the observance of SOX and Delaware Chancery) driven procedures, a rising stock market and an interesting hypothesis by Prof. Joseph Grundfest, focused on option backdating actions:

> In some situations, the uncertainties associated with the application of appropriate accounting principles may cause potential plaintiffs to recognize that they will have difficulty alleging that there was an intention to commit fraud.

Id at 3. As usual, I agree with Joe Grundfest (although without suggesting he agrees with everything in the cited material). *See Plain Talk About Stock Options: An Outline Of A New Model (Part II)*, 11/16/2006, *Buzz of the Week,* www.vcexperts.com.

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> In my view, it would be contrary to the public interest to require investors who want to participate in the nation's equity markets to waive access to a judicial forum for vindication of federal or state law rights, where such a waiver is made through a corporation charter rather than through an individual investor's decision .. [t]he Supreme Court has suggested that where the congressional purpose underlying the private right is primarily to deter wrongful conduct rather than to compensate the victim, arbitration cannot be required. This distinction is based on the rationale that, despite the general policy in favor of arbitration as reflected in the Federal Arbitration Act, arbitration 'cannot provide an adequate substitute for a judicial proceeding in protecting' certain federal statutory and constitutional rights. Shareholder claims, where the allegedly unlawful conduct is likely to involve public dissemination of false information or false filings with the Commission, generally involve numerous victims and may, more so than is the case as to broker/customer claims, bear on the integrity of the nation's securities markets as a whole. Because such misconduct directly undermines the disclosure and antifraud purposes of the federal securities laws, actions based on such conduct should be viewed as primarily deterrent in purpose and should not be subject to mandatory arbitration (footnotes omitted).

The Proposal As A Win/Win Solution

I recommend the SEC relax its unconditional opposition to potential registrants adopting charter provisions which confine stockholder suits to arbitration.[19]

In today's legal climate, such provisions, at least if adopted by the company's shareholders while it is still private, would be an effective bar to shareholder class actions of the sort which subvert the defendants' opportunities to defend themselves on the merits.

The new policy should not, of course, be unconditional; it would not be responsible for the Agency charged with enforcing federal securities law to abdicate its oversight responsibilities. Accordingly, I suggest an ambulatory (subject to change based on experience) set of SEC Guidelines along the following lines:

PROPOSED GUIDELINES

> **The Commission will not object to a provision in the registrant's charter requiring that actions by a present or past shareholder or holders against the issuer, its officers, its directors and/or its controlling shareholders[20] based on alleged violations of federal or state securities law must be submitted to, and only to, binding arbitration, provided that:**

Note this will be, or should be, easy for most pre IPO, private companies to comply with. It is arguable, of course, there should be some reasonable procedure for amendments by public companies as well ... by, say, two-thirds of the disinterested shareholders, the SEC retaining jurisdiction over the duty of disclosure in the proxy statement but deferring to the States to craft protections … *e.g.*, independent committees and advisers … to protect the minority. However, in order to simplify the instant proposal (the "Proposal"), and get the ball rolling, the Proposal deals only with companies adopting the charter provision upon incorporation or by vote of 100 percent of the shareholders.

> **(i) The SEC retains jurisdiction to review the collective waiver provision based on experience in specific cases, and to impose constructive changes based on that experience.**

Riesenberg, "Arbitration and Corporate Governance: A Reply to Carl Schneider," 4 *Insights* 31 (Aug. 1990). I am not aware (and not having researched the issue) of any other SEC public statements on the question. I am told, but have not located remarks by Chairman Breeden on the subject were published.

[18] Carl W. Schneider, "Arbitration in Corporate Governance Documents: An Idea the SEC refuses to Accelerate" 4 *Insights 5*.(May 1990).

[19] Assuming the SEC's objections are relaxed, it is likely that States, *e.g.*, Delaware, interested in providing a home for new incorporations, will adopt specific provisions validating the practice.

[20] The parties protected by the charter provisions are limited the corporation itself, its directors and its officers plus any shareholder deemed to be controlling. Theoretically, the protection could be extended to professionals involved in public and private flotations, including the accountants and the investment banking syndicate. The Proposal does not extend that far because, at least according to the evidence currently at hand, it need not. The objective is to provide clarity and even handed treatment to the registrant, its management and its board… the decision makers which select the market on which to list the IPO flotation.

Note the SEC's objective will be to use its review power to insure that, as per *Mitsubishi Motors Corp*.,[21] a disappointed securities stock purchaser can "effectively vindicate" her rights in arbitration.

(ii) The charter, a public document, contains a full description of the provision, so that all subsequent investors enjoy actual or constructive notice of its existence. Notice of the provision must be prominently included in all required public disclosures, stock certificates accordingly legended and notice contained on the face of all subscription agreements executed by shareholders first purchasing shares from the issuer.[22]

(iii) The SEC is given notice of the commencement of any arbitration involving an action against a company registered under the `34 Act and is afforded the right to intervene on issues involving construction of the federal securities laws.

(iv) The provision is repeated in the bylaws, expressly binds the statutory officers and the board members and the company is required to obtain consent thereto from the five highest paid executives.

(v) The decision of the arbitrators is stipulated as final, excepting only the opportunity for (i) either the SEC or the losing party to seek review of any rulings on federal securities law questions in the U.S. Court of Appeals, the Court applying its customary standard of review; and (ii) either party to seek review of any state law issues in, *e.g.* the Delaware Chancery Court.[23]

(vi) The panel has authority, in its discretion, to consolidate cases and order class wide arbitration.

Note that the collective action waiver is a waiver of class action complaints as a right. In a given case, the panel is empowered to order class wide arbitration. Class arbitrations are not foreclosed by the Federal Arbitration Act, [24] but it should be noted that class arbitrations are not includable, by NASD Rule, in

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[21] 473 U.S. 614 (1985).

[22] The question whether arbitration is a desirable result depends in part on whether the procedure is, in the language of *Gilmer v. Interstate/Johnson Lane Corp*., 500 U.S. 20 (1991) and *Green Tree Financial Corp. v. Randolph*, 531 U.S. 79 (2000) "unconscionable" in that the procedure makes the plaintiffs' job "prohibitively expensive."

The answer to that objection can be found in the requirement that, as a condition of its agreement to accelerate the effectiveness of the registration statement, the Commission retains jurisdiction to review the arbitration procedures established by the registrant as fair to both the defendant or defendants and potential plaintiffs … establishing a level playing field. Based on experience, the Commission and its Staff can adjust the Guidelines in view of actual results if it turns out that the one side or the other is unfairly benefited or penalized. The objective is to give plaintiff and defendant a fair and equal opportunity to present the case to a neutral and objective trier of fact.

[23] It can be confidently predicted that Delaware will be the domicile of choice if, as can also be confidently predicted, the Delaware legislature conforms the Delaware G.C.L. to accommodate, if indeed any language is needed, the charter provisions. To review a cognate action by the Delaware legislature (special mediation authority granted to the Chancery Court in order to settle "technology disputes"), see the article by my Fish & Richardson colleagues, Marsden & Hayes, "A New Tool For Resolving Technology Disputes." *Technology Times*, 16 (Aug. 2006), including with early, anecdotal evidence that the procedure is "effective.".

[24] The Federal Arbitration Act (FAA) does not foreclose class arbitration. Where an arbitration clause does not lawfully and clearly preclude class arbitration, the availability of class arbitration

customer broker/dealer agreement.[25] That said, the safety mechanisms built into the charter provisions I suggest should obviate the concerns which, presumably, motivated the NASD Rule. With the SEC coach enjoying the ability to coach from the wings, and the Delaware (presumably legislature) addressing the issue, the process should pass the acid test of fairness, based on a system designed by objective experts to secure a fair and efficient adjudication of the facts and arguments presented by the litigants … the real parties in interest. The resolution has nothing to do with the economic interests of the lawyers involved, particularly the specialists in capturing lead plaintiff status and extorting fee-rich settlements.

The term "extortion" in this context is not meant to imply criminal, or even unethical behavior. The fact is that winning lead plaintiff status in a securities case is a "free good". Why wouldn't alert counsel, often with well cultivated political connections (again, not illegal), bid for the "free good", using speed of foot ... the entrepreneurial firm which first identifies the opportunity and lines up a plausible plaintiff has an opportunity to invest several hundred thousand dollars (+/-) in contingent time charges as the ticket of admission to the grand prize … millions in fees, for settling the case. The law firm is not succumbing to "greed;" the system openly invites Johnny-On-The-Spot to bid for and then buy the opportunity to wind up with exponential returns. The weakness is in the system, which rigs the game for the benefit of the plaintiffs counsel as the real party in interest, with the consequence that: the actions are often not meritorious, or (if they are), the injured parties' interest are compromised; and, the tab is picked up by the issuer and its shareholders … the parties which, in a rational system, would be the winners vs. the losers.

Class certification is only one option in the panel's arsenal. The idea is to facilitate real cases … a plaintiff with enough confidence in the case (as in any other area of the law) that it is ready and willing to retain and pay counsel. (A dirty little secret: most of the celebrated plaintiff's counsel in today's environment have never actually tried a case … or wanted to). The Guideline's preference is for cases which proceed to the point the panel adjudicates the merits .. efficiently and expeditiously … and renders an opinion. There will often, given the nature of securities litigation, be an occasion for consolidation of multiple law suits, on motion of any or all parties … consolidation which may be (i) of interlocutory proceedings, *i.e.*, document production; (ii) individual actions; or (iii) certification of an entire group as a class.

> is to be determined using a state-law contract interpretation as to whether class arbitration is permitted or prohibited. This determination must be made by the arbitrators, not the courts.
> There is, thus, a presumption in favor of class arbitration in the sense that class arbitration will be permitted unless (i) the arbitration clause clearly precludes a class determination, or (ii) the law of the applicable state precludes class arbitration procedures. *See also*, *Green Tree Financial Corp. v. Bazzle*, 539 U.S. 444 (2003).

Oehmke, 1 *Commercial Arbitration*, Section 16.1 at 16-2 (3d Ed. 2005).

[25] [S]ince 1983, the National Association of Securities Dealers (NASD) has had a rule that all new customer agreements in the industry not only require arbitration of disputes but, also, must prohibit customers from bringing class actions to arbitration and must prohibit member firms from attempting to enforce an agreement to arbitrate against a member of a class action. Hammering the nail in the coffin of class arbitration, this rule was approved by the Securities and Exchange Commission (SEC) under its statutory authority. This NASD exclusion of class arbitration is bolstered by a notice in customer and member contracts that both arbitration is required and class proceedings are prohibited.

Oehmke, n. 16 *supra*. Section 16.14 at 16-44, citing NASD Rules of Fair Practice, Article III, Section 21(f).

(vii) Discretion will lie in the panel to oversee awards payment of counsel fees in class arbitrations, including imposition of the U.K. "loser pays" system.[26] **However, counsel fees will not be favored simply because the action settles and a cosmetic "reform" is instituted.**[27]

Plaintiffs and their counsel will always have the opportunity to pay their counsel out of their own pockets, taking the risk the action will not succeed or settle on favorable terms … the so-called "American System." However, if class arbitration is ordered and/or multiple individual actions are consolidated by the panel, in the interests of efficiency and justice to both sides, the panel may order fee awards as it feels are equitable under the circumstances … including, on the one hand, payments to lead counsel which take into account its risk and, on the other hand, a "loser pays" penalty saddled on plaintiffs' counsel.

(viii) Adversaries in class arbitration will not be permitted to negotiate a fee award until after a settlement has been approved by the Panel.[28]

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[26] *See* Coffee, n. 11 *supra*. at p. 62

> Under the converse 'English rule,' which shifts the victor's expenses to the loser, the less the chance of a favorable verdict, the more the reciprocal possibility grows that the plaintiff will be held liable to the defendant for the latter's legal fees. In effect, the English rule encourages the plaintiff to bring an action having a high prospect of success, while the American rule might discourage him (to the degree that his own expected legal costs reduced the size of the net recovery). Conversely, the American rule encourages actions having a lower prospect of success that the English rule would discourage, because the plaintiff need not fear liability for the defendant's costs if he is unsuccessful.'

[27] See Coffee, n. 11 *supra*. at p. 23 (footnote omitted)

> … a special doctrine applicable to the derivative action increases the potential for collusion. Over the last twenty years, a 'liberal' rule has evolved that a nonpecuniary settlement can justify an award of attorney fees in a derivative action. Typically, such nonpecuniary settlements involve 'therapeutic' reforms, such as revised auditing systems, corrective disclosures, or changes in the structure and composition of the board. This doctrine can, however, be easily exploited. If the two adversaries are so minded, they can reach a nonpecuniary settlement under which the defendants do not make any cash contribution (or only contribute a nominal amount). Each side can then shift its legal fees to the corporation through, respectively, a fee award or indemnification. For the adversaries, this is a painless way to resolve litigation--if they can convince the court to approve such a settlement. Of course, the court may sometimes resist acceptance of a settlement in which the corporate recovery seems trivial or out of proportion to the requested fee award. Nonetheless, the possibility of judicial resistance logically means only that the settlement process will be extended until the parties tender the minimal settlement that the court will accept, not that the outcome will reflect true adversative bargaining. … In overview, the nonpecuniary settlement fits the paradigm of the non-zero sum game. Normally, in litigation, the winning side's recovery equals the losing side's losses, much as in poker. But in this variety of non-zero sum game, an absent third party, the corporation, bears the expenses of both sides. Meanwhile, the litigation is dismissed with prejudice, and principles of collateral estoppel prevent the underlying claim from being relitigated by a more faithful champion.

[28] See Coffee, n. 11 *supra* at p. 71 (footnotes omitted):

> A rule against contemporaneous negotiation of the fee award and the settlement shifts discretion from the parties to the court. Existing precedents in some jurisdictions support this rule, as have commentators. Moreover, the usual counterargument against it--namely, that it would deny the defendant the opportunity to know his total liability --is simply inapplicable in the case of the derivative action. Because the corporation and not the defendant pays the fee award in derivative

The point is that, by avoiding a hard and fast rule, the incentives and opportunities to game the system can be checkmated by the Panel. Experience teaches that a bright line rule established by, say, Congress inherently suffers from the problem that it becomes a challenge to creative, and perfectly ethical, lawyers to find ways, which they usually do, to skate around it … a little like poker when one player has to show her hand first. As the cases multiply, the Agency, working with the Panel, can adjust the fee system to support its objectives. Legitimate plaintiffs can afford to bring actions and defendants can defend … a level playing field, cases decided fairly and efficiently, and justice done.

> **(ix) The parties will be entitled to any remedies (not including punitive damages) which would be available in the absence of the provision. The arbitrators may refer appropriate cases to the local U.S. District Court for temporary equitable relief if necessary.**

> **(x) The arbitrators are required to apply applicable substantive law and to write opinions. The expenses of the Panel, to be shared, will include payment of the stipends of all law clerk(s) if the Panel elects to employ the same.**

Note, it is highly likely the Panel will include, at least one member drawn from a pool of highly experienced, retired federal judges.

> **(xi) All other procedures are to be consistent with applicable State law.**

Discussion

The Proposal is designed to provide a fair and equitable venue both for aggrieved shareholders and responsible boards and managers, in order to reach just solutions in the case of alleged malfeasance. The core idea is to give (a) plaintiffs an opportunity to have their grievances heard, but in a single venue; (b) the Agency an opportunity to participate in and make known its views on (i) the appropriate interpretation of federal securities regulation and (ii) the fairness and efficiency of the rules; and (c) responsible boards and management have the assurance that they too will have their day in court … and not be bludgeoned into settling,[29] regardless of the merits, because the system is so heavily tilted against them. The Proposal

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> actions, it is irrelevant that the fee award will not be known by the defendant at the time he accepts the settlement.
>
> In reality, opposition to such a rule is based largely upon a different consideration. Litigators for both plaintiffs and defendants recoil at any proposal that restricts their ability to settle a case. When the counterargument is advanced to them that such a rule would, over the long-run, discourage frivolous actions because the plaintiff's attorney could not expect to receive a substantial fee award from the court in return for a cheap settlement, their consistent response has been that they are not counsel to the long-run, but only the individual case involving their clients. This response once again illustrates the centrality of the ex ante/ex post distinction. If one looks only ex post (that is, after the action is begun), the defendant's interest may seem to lie in obtaining the cheapest possible settlement. Examining the same issue ex ante (before an action is brought), the client's legitimate interest lies in reducing the incidence of frivolous actions. The prospect of collusive settlements maximizes the likelihood of nuisance actions, and a prophylactic rule barring contemporaneous fee and settlement negotiations minimizes this likelihood.

[29] Under the current system, career plaintiffs' counsel in class actions are in a very good business:

> The costs that plaintiff and defendant will typically incur are asymmetric, with the defendant's costs being considerably greater than the plaintiff's. This cost differential may make it cheaper for the defendant to settle than to fight. Several factors support the assertion that the plaintiff can

is not bottomed exclusively on the adverse impact of IPO flight, followed by emigration of the IPO issuers as well. I am not endorsing a race to the bottom. Rather, the Proposal is meant to be an improvement, in all respects, over the current class action free-for-all. Let me quote an influential and prescient piece[30] by Prof. Ramirez, a former SEC enforcement lawyer (footnotes omitted):

> Arbitration (the core of the Proposal) is capable of achieving rapid adjudications that undermine the possibility of extortionate settlements. Arbitration can reduce defense costs and permit meritorious claims to be resolved quickly by expert panels at little or no net cost to taxpayers. Most importantly, industry-sponsored arbitration in the securities broker-dealer industry under Securities and Exchange Commission (SEC) supervision provides investors with a fair process for the resolution of securities claims. In short, arbitration can enhance the quality of justice available in this vital area as well as protect incipient capital formation from the costs of "strike suits.

It is interesting that Prof. Ramirez concerns were not derived from his conclusion that under the current system, defendants are being abused and bled white but, rather, that investors (*i.e.*, plaintiffs) often don't receive a fair shake.

The SEC's 1990 Objections

Thomas Riesenberg, an Assistant GC at the SEC, wrote an article explaining the legal grounds for the SEC's resistance to arbitration clauses in corporate charters.[31] He presented four arguments as to why such clauses should not be permitted: (i) anti-waiver provisions of the federal securities laws preclude arbitration clauses in corporate charters; (ii) federal case law precludes shareholders from collectively waiving access to a judicial forum to assert federal statutory rights; (iii) corporate charters may not create

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> litigate more cheaply than the defendants. First, the financial burdens associated with discovery fall more heavily on the defendants. Without much time or effort, the experienced plaintiffs' attorney can prepare a voluminous list of interrogatories and demand production of crates of documents. Responding to these requests takes more time; files must be searched, answers drafted, and objections made. Witnesses must also be prepared for deposition, and this can involve a rehearsal process that exceeds the length of the actual deposition. Second, the defendants will frequently need to engage multiple counsel: one for the parties involved in the specific transaction, another for the outside directors who approved it, and special counsel for the corporation (and possibly another for its special litigation committee). … Overhead is a third difference. Typically, the principal defendants will be represented by the corporation's normal outside counsel (because it is familiar with the transactions at issue); this institutional firm will typically have expensive hourly rates and a professional tendency toward meticulous preparation for any litigation, whatever its size. In contrast, because the plaintiff's attorney is the engine that runs the derivative action, he is better able to minimize his own out-of-pocket expenses and may engage in only minimal pretrial preparation when his real goal is an early settlement. The contrast here is between extensive pretrial preparation on the defendant's side and a form of feigned litigation that sometimes occurs on the plaintiff's. Although the plaintiff's side may make extensive discovery requests, it does not follow that the plaintiff's attorney will always review carefully the documents he requests. To be sure, he must appear to be serious about the case or he will sacrifice some negotiating leverage, but the distance between appearance and reality can be considerable."

See Coffee, n. 11 *supra*. at p. 17.

[30] Ramirez, *supra* note 2, at 1061.

[31] Riesenberg, *supra* note 12 at 2.

binding contractual waivers of access to court; and (iv) where the underlying private right of action is to deter wrongful conduct rather than to compensate victims, arbitration cannot be required.[32]

Mr. Riesenberg argued that corporate charters containing arbitration agreements are unenforceable against shareholders because anti-waive provisions in federal securities laws void any such agreement whenever arbitration is inadequate to protect federal rights.[33] He reasoned that arbitration procedures are unfavorable to investors due to a lack of SEC oversight authority over shareholder/issuer disputes[34] and cited *Shearson/American Express v. McMahon*[35] to support his argument that statutory anti-waiver provisions may void agreements binding them to arbitration.

Mr. Riesenberg's second argument was that it is doubtful "whether shareholders can be required collectively, as opposed to individually, to waiver access to a judicial forum to assert a federal statutory right."[36] He asserted that an investor who waives the right to a class action suit by purchasing shares in a corporation is analogous to a worker who waives the same right through a collective bargaining agreement. Citing *Barrentine v. Arkansas-Best Freight System*,[37] he argued that the Supreme Court "distinguished between situations in which persons individually agree to arbitrate their individual federal statutory claim and a situation where the plaintiff had been forced to arbitrate his claim because of a collective agreement."[38]

Mr. Riesenberg's third argument was that corporate charters do not create binding contractual waivers of access to court. His essential premise was that no contract arises when shareholders purchase shares in a corporation; since shareholders do not sign any document agreeing to the terms of the charter when they purchase shares, they have no notice of the charter's terms and therefore cannot be bound by any provision requiring arbitration. This argument focused on the threshold question of whether the parties agreed to submit to arbitration, an issue decided under state law.[39]

Finally, Counsel Riesenberg cited the familiar contention that the class action is necessary to deter wrongful conduct. He argued: "the Supreme Court suggested that where the Congressional purpose underlying the private right is primarily to deter wrongful conduct rather than to compensate the victim, arbitration cannot be required."[40] This distinction is based on the rationale that, despite the general policy in favor of arbitration as reflected in the Federal Arbitration Act, arbitration "cannot provide an adequate substitute for a judicial proceeding in protecting" certain federal statutory and constitutional rights.[41] Shareholder claims, where the allegedly unlawful conduct is likely to involve public dissemination of false information or false filings with the Commission, generally involve numerous victims and may,

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[32] *Id.*
[33] *Id.*
[34] *Id.*
[35] 482 U.S. 220 (1987).
[36] *Id.*
[37] 450 U.S. 728 (1981).
[38] *Id.*
[39] *See* Charles Davant IV, "Tripping on the Threshold: Federal Courts' Failure to Observe Controlling State Law Under the Federal Arbitration Act," 51 *Duke LJ*. 521, 522 (2001) (noting that the Supreme Court indicated in *Perry v. Thomas*, 482 U.S. 483 (1987), that state law "governs the threshold question of whether parties agreed to submit their disputes to arbitration.").
[40] *Mitsubishi Motors Corp. v. Soler Chrysler Plymouth, Inc*., 473 U.S. 614, 635-36 (1985); McMahon, 107 S.Ct. at 2343-46.
[41] *McDonald v. City of West Branch*, *Michigan*, 466 U.S. 284, 290 (1984).

more so than is the case as to broker/customer claims, bear on the integrity of the nation's securities markets as a whole.[42] Because such misconduct directly undermines the disclosure and antifraud purposes of the federal securities laws, actions based on such conduct should be viewed as primarily deterrent in purpose and should not be subject to mandatory arbitration.

The Issues: Legal and Policy

(i) Compulsory Arbitration is Against Federal Law

Mr. Riesenberg's arguments are based largely on *Shearson/American Express v. McMahon*.[43] In *McMahon*, the Supreme Court permitted arbitration of a claim based on the substantive rights of the 1934 Exchange Act due to pre-dispute arbitration agreement between the parties.[44] Investor McMahon brought § 10(b) claims against broker Shearson. The District Court rejected McMahon's contention that the arbitration agreement between the parties was an unenforceable adhesive contract and held that the claim was arbitrable.[45] McMahon appealed arguing that since § 27 of the Exchange Act granted the district court jurisdiction over claims arising from the Act, arbitration was precluded because § 29 voids any waiver of rights under the Act. The Court rejected this argument noting that the provision granting jurisdiction to district courts was not a statutory duty covered by the anti-waiver provision in § 29.[46] In other words, the jurisdiction provision in § 29 simply means that if litigants assert their statutory rights in court, district courts have jurisdiction. The anti-waiver provision does not negate the ability to agree to arbitration, an alternative strongly encouraged by the Federal Arbitration Act. Mr. Riesenberg argued that the Court reached its conclusion solely on the existence of adequate procedures for broker/dealer arbitration.[47] He ignores the fact that the Court's focus on the broker/dealer context was an effort to distinguish its holding from that of an earlier case, *Wilko v. Swan*, where it held that a pre-dispute arbitration agreement could *not* be enforced under § 12 of the Securities Act (the analog of § 27 of the Exchange Act) due to an anti-waiver provision in § 14 (the analog of § 29 of the Exchange Act). *McMahon* and *Wilko* reached the opposite conclusions despite very similar facts, a reversal the Court attributes to the progression of arbitration. The *McMahon* Court explained that the Federal Arbitration Act was intended to end judicial hostility towards arbitration agreements and render them as binding as other contracts.[48] It breathed life into arbitration agreements by stating that they "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."[49] The Act established a federal policy favoring arbitration[50] even where parties raise claims based on statutory rights.[51] The holding in *McMahon* was not premised on the narrow argument that

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[42] *See e.g., Globus v. Law Research Service, Inc*., 418 F.2d 1276, 1288 (2d Cir. 1969), cert. denied, 387 U.S. 913 (1970) ("Civil liability under section 11 [of the Securities Act] and similar provisions [was] designed not so much to compensate the defrauded purchaser as to promote enforcement of the Act and to deter negligence by providing a penalty for those who fail in their duties.")
[43] 482 U.S. 220 (1987).
[44] *Id.* at 229.
[45] *Id.* at 224-5
[46] *Id.* at 228
[47] *Id.* at 234. Mr. Riesenberg quotes the following from *McMahon*:

> We conclude that where, as in this case, the prescribed procedures are subject to the Commission's Section 19 authority, an arbitration agreement does not effect a waiver of the Act.

[48] *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 226 (1987).
[49] 9 U.S.C. § 2.
[50] *McMahon* at 226.
[51] *Id*.

arbitration had become more effective within the broker/dealer context but was a broad acknowledgment of arbitration's effectiveness *in general*.[52] The Court acknowledged that "[i]t is difficult to reconcile *Wilko's* mistrust of the arbitral process with this Court's subsequent decisions involving the Arbitration Act … ." Indeed, most of the reasons given in *Wilko* have been rejected subsequently by the Court as a basis for holding claims to be nonarbitrable."[53]

Mr. Riesenberg also cites *Rodriguez de Quijas v. Shearson/American Express, Inc.*[54] to support his argument that securities statutes preclude investors from waiving judicial remedies in favor of arbitration. But *Rodriguez* was even more adamant than *McMahon* in dismissing the premise that arbitration is ineffective. In *Rodriguez*, the Supreme Court applied the rationale from *McMahon* to § 14 of the Securities Act and held that it did not void a pre-dispute arbitration agreement,[55] a conclusion diametrically opposed to *Wilko. Rodriguez* declared that, "To the extent that *Wilko* rested on suspicion of arbitration as a method of weakening the protections afforded in the substantive law to would-be complainants, it has fallen far out of step with our current strong endorsement of the federal statues favoring this method of resolving disputes."[56] Since these cases acknowledge the general effectiveness of arbitration they undermine the basic premise of Mr. Riesenberg's argument that corporate charters cannot bind shareholders to arbitration because it is an ineffective method of resolving disputes.

Since the publication of Mr. Riesenberg's article, case law has been increasingly supportive of arbitration in a variety of circumstances.[57] The reason is rooted in a common sense appraisal of judicial attitudes, that judges are human. "As cases cascade over the dockets of the modern district judge, innovations that will reduce judicial strain are increasingly welcome."[58]

(ii) <u>Lack of Notice</u>

Riesenberg's argument on the issue of notice does not appear particularly powerful. One can argue that shareholders, like broker dealer customers, are likely to be in fact unaware of the arbitration provision. Nonetheless, it is highly likely that the issue will be reported in financial and mainstream media and that companies so adopting the procedure will be recognized as belonging to the category of adopters … as are companies with poison pills, staggered boards and disparate voting rights. If the arbitral procedures are standardized and publicized under the supervision of the SEC, knowledge that such a provision exists in the first instance can be deemed to include knowledge of the procedures themselves at least for any alert shareholder. Thus, an influential commentator on this subject, Professor Myriam Gilles, in a 2005 article in *The Michigan Law Review*, remarked:[59] …

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[52] *Id.* at 232.
[53] *Id.*
[54] 490 U.S. 477 (1989).
[55] 490 U.S. 477, 481 (1989).
[56] *Rodriguez* at 481.
[57] *Buckeye Check Cashing Inc. v. Cardegna*, 126 S.Ct. 1204, 1207 (1995) (holding that § 2 of the Federal Arbitration Act, "embodies the national policy favoring arbitration"); *Green Tree Financial Corp-Alabama v. Randolph*, 531 U.S. 79 81 (2000) (purpose of Arbitration act was to "reverse longstanding judicial hostility to arbitration agreements" and establish a "liberal federal policy favoring arbitration agreements.").
[58] McLaughlin & Hartmere, "Accidental Waiver of Right to Arbitrate," *2006 New York Law Journal*, 12/19/2006.
[59] *See* "Opting Out Of Liability: The Forthcoming, Near-Total Demise Of The Modern Class Action," 104 *Mich. L. Rev*. 373.

> [C]lear notice shouldn't be very difficult at all. I can imagine, for example, a NASDAQ website listing companies who have elected to 'opt out' of class action exposure. Perhaps (somewhat formalistically) courts would require securities to bear legends reflecting the opt out. Certainly, actual notice could easily be provided by issuers to the stock exchanges, investment banks, and brokerage houses, all of which might be obligated to notify their customers in some broad fashion. Ultimately, companies could simply amend their corporate charters to give notice of the collective action waiver.

and Prof. Coffee has remarked:

> Lack of notice of the arbitration provision could be easily cured by issuing stock certificates with an appropriate warning. Although many shareholders never physically see their certificates, the SEC could promulgate regulations requiring brokers to notify purchasers about the arbitration terms. In any event, the notice issue appears less important in the context of an IPO because actual consent to arbitration can be secured. If an arbitration provision is created at the birth of a corporation, future shareholders cannot claim that their rights were diminished while they owned the shares. [60]

(iii) Lack of an 'Agreement'

A related question is whether, for purposes of the Federal Arbitration Act, the charter and bylaws, coupled with adequate notice, is an 'Agreement.' The Act provides that a dispute must be resolved by arbitration only if the parties agreed to submit the matter to arbitration.[61] Presumably, then, shareholders who dispute the contractual nature of a corporate charter binding them to arbitration may avoid being subject to the Federal Arbitration Act because no "contract" ever existed.

However, recently the Supreme Court in *Buckeye Check Cashing, Inc., v. Cardegna*[62] held that "a challenge to the validity of the contract as a whole, and not specifically to the arbitration clause, must go to the arbitrator."[63]

Shareholders may attempt to escape arbitration by arguing that (i) no corporate contract arose because the shareholder lacked notice of the provision requiring arbitration and therefore never accepted its terms and that (ii) recognizing such a contract would be "unconscionable." The notice issue is dealt with *supra*.

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[60] John C. Coffee Jr., "Arbitration and Corporate Governance," *NYLJ*, May 31, 1990.

[61] *First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938, 944 (1995) (holding the litigant who did not personally sign an arbitration agreement was not subject to arbitration and stating, "When deciding whether the parties agreed to arbitrate a certain matter (including arbitrability), courts generally … should apply ordinary state-law principles that govern the formation of contracts.").

[62] 126 S. Ct. 1204, 1208 (2006).

[63] *Id.* at 1210.

> This [Buckeye] leaves open the possibility that a shareholder may use state law to specifically challenge an arbitration clause thereby gaining direct access to the courts. But even if a shareholder challenged the existence of an arbitration agreement, there are common law doctrines that bind non-signatories to arbitration agreements such as incorporation by reference, assumption, agency principles, veil-piercing and estoppel.

Davant at 532.

And, Professor Shell has offered powerful rebuttals to both of the above arguments.[64] He pointed out that:

> … failure to read a corporate charter does not negate its contractual nature.[65] Additionally, the terms of the charter are presumably factored into the share price so the shareholder 'gets what he pays for.' One could argue that a corporate charter should not be a literal contract simply as a matter of policy but courts have upheld arbitration provisions in the bylaws of numerous private associations including labor organizations, religious groups, realty boards and securities exchanges.[66]

This issue was recently addressed in an article in 20 *Insights* 4 (Apr. 2006) p. 8, entitled, "Arbitration Bylaws to Bar Shareholder Class Actions," by Cyril Moscow. Moscow refers, in turn, to the law review article in *The Michigan Law Review* by Prof. Gilles cited above. Mr. Moscow's article cites post 1990 developments, including Congressional concern over class action abuse, resulting in passage of the Private Securities Litigation Reform Act of 1995, the Securities Litigation Uniform Standards Act of 1998, and the Class Action Fairness of Act of 2005. He concludes that a waiver will constitute an "agreement" under the Federal Arbitration Act. He notes that:

> As recently as February 2006, the Court held that it was up to the arbitrator to determine whether an entire consumer agreement containing an arbitration clause was illegal. Following these cases and assuming that a charter or bylaw provision[67] would be deemed to be an agreement to arbitrate, a bylaw arbitration clause should be enforceable under state and federal law.

And, according to Professor Gilles:

> Courts following the reasoning exemplified in Judge Easterbrook's *Hill* decision have not hesitated to recognize binding arbitration clauses that obligate a plaintiff-consumer to arbitrate claims against a defendant-manufacturer, where the clause was contained inside (or on) a box that she bought at a third party retailer.[68] On this three-sided model, there is not necessarily any contract between consumer and manufacturer (although there may be a warranty or some ongoing service component); the only real contract is between the consumer and retailer. All that really matters to the court is that the consumer acts (or refrains from acting) while on notice that the terms and conditions established by the manufacturer include arbitration. It is a fiction to speak of an "agreement" to arbitrate between the plaintiff and the manufacturer, although courts often do.[69] What judges really

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[64] G. Richard Shell, "Arbitration and Corporate Governance," 67 *N.C.L.Rev*. 517, 545 (1989).
[65] *Id.*
[66] *Id.*
[67] Moscow suggests either the charter or the by-laws. I submit that both should be involved if the provision is to be deemed an agreement binding shareholders, the charter is the more appropriate instrument. The bylaws bind the directors, who adopt and patrol them, and the managers whom they employ.
[68] *See, e.g., Cavalier Mfg., Inc. v. Clarke*, 862 So. 2d 634 (Ala. 2003) (compelling arbitration of claim brought by mobile home purchaser against manufacturer, even where manufacturer was not party to the retail installment contract in which the arbitration clause appeared).
[69] In *Ross v. Bank of America*, for example, plaintiff cardholders allege that they never entered into valid and binding agreements to arbitrate disputes:

> mean is that the manufacturer clearly announced the terms and conditions that attach to its product, and the consumer--on notice of those terms--accepted the product or elected not to return it. The requirement of privity is replaced by a "notice-plus-acceptance" test.[70]

Prof. Gilles goes so far as to predict that compulsory arbitration is enforceable even in cases where companies send out unilateral amendments to consumers under "change-in-terms" provisions--that is, contractual clauses that give companies the right to alter the terms of the agreement on written notice to the consumer.[71]

> Delaware (whose law would be designated to control the contracts of any Delaware-chartered bank or corporation) has enacted a statute that expressly authorizes the addition of arbitration clauses through change-in-terms provisions.[72]
>
> In the end, then, I think the cases refusing to recognize unilaterally imposed arbitration clauses are no more than speed bumps on a road inevitably leading away from traditional contract principles in the area of arbitration.[73] Courts have already recognized a number of circumstances under which nonsignatories may be bound to arbitration agreements,

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> While defendants agreed between and among themselves to impose arbitration clauses, plaintiffs and other members of the class did not affirmatively agree to accept them. Defendants imposed the arbitration clauses on their cardholders in a manner designed to avoid detection by cardholders. The clauses were either engrafted onto existing cardholder agreements through change in terms notices or buried in the cardholder agreements of new cardholders. By hiding the arbitration clauses in change in terms announcements and cardholder agreements, defendants did not reasonably inform their cardholders of the arbitration clauses or their consequences. Either way, Plaintiffs and other members of the Class did not "agree" to the arbitration clauses. The clauses are never signed by any "party" to them. Silence on the part of cardholders is not evidence of an "agreement" to arbitrate.

Complaint PP125-26, *Ross v. Bank of Am.*, No. 05 CV 7116 (S.D.N.Y. Aug. 21, 2005).

[70] Professor Stephen Ware describes this as a "hub-and-spoke" version of contracting:

> [A]utomobile insurance companies could have an enormous impact on negligence law if all their insurance policies had arbitration clauses making all the company's other policyholders third-party beneficiaries. Then an auto accident involving, for instance, two Allstate customers would go to arbitration, not litigation. If all the insurers contracted with each other, they could extend this arbitration system to accidents involving customers of different insurers.... Nor would insurers have to be the only hub of hub-and-spoke arbitration agreements. A magazine could be a hub with spokes connecting all its subscribers. Mastercard could be a hub with spokes connecting all its cardholders.

Stephen J. Ware, Default Rules from Mandatory Rules: Privatizing Law Through Arbitration, 83 Minn. L. Rev. 703, 752 (1999) (footnote omitted).

[71] *See Stone v. Golden, Wexler & Sarnese*, 341 F. Supp. 2d 189 (E.D.N.Y. 2004); *Perry v. FleetBoston Fin. Corp*., No. 04-507, 2004 U.S. Dist. LEXIS 12616 (E.D. Pa. July 6, 2004); *Long v. Fid. Water Sys., Inc.*, No. C-97-20118, 2000 U.S. Dist. LEXIS 7827, at 9 (N.D. Cal. May 26, 2000); *Badie v. Bank of Am*., 79 Cal. Rptr. 2d 273 (Ct. App. 1998); *Discover Bank v. Shea*, 827 A.2d 358 (N.J. Super. Ct. Law Div. 2001); *Sears Roebuck and Co. v. Avery*, 593 S.E.2d 424, 426 (N.C. Ct. App. 2004).

[72] *See* Del. Code Ann. tit. 5, § 952(a) (2005) (Delaware statute expressly authorizes addition of arbitration clause through this method).

[73] And of course, as collective action waivers proliferate over time, there will be less need to impose such clauses through unilateral change-in-terms provisions. Such unilateral amendments simply accelerate the pace at which the waivers may become commonplace.

> including the assumption by a nonparty of rights and responsibilities under a contract that contains an arbitration clause.[74] This is not a distant leap from a doctrine holding that a collective action waiver "travels with the stock," as part of the basket of rights purchased by the shareholder in the open market when he purchases a company's common stock.

Deterrence

The deterrence argument can be turned on its head. The deterrence which concerns me is the deterrence to corporate shareholders, directors and management to bring their companies public in the United States. A case in point: I will not name the company, as it remains private. But I will testify that the following description is accurate in all material respects:

A highly successful venture-backed company is contemplating a public offering, with a market capitalization somewhere in the area of $200 or $300 million. Underwriters are beating a path to the company's door. The company's owners consist primarily of the founder; the managers; and a significant private equity fund based in the Southwest, owning a sizeable chunk, although not controlling, of the company's stock. The fund has made it known that, assuming the company does elect to go public in the U.S., it will seek a buyer for its position prior to the offering. Preliminary negotiations in that respect have indicated that the fund will end up with a haircut amounting to the tens of millions of dollars … comparing the price of the private sale versus the market value of the fund's holdings once the company is public. There is no suggestion that fund's thinking is driven by a fear that the company's shares, once public, will tank; it is not that kind of a company. In fact, the reverse is more likely. Nonetheless, the fund's managers, themselves highly experienced in the game, want no part of the stewardship of a U.S. public company.

Indeed, since Riesenberg's article, there have been any number of quite fierce and Draconian results deterring bad conduct by the management of U.S. public companies. It is hard, indeed impossible, to understand how strike suit litigation adds much to the civil and criminal penalties under Sarbanes-Oxley. On this point, let me stress again that no critic, certainly not I, is arguing that actions by defrauded shareholders should be curtailed. Fundamental to enlightened securities regulation in this country is the following proposition:

> As James Landis, the principal author of U.S. securities laws, recognized, making private recovery of investors' losses easy is essential to harness the incentives of market participants to enforce securities laws.[75]

The Proposal advanced in this paper is designed to make it easier for investors to recover their opportunity to make their claim not usurped by the instantaneous filings of professional class action firms, most of which rarely, if ever, actually go to trial. The trick, again, is to offer up one venue, experienced triers of fact, expedited procedures, fair to both sides. Quoting one of the several commentators:

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[74] The Second Circuit, for example, has thus far recognized five theories for binding nonsignatories to arbitration agreements: 1)incorporation by reference; 2)assumption; 3)agency; 4)veil-piercing/alter-ego; and 5) estoppel. *See Smith/Enron Cogeneration Ltd. P'ship, Inc. v. Smith Cogeneration Int'l, Inc.*, 198 F.3d 88, 97 (2d Cir. 1999); *Thomson-CSF, S.A. v. Am. Arb. Ass'n*, 64 F.3d 773, 776 (2d Cir. 1995); *In re Currency Conversion Fee Antitrust Litig*., 265 F. Supp. 2d 385, 401-02 (S.D.N.Y. 2003).

[75] Porta, Lopez-de-Silanes, Shleifer, "What Works in Securities Laws?" LX!, 1 *The J.of Fin* .(Feb. 2006).

> … attorneys often bring meritless derivative suits against corporations just to extort a settlement. All too often, this technique is successful; empirical studies and practical experience have led to a growing consensus among judges and academics that shareholder litigation is open to abuse by plaintiffs and their attorneys to a greater extent than are other fields of civil litigation. Among shareholder suits, derivative suits are the most likely to be frivolous.
>
> Plaintiff's attorneys are the controlling force I shareholder litigation, and like most other actors in the economy, including corporate managers and shareholders, they are often motivated by the prospect of personal financial gain or loss. There is nothing necessarily wrong with this motivation; indeed, it's the motivation we have come to expect, and at times even revere, in our capitalist system. However, unlike in private sector markets where the "invisible hand" turns individual avarice into societal wealth, in the legal system policymakers must take care to craft rules that turn attorneys' self-interest into wealth-maximizing behavior. We must create incentives that reward efficient, wealth-creating activities and deter inefficient, wealth-destroying activities.[76]

"Unconscionable Contracts of Adhesion"

Another way of expressing the fairness point is to claim that a charter provision is a "contract of adhesion" and it is "unconscionable" to hold a shareholder to it, regardless of actual or constructive notice. A similar argument in the context of a brokerage firm arbitration agreement with a customer was found to be so frivolous that Rule 11 monetary sanctions were imposed upon the plaintiff customers and their counsel. *Mastrobuono v. Shearson Lehman Hutton, Inc.,* No. 89 C 0773, 1989 U.S. Dist. LEXIS 14432 (E.D.Mo. Dec. 1, 1989) (investors were presumed to be aware of existence and effect of arbitration agreement in brokerage firm agreements they signed; broker had no special duty to highlight or explain clause). As a practical matter, it would be far easier for an investor to find an alternative to the company's stock as an investment opportunity, if he objected to the company's arbitration provision, than it would be to find a broker that did not insist on an arbitration agreement.

Moreover, in the leading California case on "unconscionability," *Armendariz v. Foundation Health Psychcare Services, Inc.*[77] the California Supreme Court upheld the enforceability of an employer/employee agreement subject to "minimum standards," *viz*:

> The arbitrator must be neutral.
>
> There must be adequate discovery sufficient to permit the employee to prove his/her claims.
>
> There must be a written decision that would permit limited judicial review.
>
> The clause must not limit or exclude any type of relief that would be available in court.
>
> The employer must pay any costs that are unique to arbitration (such as the arbitrator's fee or the fees of the alternative dispute resolution provider.

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[76] Smith, _____ *supra* at 2.
[77] 24 Cal. 4th 83 (2000). *See* Roberta Hayashi, presentation at a PLI Conference, "Drafting Corporate Agreements," 2006.

Leaving the last aside as inapplicable, the Proposal is designed to satisfy all such minimum standards … and more.

Further, as Prof. Schell points out,[78] publicized arbitration awards send a deterrent signal just like cases decided in court. The deterrence argument is then reduced to the fact class action plaintiff's counsel can get more money and, therefore, impose greater penalties on the corporation than if arbitration were the norm in any given case. However, the problem is, again as Schell points out, it is typically the corporation, meaning its shareholders, which winds up paying the piper. The directors and executives are protected by D&O insurance and the cost of that insurance is passed along to the corporation, in the form of higher premiums, if there is an award. Since the corporation is owned by the shareholders the actions typically involve a transfer of wealth from one shareholder group to another … or, more to the point, from the corporation and its shareholders to plaintiff's counsel.

Fairness To The "Little Guy"

Absent the possibility of class action participation, the ''little guy'' … who has lost, say a couple of thousand dollars … will be out of luck. There is not enough at stake to get a lawyer to advance her claim, $2,000 may be a very significant number to the individual concerned but nonetheless not robust enough to admit the victim to the party. On the surface, this would appear to be an unhappy result.

However, the ''little guy'' is going to have fewer opportunities to buy the stock in our markets, as companies are increasingly unlikely to float in the United States; the 'little guy,' unless participating through a mutual fund or some other institutional manager, is not going to be placing orders on The AIM or the Hong Kong Stock Exchange. More importantly, and testifying from personal experience, I have held equity securities in my personal accounts for 40-some odd years and, in at least a few cases, have been swept up into a class action lawsuit. I have yet to see recovery personally, however, of more than $10 or $15; every now and then I get a small check but never more than that. I am not a major investor, of course, but neither is the 'little guy' we are talking about. With the current class action structure the odds against the 'little guy' realizing any personal money are so remote that allowing arbitration will hardly make matters worse.

Derivative Actions

On the issue of arbitration of derivative actions, Prof. Schell suggests that the arbitrators should be free to impose the typical restrictions designed under corporate law to prevent frivolous derivative actions … including contemporaneous ownership, "security bonds, demand requirements, and court approved [in this case arbitration board approved] settlements."[79]

Discovery

One objection is that arbitration procedures may be inadequate in terms of pre-trial discovery to handle complex cases; the rebuttal again is to give the arbitrators the power to handle complex cases and to insist on pre-trial procedures. The American Arbitration Association's commercial arbitration rules make no provision for mandatory evidentiary discovery. However, arbitrators have the power to provide for document production and depositions. Indeed in Delaware, Section 220 of the G.C.L. provides liberal

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[78] Schell, n. 55, *supra* at 564.
[79] Schell, n. 55 *supra*, at 564

(although not unrestricted, of course), discovery to any shareholder of a Delaware corporation. The idea is to provide for fair and expeditious discovery and not of the kind which is designed to wear the other side out.

Thus, disputes between stock brokers and their customers are most often resolved through arbitration. In these cases, the discovery process has grown more sophisticated and explicit[80] to account for the fact that plaintiffs are often small time customers with little hard evidence at the outset of a suit. The industry has managed to accommodate the discovery needs of investors in suits against brokers and there is no reason to believe the same would not occur in other actions. After all, it is in the interest of all parties to foster arbitration as an alternative to painful litigation. And if industry fails to work out the kinks, the SEC may protect investors by enacting thorough discovery procedures.

Litigation Concerning The Panel's Jurisdiction and Procedures

One of the problems about collection action waivers is the possibility that litigation over the arbitration procedures themselves will be wasteful, inefficient and time consuming. At my prior law firm, one of the more prominent litigators was a specialist in litigating the meaning and coverage of arbitration provisions in specific cases. I take Prof. Schell's point that arbitration involving complex cases "take a long time to resolve and can be just as expensive as court trials."[81] However, the object of the Proposal is not necessarily about the money. That said, I submit an appropriately drafted set of rules will make the process much more efficient and expeditious. The idea is to, again, to level the playing field … to give the defendant at least a chance for a day in court, to run this case before an experienced panel and to defend in one venue rather than face the probability, absent a rich settlement, of multiple jury trials in multiple state or federal courts.

In Allied-Bruce Terminex Companies, Inc. v. Dobson[82] the Supreme Court made it clear that the scope of the Arbitration Act is commensurate with Congress' broadest permissible power under the Commerce Clause. There is no reason to carve out an exception for securities arbitration. More recently in Green Tree Financial Corp. v. Bazzle, the Court held that the Federal Arbitration Act permits class-wide arbitration where an arbitration clause does not clearly preclude class arbitration.[83] This indicates that a corporate charter binding shareholders to arbitration would also be permissible. One possible challenge to the collective action waiver could be that judicial enforcement of arbitration is state action thus raising due process and equal protection issues. But "[e]very federal court considering either question has concluded that there is no state action present in either securities or contractual arbitration."[84]

Interim Report of the Committee on Capital Markets Regulation

Attached as Appendix A are the relevant excepts from the Interim Report on the Committee Capital Markets Regulation, chaired by Prof. Hal Scott and Glen Hubbard. The entire report is available at:

[80] Barbara Black, *The Irony of Securities Arbitration Today: Why do Brokerage Firms Need Judicial Protection?*, 72 U. Cin. L. Rev. 415, 449 (2003).
[81] Schell, n. 55 *supra* at 572-753.
[82] 513 U.S. 265, 273-4 (1995).
[83] 539 U.S. 444, 454 (2003). For an in depth analysis of *Green Tree*, *see* Imre S. Szalai, *The New ADR: Aggregate Dispute Resolution and Green Tree Financial Corp. v. Bazzle*, 41 Cal. W. L. Rev. 1 (2004).
[84] Sarah Rudolph Cole, *Fairness in Securities Arbitration: A Constitutional Mandate?*, 26 Pace L. Rev. 73, 75 (2005). *But see* Sternlight, *As Mandatory Binding Arbitration Meets the Class Action, Will the Class Action Survive?*, 42 *Wm. & Mary L. Rev*. 1, 53 (2000) (arguing that there are due process concerns).

http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf. The Interim Report has long been anticipated given the prestige of the Committee members including a number of leading academics and former government officials. On the subject matter discussed in this memorandum, Tort Reform, the Committee had the following to say.

> The Committee recommends that the SEC should permit shareholders to adopt alternative procedures for resolving disputes with their companies. These procedures might include arbitration (with or without class actions) or the waiver of jury trials (a waiver commonly made in a variety of circumstances). The Committee recognizes the difficulties that will be faced by shareholders in deciding whether to adopt alternative procedures. For example, arbitration usually does not permit summary judgment and there is no appeal. These costs would have to be weighted against the possible benefits of reducing burdensome litigation. Although the decisions may be difficult, the Committee believes that shareholders should have the right to choose, particularly given the current high cost to shareholders of litigation.
>
> With respect to IPOs, there could be a vote on amending the corporate charter and by-laws at the first shareholder meeting after the IPO, which could be a special meeting. Requiring a vote on a charter amendment, rather than dealing with the issue through a covenant in the IPO, will help ensure that the issue receives the required attention apart from the multiplicity of factors that influence the decision to buy stock in an IPO. For existing companies, shareholders would be free to vote on alternative remedies at a properly called meeting.

The Proposal comes out at the same place as the proposal in the Interim Report, but with two important procedural differences.

First, if the issue of amending the charter is put to the shareholders post the IPO, then the SEC's position on accelerating the effectiveness of registration statements is, arguably, no longer relevant. The registration statement is already effective, prior to the date the shareholder vote is scheduled and the Commission, if it wants to object, would have to bring in an independent proceeding … presumably to invalidate or otherwise restrain the vote. The registration statement and prospectus will signal to the shareholders that the matter was going to be put to a vote at some future date, at a special meeting as suggested in the Report.[85]

Secondly, in my view a vote of only a majority of the shareholders is more vulnerable than if, at some point in the Company's existence, one hundred percent of the shareholders have agreed to compulsory arbitration. It is for this reason that the instant Proposal contemplates unanimous agreement on the draft charter provisions (see suggested model, attached as Appendix B), with notice to all shareholders who elect to buy or otherwise acquire shares in the Company from that date forward that the compulsory arbitration provision exists. Under those circumstances assuming again that notices are widely enough promulgated that the acquirors of Company shares have either actual or effective constructive notice, there cannot be a claim that anybody has put money up under, if you will, false pretences.

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[85] The Report goes on to say, in the last sentence of the excerpt quoted above, that for existing public companies, compulsory arbitration through a Charter Amendment is recommended or at least not opposed as a solution to the problem if at a special or the annual meeting the shareholders, properly informed, vote to do so.

Moreover, by including the provision in the Charter when the Company initially registers to become a public company, this allows the SEC to assert its authority, using its acceleration provisions as the hook, over the all important arbitration procedures the agency thus acting as a back stop in case for any reason improvements are needed to enhance the fairness and equity of the procedures. There is some evidence, for example, that, in NASD arbitration with customers claiming against their broker, the broker wins something like 95 percent of the time. If that were to be the experience in this case, one would want the most logical agency, the SEC, to have the ability to step and massage the rules so that both claimant and defendant have an equal and fair opportunity to present their case.

Conclusion

My arguments in favor of the Proposal include:

- It will significantly help stem the flight of IPOs to offshore trading platforms

- It leaves Sarbanes-Oxley alone.[86] The fix on that score is well within the Agency's legitimate powers and conceded jurisdiction … to cut waste and expense while leaving the protections in tact or, as Chairman Cox puts it, strengthening companies rather than draining resources.[87]

- It involves no heavy bureaucratic gymnastics. The existing policy, informally announced in the first instance, is simply amended (informally or formally; I am indifferent) so as to fix a major, otherwise hard-to-fix (as a practical matter) deterrent to the robust health of U.S. IPOs.

- It retains jurisdiction in the SEC to protect the public interest: Thus,

  > If the SEC were responsible for overseeing the arbitration of investor claims involving publicly-traded companies, it would begin with some key advantages. The SEC is widely perceived to be a tough, fair, and efficient industry watchdog. The SEC has established itself generally as a pro-investor agency over the years. The SEC already has a long history in supervision arbitration in a balanced fashion. With this reputation, any SEC-operated arbitration forum would start out as presumptively fair. The SEC also has a specific mandate from Congress to use its expertise to stem fraud in the securities markets: Rule 10b-5.[88]

- It focuses on IPOs, avoiding Professor Coffee's problems with provisions imposed retroactively on minority shareholders in already public companies.[89] Note that the flight of IPOs is the problem being addressed.

- Finally, and most importantly, the Proposal is an improvement over the current hit-or-miss, free-for-all, 'Lawyer Relief Act' system. To express this critical point, it is hard to improve on Prof Ramirez's summary:

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[86] There is a piece in a recent *CFO Magazine* which makes the point that a number of CFOs are glad to see SOX on the books. No longer can the CEO pull the CFO off in a corner, ask him or her to "make the numbers" and threaten loss of job if the CFO objects.
[87] Cox, quoted in *The Deal*, Vol. 4:, No. 22, p. 14 (May 15-May 26, 2006).
[88] Ramirez n. 2 *supra* at 1122.
[89] Coffee, "Arbitration and Corporate Governance," *NYLJ* 5: (5/31/90).

> [S]ecurities disputes appear to be ideally suited to arbitration. First, this is an area where expert adjudicators have the ability to extend a higher quality of justice because of the complexity and specialized nature of these disputes. Courts have recognized the shortcomings of juries in the context of sophisticated business litigation. One court even held that in certain cases due process could be denied if a case is of sufficient complexity as to be beyond the ken of a typical jury. Securities litigation often may qualify as such a case. It often demands knowledge of sophisticated business techniques and financial analysis, as well as how such factors may affect a company's securities. Highly qualified experts with advanced business degrees may be called upon to testify. Depending upon the business involved, a case may require expertise in biotechnology, computer engineering, or the oil industry. Arbitration seeks to substitute expert fact finders for lay fact finders. This may not only enhance the quality of justice available but also lower the cost of adjudication.[90] Using experts in this way does not in any way call into question the abilities of jurors. In fact, specialized arbitrators also may be preferable to judges. An arbitrator who is an accountant is likely to know what motivates accountants better than a judge without an accounting background.[91] In any event, comparisons between juries and arbitrators are misplaced. Under the PSLRA, juries only hear securities claims. Arbitration of these disputes thus is more democratic than the current dispute resolution regime.
>
> Second, this is an area that can limit litigation costs by requiring standardized discovery. Transactions involving securities of publicly-traded companies produce predictable sources of documentary evidence.[92] For example, investment bankers and other professionals usually are involved in material transactions and compile extensive 'due diligence' files containing the findings of their investigations.[93] Similarly, attorneys and accountants maintain detailed files containing relevant, nonprivileged information.[94] These documents can be produced at the outset of every

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[90] See Kenneth R. Davis, When Ignorance of the Law is No Excuse: Judicial Review of Arbitration awards, *45 Buff.L.Rev. 49, 132 (1997)*; Ann C. Hodges, The Steelworkers Trilogy in the Public Sector, *66 Chi-Kent L.Rev. 631, 678 (1990).*

[91] See generally *DiLeo v. Ernst & Young 901 F.2d 624, 629 (7th Cir. 1990)* (holding as a matter of law that an accountant would not engage in fraud in exchange for fees).

[92] Publicly traded companies are required to submit reports to the SEC and their shareholders. See 17 *C.F.R. 240.13a-1, 240.13a-11, 240.13a-13, 240.14a-3 (1998).*

[93] *See 15 U.S.C. 77k(a)* (1994) (providing a cause of action to any purchaser of securities for mispresentations in a registration statement filed with respect to the securities under the Securities Act). This liability applies to issuers and those who sign registration statements, as well as experts, like underwriters, accountants, or other professionals, who allow their statements to be used in the registration statement. A person, other than an issuer, escapes liability by showing "after reasonable investigation" that there was no ground for believing that the registration statement was materially misleading. See *Id.*77k(b)(3). Thus, this liability creates an incentive for professionals, directors of an issuer, and senior officers to undertake a "due diligence" investigation of the offering. See *Escott v. Barchris Constr. Corp. 283 F.Supp. 643, 682-98 (S.D.N.Y. 1968)* (applying section 77k to underwriters, accountants, officers, and directors).

[94] See *Apex Mun. Fund v. N-Group Sec. 841 F.Supp. 1423, 1430-32 (S.D. Tex. 1993)* (discussing "due diligence" and waiver of privilege).

> securities dispute, thereby greatly reducing discovery squabbles, lowering expenses, and increasing efficiency.[95]
>
> Third, speedy adjudications would provide unique benefits to the parties to these kinds of disputes.[96] Business risks and uncertainties would remain unresolved for less time. For companies that have engaged in no wrongdoing, quick adjudication and lower defense costs eliminate pressure to settle otherwise meritless claims.[97] If a defendant is faced with a weak claim that can be economically and quickly resolved, the leverage of an 'extortionate' settlement evaporates.[98] Granting arbitrators the express power to sanction parties for pursuing frivolous claims or maintaining frivolous positions can strengthen this aspect of arbitration.[99] As an additional tool to deter frivolous litigation, courts have recognized that arbitrators retain discretion to award attorneys' fees to prevailing parties.[100] Even in the absence of a provision within the agreement commanding arbitration or a rule of the arbitration forum, courts have upheld awards of attorneys' fees.[101] In short, arbitration can eradicate the ills that formed the basis for enacting the PSLRA.[102]

Obviously, there will be opposing points of view. But my question to the inevitable skeptics is as follows: "If you don't like this solution, what's yours? And, if you don't think there is a problem involving the flight from our markets of capital, wealth, trading activity, corporate finance and, ultimately, employment, you are not paying attention to what is happening in, *e.g.*, London, Amsterdam and Hong Kong."

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[95] See *Arbitration Policy Task Force, supra* note 21, a82-86. [*See* Arbitration Policy Task Force, Report on Securities Arbitration Reform 1-3 (1996) ("Ruder Report")].

[96] *See* C. Edward Fletcher, Arbitrating Securities Disputes xviii (1990) "[I]t is undeniable that, guided by the Securities Industry Conference on Arbitration (SICA) and goaded from time to time by the SEC, arbitration [is] . . . a relatively low-cost, usually expeditious, and generally fair means of resolving customer . . . disputes with broker-dealer firms."; Deborah Masucci, Securities Arbitration-A Success Story: What Does the Future Hold?, *31 Wake Forest L. Rev. 183, 183 (1996)* ("Despite media criticism of the [arbitration] process, specifically allegations of a pro-industry bias at forums sponsored by self-regulatory organizations (SROs), the process and its performance have been largely successful.").

[97] See *supra* note 254. *See* William Twining, Alternative to What? Theories of Litigation, Procedure and Dispute Settlement in Anglo-American Jurisprudence: Some Neglected Classics, *56 Mod. L. Rev. 380, 380 (1993)* (stating that three primary concerns behind the drive for ADR in the American legal system are: the perception of overburdened courts, the need for specialized private fora, and issues of cost and access).

[98] See Miller, *supra* note 18. *See* Arthur R. Miller, The Adversary System: Dinosaur or Phoenix, *69 Minn. L. Rev. 1, 9 (1984).*

[99] See *Id*. at 17-19; Thomas J. Stipanowich, Rethinking American Arbitration, *63 Ind. L.J. 423, 483* (1987-1988).

[100] See *e.g. Marshall & Co. v. Duke, 114 F.3d 188, 189 (11th Cir. 1997*) (upholding an award of $634,107 in attorneys' fees in favor of brokerage firm), cert. denied, *118 S. Ct. 1043 (1998).*

[101] See *Todd Shipyards Corp. v. Cunard Line, Ltd. 943 F.2d 1056, 1064 (9th Cir. 1991)* (holding that arbitrators may sanction "bad faith" conduct); *First Interregional Equity Corp. v. Houghton, 842 F. Supp. 105, 112-13 (S.D.N.Y. 1994)* (same). But *see McDaniel v. Berhalter, 405 So.2d 1027, 1029 (Fla.Dist.Ct. App. 1981)* (holding that absent statute or specific agreement, arbitrators may not award attorneys' fees).

[102] Ramirez, no. 2 *supra* at 1112..

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APPENDIX A

Excerpt From The Interim Report of the Committee on Capital Markets Regulation

Enforcement in Private Securities Litigation

One recent study concludes that the average public company has nearly a 10 percent probability of facing at last one shareholder class action lawsuit over the course of a five-year period.[103] Clearly, the threat of private liability is something any public company must take seriously. While much is in dispute about securities class action litigation, the prevalence of the lawsuits, the enormous size of their settlement values, and the large burden they impose on companies and their shareholders are not.

Securities Class Action Lawsuits are a Very Important Kind of Class Action Litigation in Federal Courts

On an unconsolidated basis, securities class actions accounted for roughly 48 percent of all class actions pending in federal court in 2004 and 2005, as set forth in the Table below. However, since most securities class actions are consolidated for purposes of discovery and few of even the consolidated cases are ever tried, these statistics may overstate the scope of the judicial burden imposed by securities class action lawsuits.[104]

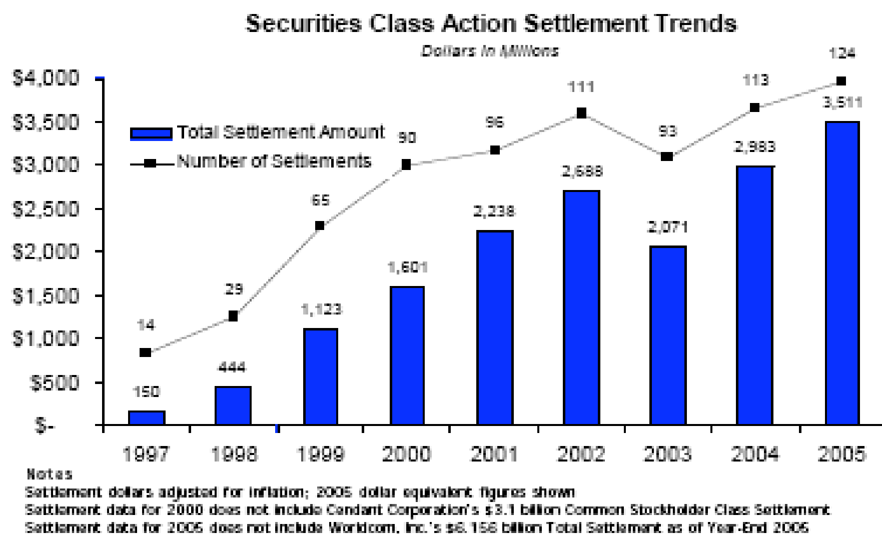
TABLE III.3
Class Actions Pending in Federal Courts as of September 30

Type of Case	2002	2003	2004
Contract	282	290	289
Real Property	33	38	34
Tort Actions	529	604	600
Antitrust	249	231	202
Employment Rights	164	159	173
Other Civil Rights	298	274	266
Prisons, Prisoners	66	64	82
RICO	53	76	46
ERISA	134	183	216
Other Labor Suits	180	204	262
Securities/Commodities/Exchange	*2,325*	*2,339*	*2,480*
Others	522	514	529
Total	**4,835**	**4,977**	**5,179**
Securities Class Actions as a percentage of total	**47.5%**	**47%**	**47.9%**

[103] Buckberg *et al.* (2006) at 3.
[104] *See The Administrative Office of the United States Courts, Annual Reports on the Judicial Business of The United States Courts* for the years 2002 – 2004. However, even cases consolidated under this provision must be remanded back to the original district court at the conclusion of the pretrial proceedings. *See Lexecon, Inc. v. Milberg Weiss Bershad Hynes & Lerach,* 523 U.S. 26 (1998). Moreover, even if unconsolidated class actions are an inexact measure of the judicial burden, they do show the number of attorneys involved.

Although the Filing Rate for Securities Class Action Lawsuits has Fallen in 2005 and 2006, the Drop in Filings has been Accompanied by a Rise in Settlement Sizes to New York Unprecedented Levels

In 2005, U.S. public companies paid more than $3.5 billion to settle securities class action lawsuits, not including the $6.156 billion settlement incurred by WorldCom as of the end of that year. The average settlement size paid by each of these companies was higher than in years past. Excluding the mega-settlements in Enron and WorldCom, the average settlement in 2005 was $71.1 million – an increase of 156 percent over the $27.8 million average settlement in 2004.[105] The table below provides an inflation-adjusted look at the growth in total settlement payments related to securities class action law suits since 1997.



Source
Laura E. Simmons and Ellen M. Ryan, Post-Reform Act Securities Settlements: 2005 Review and Analysis (Cornerstone Resear

A similar study by the National Economic Research Association (NERA)[106] observes that. Although average and median settlement amounts have increased significantly from the 1996 – 2001 period to the

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[105] Pricewaterhouse Coopers 2005 Securities Litigation Study, website summary. A similar study by the National Economic Research Association excludes data related to both WorldCom and Enron, as well as any settlements reached by year-end 2005 but not yet finalized. Because this approach omits from the 23005 calculations many large settlements, it suggests a much smaller growth in the average settlement value between 2004 and 2005 – approximately 28 percent. Although the NERA study suggests that, underneath the mega-settlements, there may be some stabilization occurring in average settlement values, it also shows the scope of the upward shift in those values. According to NERA;s study, the average settlement value for the period 1996 – 2001 was $13.3 million. The average settlement value for the period 2002 – 2005 was $22.3 million. Buckberg *et al.* (2005) at 6.
[106] Buckberg *et al.* (2006).

2002 – 205 period, much of the increase is driven by the large investor losses during the 2000 – 2002 period. This is due to the fact that securities class actions take about five years on average to settle. When these suits are excluded there is a much smaller growth in the average settlement value between 2004 and 2005 – approximately 28 percent. According to NERA's study, the average settlement value for the period 1996 – 2001 was $13.3 million. The average settlement value for the period 2002 – 2005 was $22.3 million. of course, 28 percent growth is still quite significant.

The reason for the soaring settlement values is less clear, but the data are equally undeniable. The ten largest securities class action settlements since the passage of the Private Securities Litigation Reform Act (PSLRA) in 1995 are set forth in the Table below.[107]

TABLE III.4
Ten Largest Securities Class Action Settlements Since 1995

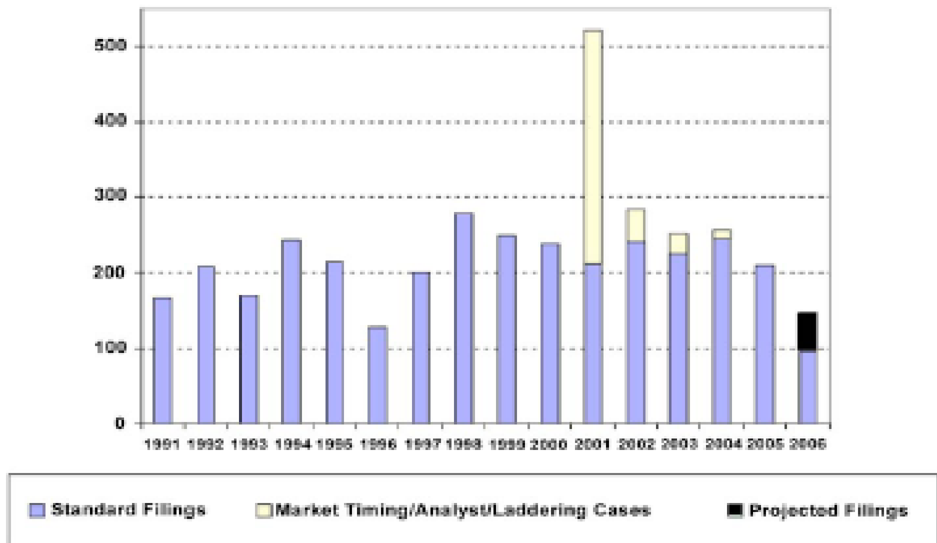
Rank	Issuer	Maximum Asserted Valuation
1	Enron	$7,160.5 Million
2	WorldCom	$6,156.3 Million
3	Cendant	$3,528.0 Million
4	AOL Time Warner	$2,500.0 Million
5	Nortel Networks	$2,473.6 Million
6	Royal Ahold	$1,091.0 Million
7	IPO Allocation Litigation	$1,000.0 Million
8	McKesson HBOC	$960.0 Million
9	Lucent Technologies	$673.4 Million
10	Bristol-Myers Squibb	$574.0 Million

Source: Stanford Securities Class Action Litigation Clearinghouse.

As average settlement values climb, so too do the incentives for companies to try to evade private litigation under the U.S. securities laws by simply choosing to sell their shares elsewhere.

Although the figure above shows a rise in the number of securities class action settlements, the number of federal cases actually filed declined from about 230 in 2004 to about 2005 in 2005, about 17 percent, and it appears filings will fall further in 2006 (see Table below). Numerous and varied explanations have been proposed for the recent decline. First, the stock market rose for most of 2005 and 2006, reducing the number of sudden stock price drops that might have fueled securities litigation. The 2006 indictment of

[107] Compiled by the Stanford Securities Class Action Litigation Clearinghouse.



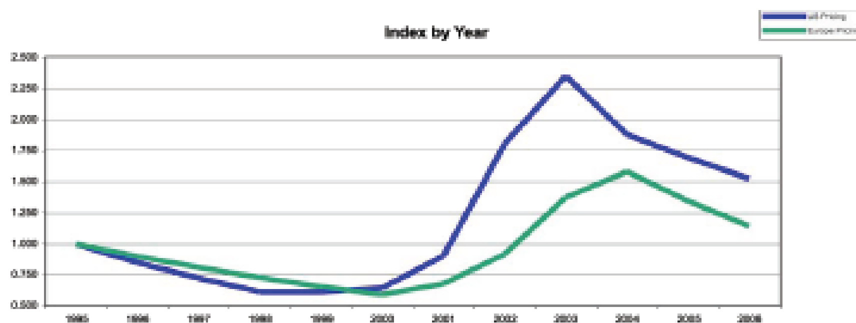
Source: "Recent Trends in Shareholder Class Action Ligitigation", Todd Foster et al., NERA.

Milberg, Weiss, once dominant in representing class plaintiffs, may also have affected the filing rate. The indictment may have deterred other firms from filing lawsuits, and it may have become more difficult for hose firms that did still wish to file securities class action lawsuits to find or use "professional" plaintiffs – that is, plaintiffs who are (probably) paid to participate.[108] Finally, it is possible that the lower filing rate reflects the success of the 2002 Sarbanes-Oxley legislation in curbing managers' incentives to recognize income prematurely or engage in other dubious accounting manipulations.

Compared to Europe, the high level liability in the U.S. system results I substantially higher insurance costs. D&O insurance limits purchased by Fortune 500 companies are typically $500 million in the United States compared with $250 million in Europe. The rate paid in the United States is about four percent, for a total cost of $20 million. In Europe, this rate is 1.3 percent, or a total cost of $3.25 million. Thus, insurance costs for a Fortune 500 company are over six times higher in the United States than in Europe. As the Table below shows, European and U.S. rates started diverging after 2001.

[108] These professional plaintiffs still appear in a large percentage of securities class actions, even if institutional investors now serve as the lead plaintiffs in the largest securities class actions.

Public D&O Industry Pricing



Source: Major Reinsurance Company

Cost-Benefit Analysis of Shareholder Litigation

The modern securities class action lawsuit creates a heavy burden for public companies; without a substantial social benefit, this burden cannot be justified. As discussed in greater detail below, however, the public value of the securities class action litigation is questionable. First, the potential deterrent function of private securities litigation is debatable because virtually all the costs fall on the corporation and its insurer, which means they are ultimately borne by the shareholders,[109] Only in the rare case in which the corporation becomes insolvent *and* its insurance coverage is inadequate do the costs fall on individuals (this was the case in *Enron* and *WorldCom* where, almost uniquely, outside-directors did contribute to the settlement, a situation discussed later).[110]

Comment [JZT1]:

Second, the notion that securities class actions do a good job of compensating injured parties is belied by data suggesting that the average securities class action settles for between two percent and three percent of the investors' economic losses. NERA found the ratio of settlements to investor losses in 2002,2003 and 2004 to be 2.7 percent, 2.9 percent and 2.3 percent, respectively.[111] Moreover, any apparent recover must be reevaluated in light of the high transaction costs of this kind of litigation. Plaintiffs' attorneys customarily are awarded between 25 percent and 35 percent of any recovery (although this percentage is declining).[112] Although less evidence is available about defense costs, some recent evidence suggests

[109] A 1995 study by NERA found that even when officers and directors were named as defendants, settlements were funded 68.2 percent by liability insurance and 31.4 percent by payments from the corporation – leaving at most 0.4 percent to be paid by individual defendants or others. Dunbar *et al.* (1995) at 9. Since then, the extent to which the insurers bear the entire settlement has probably increased. There is a likely reason for this: beginning in 1996, D&O insurers began to offer insurance directly to the corporation (now referred to as "entity insurance" or "Side C" insurance). Previously, D&O insurers had insured only the directors and officers as individuals and the corporation's obligation to make indemnification payments to them. But with the marketing of entity insurance (which virtually all public corporations now carry), all liabilities flow back to a single insurer (who thus need make no allocation),

[110] The twelve outside directors of wm paid some $25 million to settle the securities class action against them. WorldCom was, of course, insolvent and its potential liabilities (over $70 billion) exceeded the D&O insurance coverage.

[111] *See* Buckberg, *et al.* 2005 at 6.

[112] Buckberg, *et al.* 2005.

they are in the same range.[113] If one adds to these numbers the admittedly hard-to-quantify costs of D&O insurance and business disruption, it is not clear that there is any positive recovery in the average securities class action.

Finally, even if there is a net recovery, contemporary securities class action litigation is still suffering from a problem of circularity. The recovery is largely paid by diversified shareholders to diversified shareholders and thus represents a pocket-shifting wealth transfer that compensates no one in any meaningful sense and that incurs substantial wasteful transaction costs in the process. Any recovery in a securities class action goes to the shareholders who traded (either bought or sold the stock) during the class period when the market price allegedly was affected by fraud. The damages these investors receive essentially are paid by those shareholders who did not trade during the class period. If a shareholder in a stock drop case brought shares both inside and outside the class period, in equal quantities, he or she would be on both sides of the division in time and would be both paying and receiving the recovery. The shareholder would have no net recovery; indeed, he or she will not even be in a neutral position, having lost money as a result of the transaction costs.[114]

To be sure, not all shareholders are diversified, and those who are not might benefit from the private litigation But in order to benefit, the shareholder must have acquired shares during the class period. Undiversified investors (and retail investors generally) tend to be investors who "buy and hold" and do not trade actively, while the typical class period is just under one year in length. As a result, the average buy and hold investor is likely to have acquired his shares before the class period commenced. Ironically, therefore, securities litigation systematically may transfer wealth from buy and hold investors to make actively trading investors. These actively trading investors may not benefit from securities litigation, but at least they lose less.

The Committee recommends that the SEC should permit shareholders to adopt alternative procedures for resolving disputes with their companies. These procedures might include arbitration (with or without class actions) or the waiver of jury trials (a waiver commonly made in a variety of circumstances). The Committee recognizes the difficulties that will be faced by shareholders in deciding whether to adopt alternative procedures. For example, arbitration usually does not permit summary judgment and there is no appeal. These costs would have to be weighted against the possible benefits of reducing burdensome litigation. Although the decisions may be difficult, the Committee believes that shareholders should have the right to choose, particularly given the current high cost to shareholders of litigation.

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[113] *See* Baker and Griffith (2006) at 10 n. 28.

[114] To illustrate, assume that a large pension fund holds substantial positions in some 1,000 stocks and that over the course of a five-year period some 100 of these companies are the subject of securities class actions (the actual rates has been 2.1 percent per year – or 10.5 percent over five years). Of these 100 stocks, the hypothetical pension fund bought its securities within the class period in 50 cases and outside the class period in another 50 cases for a total of 100), and perhaps it bought in both periods in some 25 cases. No matter how "successful" the plaintiff's attorneys believe they have been in this hypothetical litigation, they have not improved the welfare of the diversified investors. However high the settlement is, it comes from the pockets of the same investors who receive it – unless some third party (for example, the auditors or underwriters) bears a significant share of the settlement. Finally, the legal system will tax these transfer payments that investors are making to themselves heavily – with both plaintiffs' and defense counsels' fees being borne by the shareholders. The Contrary case is wm, where underwriters and auditors paid billions in settlements. If these third parties pay, they will pass the costs back to clients in the form of higher fees. This means shareholders in the end probably pay much of the costs imposed on third parties.

With respect to IPOs, there could be a vote on amending the corporate charter and by-laws at the first shareholder meeting after the IPO, which could be a special meeting. Requiring a vote on a charter amendment, rather than dealing with the issue through a covenant in the IPO, will help ensure that the issue receives the required attention apart from the multiplicity of factors that influence the decision to buy stock in an IPO. For existing companies, shareholders would be free to vote on alternative remedies at a properly called meeting.

APPENDIX B

DRAFT CHARTER PROVISIONS

Any and all disputes or controversies arising out of, related to or in connection with claims or demands by stockholders of the Corporation against, on behalf of, or for the benefit of the Corporation or its officers and directors, whether in tort, contract or otherwise, [and based, in whole or principally, on violations of federal law and regulation respecting the purchase, retention and sale of "securities" as defined in Section 2(a) of the Securities Act of 1933] shall be finally settled and determined by arbitration under the American Arbitration Association then current Rules of Commercial Arbitration (the "AAA Rules"). Each appointed arbitrator in connection with the arbitration shall have an international reputation as being experienced in the legal and technical matters related to the dispute. The seat of arbitration shall be Wilmington, DE. The arbitrator(s) may hold hearings at such other locations as the arbitrator(s) shall determine, after consultation with the parties. The arbitral proceedings and all pleadings and written evidence shall be in the English language. Any written evidence originally in a language other than English shall be submitted in English translation accompanied by the original or true copy thereof. The written award of the arbitrator(s) shall be final and binding upon the parties, and judgment on or enforcement of the award so rendered may be sought, had or entered in any court having jurisdiction, all provided that the following specific provisions shall apply and, in the event of a conflict with the AAA Rules, shall control.

- Each appointed arbitrator in connection with the arbitration shall be experienced in the legal and technical matters related to the dispute: preference shall be given to at least one member of the tribunal (the "Tribunal") being experienced in financial matters and/or accounting conventions.

- Upon commencement of any proceeding involving, in whole or in part, alleged violations of the federal securities law, including Rules and Regulations of the Securities and Exchange Commission (the "SEC"), notice shall be contemporaneously served on the SEC at its offices in Washington, D.C., in accordance with procedures adopted by the SEC with reference to compulsory arbitration charter provisions or, in default of any such procedures, the Division of Corporate Finance, Office of Chief Counsel, Securities and Exchange Commission, 100 F Street, N.W., Washington, D.C. 20549, by registered mail, return receipt requested. The SEC shall be afforded the opportunity periodically to review each proceeding and publish such rules as it may deem appropriate to insure that the procedures are appropriately designed to serve the interests of justice.

- The SEC, or its designee, shall be afforded the opportunity to participate in hearings before the Tribunal and express its views on issues involving the interpretation or application of Federal securities law to the facts of the proceeding, by filing a memorandum with the Tribunal and participating, with the consent of the Tribunal, in oral argument to the Tribunal to the extent the opportunity for oral argument is afforded to the parties, it being understood that the SEC will not participate as if a party in the instant proceeding but will limit its participation to functioning as an advisor/amicus on federal securities law issues.

- The Tribunal shall have the power to consolidate any and all actions arising out of the same or related subject matter(s) in one proceeding for purposes of: document production; depositions; expert testimony and other like interlocutory matters; and may consolidate entire proceedings into a single class arbitration, appoint lead counsel for the class, determine the compensation of lead counsel and impose other rules of procedure consistent with the Private Securities Litigation Reform Act and other federal procedural law governing class litigation.

- All settlements will be submitted to the Tribunal prior to the award of counsel fees out of the proceeds of such settlement.

- The decisions of the Tribunal shall be in writing and shall contain a statement of the facts and rulings on matters of law, unless the amount in controversy is less than $50,000 and the Expedited Procedures in Article 39 of the AAA Rules are applicable;

- The decisions of the Tribunal shall be final and binding, subject to appeal to the appropriate state or federal courts, such appeals limited to legal issues arising under federal and/or state legal principles.

- Notice of the charter provisions and the corresponding language in the by-laws of the Corporation (the "Provisions") shall be affixed on the face of all certificates representing securities issued by the Corporation, with an appropriate summary of the substance of the Provisions and directions on how to obtain, at the Corporation's expense, a complete and up to date copy of the Provisions; a copy of the entire text of the Provisions will be available on the Corporation's website; all written or digital communications with security holders of the company will contain a legend directing the holder to the appropriate portal for access to the full text of the Provisions; upon registration of the Corporation under Sections 12(g) and 15(d) of the Securities Exchange Act of 1934, all registration statements and other public disclosures required by law shall contain a legend indicating the existence of the Provisions and clearly identifying the opportunity to access the text of the same.

- In connection with the registration by the Corporation of any securities under the provisions of the Securities Act of 1933 (the "`33 Act") or the Securities Exchange Act of 1934 (the "`34 Act") the Corporation shall issue a press release, and notify all members of any underwriting syndicate and/or any broker/dealers making a market in the Company's, announcing the existence of, including instructions on how to access, the Provisions.

- In connection with the registration of any securities for public distribution securities, by the Corporation pursuant to the `33 Act, the registrant shall, at the commencement of the registration process, file a certified copy of the Provisions with the SEC in accordance with such rules as the SEC shall promulgate or in default of any such Rules, with the Division of Corporation Finance, Office of the Chief Counsel; the SEC will be expressly invited and authorized to comment on any or all of such Provisions in the interest of the fair and equitable resolution of security holder claims, demands, disputes and controversies and is expressly authorized to condition its approval of any registration materials filed by the registrant on compliance with the SEC's comments and requirements as to the content of the Provisions, all in light of the stated objective of the Corporation and the SEC, as stated above.