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Arbitration and Corporate Governance

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ARBITRATION AND CORPORATE GOVERNANCE

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The popularity of commercial arbitration as an alternative for the resolution of contractual disputes is increasing, as is criticism of the existing remedial schemes for shareholder derivative actions. As a result, commentators and practitioners have begun to consider the feasibility and merits of arbitrating shareholder derivative claims pursuant to arbitration provisions in corporate charters. Professor Shell reviews the statutory scheme for arbitration and discusses how arbitration is used to resolve shareholder actions in closely held corporations. He then analyzes the Federal Arbitration Act to determine if an arbitration provision in the charter of a publicly traded corporation would be enforceable. Professor Shell concludes that arbitration is legally feasible for the public corporation but is not likely to become a primary method for handling shareholder derivative claims. Nevertheless, corporations should experiment with its use as an alternative method for resolving such disputes.

Public corporations are resorting to arbitration as an alternative to the courts with increasing frequency. In labor relations, an estimated ninety-four percent of all collective bargaining agreements between corporations and organized labor contain arbitration clauses.[1] Spurred by recent Supreme Court victories,[2] publicly held securities brokerage firms are arbitrating disputes with customers in record numbers pursuant to the rules of the major exchanges and the National Association of Securities Dealers.[3] The employment agreements between some of the nation's largest public companies and their senior executives similarly call for arbitration of compensation and other employment-

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1. Feller, *A General Theory of the Collective Bargaining Agreement*, 61 CALIF. L. REV. 663, 747 (1973).

2. *See, e.g.*, Shearson/American Express, Inc. v. McMahon, 107 S. Ct. 2332 (1987); Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213 (1985); Brown, Shell & Tyson, *Arbitration of Customer-Broker Disputes Arising Under the Federal Securities Laws and RICO*, 15 SEC. REG. L.J. 3, 7-11 (1987); Shell, *The Role of Public Law in Private Dispute Resolution: Reflections on Shearson/American Express, Inc. v. McMahon*, 26 AM. BUS. L.J. 397 (1988).

3. *Business Bulletin*, Wall St. J., Dec. 22, 1988, at 1, col. 5 (National Association of Securities Dealers reports that more than 4,000 arbitration cases were filed with it in 1988, as compared with 2,886 cases in 1987); *October 19 Still Isn't Over*, FORTUNE, Mar. 14, 1988, at 12 (reporting that arbitration caseloads in securities industry as a whole were up over 50% since October 1987 stock market crash).

related controversies.[4] Finally, public corporations, like other business enterprises, are using arbitration to resolve differences with suppliers, franchisees, dealers, and even competitors.[5] In short, the modern public corporation is relying on arbitration to strengthen virtually every strand in its "web of contracts."[6]

At the same time that the arbitration alternative is gaining new legitimacy, the shareholder derivative action—a staple form of corporate litigation[7]—has been the subject of a fresh round of criticism. The American Law Institute's (ALI) Corporate Governance Project has made proposals regarding shareholder remedies[8] that have become the focal point for an intense debate regarding the

4. *See, e.g.*, Graphic Scanning Corp. v. Yampol, 688 F. Supp. 857 (S.D.N.Y. 1988) (arbitration agreement between CEO and public corporation); GAF Corp. v. Werner, 66 N.Y.2d 97, 495 N.Y.S.2d 312, 485 N.E.2d 977 (1985) (same), *cert. denied*, 475 U.S. 1083 (1986); Faberge Int'l, Inc. v. Di Pino, 109 A.D.2d 235, 491 N.Y.S.2d 345 (1985) (arbitration clause in employment agreement with executive vice president). A casual review of annual 10-K filings with the Securities and Exchange Commission revealed employment agreements between a number of public companies and their senior executives containing arbitration clauses. These companies included Borden, Cessna Aircraft Company, and CPC International. *See generally* 1 A. KROLL, EMPLOYMENT COMPENSATION ¶ 1011.12 (1985) (model employment agreement contains an arbitration clause). Such clauses, however, are probably still the exception rather than the rule in corporate practice.

5. *See* Comment, *The New Jersey Alternative Procedure For Dispute Resolution Act: Vanguard of a "Better Way"?*, 136 U. PA. L. REV. 1723, 1747 (1988) (discussing IBM-Fujitsu trade secret arbitration). The American Arbitration Association has reported a 49% increase in its commercial case filings of all sorts over the period 1983 to 1987. 1987 AAA Statistical Report 6 (June 1, 1988) (on file with the author).

6. Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 12 (1986). Indeed, according to recent declarations by legal commentators, conventional commercial arbitration has now "come of age." Pitt & Schropp, *Arbitration of Securities Law Disputes Comes of Age*, 1 INSIGHTS 10 (Sept. 1987); *see, e.g.*, Bedell, Harrison & Harvey, *The McMahon Mandate: Compulsory Arbitration of Securities and RICO Claims*, 19 LOY. U. CHI. L.J. 1 (1988); Hood, *Arbitration and Litigation of Public Customers' Claims Against Broker-Dealers After McMahon*, 19 ST. MARY'S L.J. 541 (1988). Arbitration is generally viewed as faster, cheaper, and more flexible than court litigation. *See infra* note 24. For most commercial disputes, this is an attractive combination when compared to the delay, expense, and formality of the courts. Indeed, there seem to be few areas of commercial practice that have not begun to feel the pressure to consider the option of replacing traditional court litigation with private arbitration as the means of resolving commercial differences. *See, e.g.*, Saturday Evening Post v. Rumbleseat Press, 816 F.2d 1191 (7th Cir. 1987) (permitting arbitration of copyright claims); Gutter & Torpey, *Lenders Use Arbitration Clauses and Jury Waivers to Protect Their Rights*, 8 BUS. LAW. UPDATE, No. 3, at 3 (1988) (banks increasingly using arbitration clauses in loan documentation); Comment, *supra* note 5, at 1747 (describing IBM-Fujitsu arbitration to resolve trade secret dispute). Many commercial claims that were recently thought to be well beyond the jurisdiction of private arbitrators have been declared by the courts to be appropriate matters for resolution in the arbitral forum. *See, e.g.*, *McMahon*, 107 S. Ct. 2332 (declaring that claims under § 10(b) of the Securities Exchange Act of 1934 and the Racketeer Influenced and Corrupt Organizations Act are suitable for arbitration); Rodriguez de Quijas v. Shearson/Lehman Bros., 845 F.2d 1296 (5th Cir.) (claims under § 12(2) of the Securities Act of 1933 are subject to arbitration), *cert. granted*, 109 S. Ct. 389 (1988); Gemco Latinoamerica v. Seiko Time Corp., 1987-2 Trade Cas. (CCH) ¶ 67,770 (S.D.N.Y. 1987) (domestic antitrust claims between companies subject to arbitration).

7. Shareholders have the right to bring two kinds of lawsuits against corporate managers: derivative and direct actions. Whether an action is characterized as one or the other depends on the types of injuries alleged. *See infra* note 138 and accompanying text. This Article deals primarily with the use of arbitration to resolve derivative claims, but many of the issues and arguments discussed apply equally to the arbitration of direct actions on either an individual or class basis.

8. These proposals are contained in a series of drafts that have yet to be finally approved by the members of the ALI. *See* Principles of Corporate Governance: Analysis and Recommendations §§ 7.01-7.18 (Tent. Draft No. 6, Oct. 10, 1986). In general, the ALI has proposed that the derivative action be retained and that the corporate board of directors be given discretion, in certain listed situations, to appoint a special committee of independent board members to review the derivative claim and make a recommendation to the court regarding the disposition of the case. *Id.*

role of these lawsuits in corporate governance.[9] In commenting on the ALI's proposals, some scholars have called for significant changes in the existing remedial scheme.[10] Others have advocated the abolition of shareholder derivative actions altogether.[11]

These two trends have not yet met in practice, but academic commentators,[12] corporate practitioners,[13] and professional dispute resolution organizations[14] have begun to discuss the feasibility and merits of arbitrating public shareholder derivative claims pursuant to arbitration provisions placed in corporate charters. The use of arbitration as a means of resolving governance disputes in public corporations promises to stir substantial legal controversy.

Arbitration is a private means of settling differences that places concerns for equity and efficiency above strict observance of legal norms. Judicial involvement in the arbitration process is minimal, and judicial review of arbitration awards is limited.[15] Arbitration thus attenuates the connection between the state and the corporation in a way that will alarm many. Moreover, if the state-created procedural rights embodied in derivative action statutes are waivable by a corporate charter amendment, perhaps shareholders may "opt out" of other seemingly mandatory legal controls, up to and including substantive fiduciary duties imposed on corporate officers and directors by state law.[16]

On the other hand, growing evidence indicates that, when the costs of derivative litigation are compared with the benefits such suits generate for public corporations, derivative actions may not be cost-effective for the majority of corporate shareholders.[17] The corporation often shoulders most of the costs of

9. *See, e.g.*, Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745 (1984); Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1259 n.1 (1983) (citing literature discussing corporate governance); Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927 (1982). This debate has extended beyond academic circles to corporate policy commentators. *See* Kristol, *The War Against the Corporation*, Wall. St. J., Jan. 24, 1989, at A-20, col. 3 (arguing that the ALI proposals on the handling of derivative actions would severely hamper effective corporate governance).

10. Coffee, *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 725 (1986) (calling for awards of multiple damages or greatly increased attorneys' fees for plaintiffs' lawyers in derivative cases); Scott, *supra* note 9, at 927 (calling for elimination of liability for duty of care violations).

11. Comment, *Shareholders' Derivative Suits and Shareholder Welfare: An Evaluation and Proposal*, 77 NW. U.L. REV. 856, 902-03 (1983).

12. *See, e.g.*, Coffee, *No Exit? Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOKLYN L. REV. 919 (1988).

13. *See, e.g.*, Pitt & Schropp, *supra* note 6.

14. *See* Franklin, *Courthouse Closed? Required Mediation of Shareholder Suits Weighed*, N.Y.L.J., Sept. 24, 1987, at 5, col. 2 (reporting that the Center for Public Resources, a New York-based dispute resolution organization, is studying alternative dispute resolution techniques for resolving shareholder disputes).

15. *See infra* notes 41-42 and accompanying text.

16. Coffee, *supra* note 12, at 925-31.

17. Fischel & Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 292 (1986) (stating that market price of shares in subject corporations is not materially affected by announcement that derivative actions have been dismissed or terminated); Jaffe & Westerfield, *Shareholder Suits and Shareholder Welfare: Some Evidence from the Stock Market* (1986) (unpublished manuscript on file with the author) (stat-

shareholder suits, including the payment of attorneys' fees to the lawyers for both plaintiffs and defendants.[18] This practice minimizes the net recovery to the corporation from settlements and judgments.[19] Thus, shareholders may gain from the use of more efficient means of resolving these cases.[20] As to the criticism that arbitration would delegalize corporate governance, the vast majority of derivative actions are dismissed or settled short of trial,[21] a fact that indicates the judicial forum is not as crucial to the suits' effectiveness as may appear at first glance.

This Article lays a foundation for the debate over the arbitration of derivative claims. Part I of the Article reviews background material on commercial arbitration practice and discusses recent developments in the Supreme Court's interpretation of the Federal Arbitration Act (FAA)[22] that form the basis for the discussion of arbitrating shareholder suits. In part II, the Article reviews the role arbitration has played in one important corporate setting, that of the closely held corporation. This section demonstrates that, after years of fighting in the courts and legislatures, shareholders in closely held corporations have won the right to use the arbitration forum.

Part III explores the issue of arbitrating public shareholder disputes. First, this section describes the essential characteristics of shareholder derivative actions and discusses the role this remedy plays in the traditional model of corporate governance. Next, part III analyzes the legal objections that might be raised if public corporations seek to require arbitration of shareholder disputes under an arbitration provision inserted in the corporation's charter. This analy-

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ing that market price of shares of subject corporations is negatively affected by announcement that shareholder action has been filed).

18. *See infra* note 142-43 and accompanying text.

19. Every state's corporation laws permit or require the corporation, under certain circumstances, to indemnify corporate directors for expenses and settlement payments made in connection with shareholder suits. *See, e.g.*, REVISED MODEL BUSINESS CORP. ACT §§ 8.50-8.58 (1984); DEL. CODE ANN. tit. 8, § 145 (1983); N.Y. BUS. CORP. LAW §§ 721-727 (McKinney 1986). In addition, most states permit corporations to purchase insurance to cover officers and directors who are sued. Such insurance may cover matters that cannot be indemnified under the corporation statute. R. CLARK, CORPORATE LAW § 5.10, at 668 (1986). The Wyatt Company, a consulting firm that conducts an extensive annual survey of claims against officers and directors, has estimated that in 1987 the average cost to U.S. nonbank corporations of defending the 111 shareholder actions (both derivative and direct) reported was $513,409. THE WYATT CO., THE 1987 WYATT DIRECTORS AND OFFICERS & FIDUCIARY LIABILITY SURVEY 30 (1987). The median amount of such fees was $275,000 and the highest amount was $4,000,000. *Id.* Moreover, companies made claims against insurers for settlement amounts ranging from $500,000 to over $5,000,000. *Id.* at 29. Seventy-four percent of the total sample of claims, however, were reported as "Closed No Payment." *Id.* When one takes into account the fact that roughly 20% of any settlement is paid to the attorneys representing the shareholder-plaintiffs, see *infra* note 142 and accompanying text, the opportunity costs of having managers tied up in the shareholder litigation, and actual expenses such as insurance premiums paid by the corporation, the net benefit of shareholder litigation to shareholders as a group is debatable.

20. There is also reason to believe that the monitoring benefits of derivative actions are overstated. Many derivative suits are filed in the wake of revelations by public agencies and "piggyback" on the investigative efforts of others without providing additional monitoring benefits to shareholders. *See* Garth, Nagel & Plager, *The Institution of the Private Attorney General: Perspectives from an Empirical Study of Class Action Litigation*, 61 S. CAL. L. REV. 353, 376-77 (1988).

21. Jones, *An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits*, 60 B.U.L. REV. 542, 545 (1980) (over 70% of cases studied settled).

22. 9 U.S.C. §§ 1-14 (1982).

sis leads to the conclusion that a corporate charter arbitration provision is likely to be enforceable under the FAA so long as the corporation takes adequate steps to notify shareholders of the existence of the clause. Part III closes with an analysis of the policy questions underlying these issues.

In part IV the Article speculates about the future of arbitration as a means of resolving public shareholder actions. This section presents an analytic model based on transaction cost economics to probe the likelihood of widespread use of arbitration in the public corporation context. The transaction cost model confirms present practice, namely that arbitration is likely to play a more prominent role in resolving disputes among shareholders of close corporations than disputes between shareholders and managers of public entities. Part IV next identifies some practical constraints on the use of arbitration in public corporations that may discourage its use.

The Article concludes that arbitration is not likely to be utilized to resolve shareholder derivative suits on any systematic, widespread basis. Nevertheless, because arbitration has gained acceptance in the legal environment, public corporations should be permitted and encouraged to experiment with it.

I. Commercial Arbitration and the Law: Current Practice

Arbitration is a private means of resolving disputes through the use of neutral third parties who are engaged by the parties to review disputed claims and render a binding decision.[23] Commercial arbitration is typically conducted pursuant to contractual agreements to submit either future or existing disputes to an arbitrator for resolution. Arbitration is generally thought to be cheaper, faster, and more flexible than litigation as a means of resolving commercial disputes.[24] Arbitration is also desirable because experts familiar with the customs and practices peculiar to an industry may serve as arbitrators.[25]

A. *Basic Commercial Arbitration Procedures*

The actual processes by which claims are adjudicated in commercial arbi-

23. M. Domke, Commercial Arbitration 1 (G. Wilner rev. ed. 1984); Shell, *Res Judicata and Collateral Estoppel Effects of Commercial Arbitration*, 35 UCLA L. Rev. 623, 628-29 (1988).

24. *See* Kritzer & Anderson, *The Arbitration Alternative: A Comparative Analysis of Case Processing Time, Disposition Mode, and Cost in the American Arbitration Association and the Courts*, 8 Just. Sys. J. 6-7 (1983). The New York Stock Exchange reported to the author that the average arbitration under the auspices of that organization takes less than one year to complete from initial demand to final award. *See* Shell, *Keep Broker-Client Disputes Out of Court*, Wall St. J., Mar. 3, 1987, at 32, col. 2. Moreover, a recent comparative study of customer-broker securities arbitration with similar cases brought in court concluded that the average arbitration takes 434 days to conclude, as compared with 599 days for a similar litigated case. The average cost of defending customer-broker disputes in court was $20,000 per case as compared with $8,000 per case in arbitration. Finally, customers recovered an average of $35,000 per claim in arbitration as compared with $25,000 per claim in litigation. *See* Letter from James E. Buck, Senior Vice President and Secretary of the New York Stock Exchange, Inc. to The Honorable David S. Ruder, Chairman of the Securities and Exchange Commission, Exhibit A (Oct. 14, 1988) (on file with the author) (reporting results of comparative study of 243 cases in arbitration and litigation conducted by Deloitte, Haskins & Sells at request of New York Stock Exchange).

25. R. Coulson, Business Arbitration—What You Need to Know 9 (3d ed. 1986).

tration vary. The American Arbitration Association's (AAA) Commercial Arbitration Rules offer an example of the general procedures usually encountered in commercial arbitration. A claimant initiates arbitration under the AAA rules by filing a written demand and serving this demand on the opposing side.[26] Once the demand is filed and a response received, arbitrators are appointed. Arbitrators need not be lawyers or even familiar with the law that may govern a particular dispute.[27] Under the AAA rules the parties receive lists of potential arbitrators and their biographical sketches. Each party then strikes from the list those arbitrators to whom he objects. The AAA administrator compares the lists and selects an arbitrator or panel from the remaining names.[28]

The rules make no provision for mandatory evidentiary discovery prior to the arbitration hearing.[29] Under federal and state arbitration statutes, however, arbitrators have the power to subpoena evidence and witnesses for the hearing,[30] and some state arbitration statutes expressly provide for prehearing exchange of documents and/or depositions of witnesses who will not be available to testify.[31] Courts sometimes order prehearing depositions in aid of arbitration in extraordinary circumstances.[32] In addition, a court that has stayed judicial proceedings pending arbitration can order discovery if such an order does not interfere with the arbitration.[33]

Arbitration hearings are informal. The arbitrators need not apply rules of evidence;[34] parties are entitled to cross-examine witnesses liberally;[35] and the record may include testimony by affidavit at the discretion of the arbitrator.[36] The AAA does not require that a stenographic record be kept of the proceed-

26. AMERICAN ARBITRATION ASSOCIATION, COMMERCIAL ARBITRATION RULES 6(a)-(b) [hereinafter AAA RULE] (effective Sept. 1, 1988). The AAA has slightly different and, in some respects, more formal rules governing securities disputes. *See* AMERICAN ARBITRATION ASSOCIATION, SECURITIES ARBITRATION RULES (effective Sept. 1, 1987); Shell, *supra* note 2, at 422-23.

27. Lawyers, however, are frequently found on lists of persons available to serve as arbitrators, and many commercial arbitration panels doubtless have one or more lawyer members. *See* Shearson/American Express, Inc. v. McMahon, 107 S. Ct. 2332, 2340 (1987); Mitsubishi Motors v. Soler Chrysler-Plymouth, 473 U.S. 614, 634 (1985); R. COULSON, *supra* note 25, at 9.

28. AAA RULE 13; *see* Posner & Landis, *Adjudication as a Private Good*, 8 J. LEGAL STUD. 235, 248 (1979). Parties may also select arbitrators by other methods if they mutually agree on a procedure. AAA RULES 14, 15.

29. The AAA Rules simply do not address the subject of discovery and provide only that "[a]n arbitrator or other person authorized by law to subpoena witnesses or documents may do so upon the request of any party or independently." AAA RULE 31.

30. *See* 9 U.S.C. § 7 (1982); UNIF. ARBITRATION ACT § 7, 7 U.L.A. 114 (1985).

31. *See, e.g.*, CONN. GEN. STAT. § 52-412 (1982); MASS. GEN. L. ch. 251, § 10 (1977); N.Y. CIV. PRAC. L. & R. 3102(c) (McKinney 1970); 42 PA. CONS. STAT. § 7309(c) (1982).

32. *See* Allison, *Arbitration Agreements and Antitrust Claims: The Need for Enhanced Accommodation of Conflicting Public Policies*, 64 N.C.L. REV. 219, 250-51 (1986); Willenken, *The Often Overlooked Use of Discovery in Aid of Arbitration and the Spread of the New York Rule to Federal Common Law*, 35 BUS. LAW. 173 (1979); Note, *Relaxing the Standard for Court-Ordered Discovery in Aid of Commercial Arbitration*, 50 FORDHAM L. REV. 1448 (1982).

33. *See* Fletcher, *Privatizing Securities Disputes Through the Enforcement of Arbitration Agreements*, 71 MINN. L. REV. 393, 453 (1987); Note, *Arbitration and Award-Discovery-Court May Permit Discovery on the Merits When it Will not Delay Arbitration*, 44 U. CIN. L. REV. 151 (1975).

34. AAA RULE 31.

35. AAA RULE 29.

36. AAA RULE 32.

ings, but parties may have such a record made at their own expense.[37]

Arbitrators' awards must be in writing[38] but need not state any reasons or findings supporting the decision.[39] After an arbitrator has rendered an award, federal and state arbitration statutes provide means for converting the award into a judgment through judicial confirmation.[40] Awards are subject to challenge only on extremely narrow grounds. The FAA provides that an arbitration award, once rendered, is final and must be confirmed by a court unless the disappointed party can demonstrate that 1) the award was procured by corruption, fraud, or undue means, 2) the arbitrators exhibited evident partiality, 3) there was gross misconduct by the arbitrators in refusing to hear evidence, 4) the arbitrators "exceeded their powers" or failed to render a final decision, or 5) the arbitrators exhibited a "manifest disregard" for applicable law.[41] Courts may not upset an award merely because arbitrators made errors of fact or law.[42]

B. *The Federal Arbitration Act: Recent Developments*

Federal and state arbitration statutes provide the legal frameworks through which courts enforce arbitration agreements and confirm arbitration awards. The FAA applies to contracts affecting interstate, foreign, or maritime commerce.[43] State arbitration laws are the means of enforcement for contracts involving exclusively intrastate commerce.[44] Because the securities of public corporations are traded on national markets and thus affect interstate commerce, this Article focuses on federal arbitration law under the FAA.

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37. AAA RULE 23.

38. AAA RULE 42.

39. The AAA encourages its arbitrators not to issue written opinions explaining their decision because such explanations "might open avenues for attack on the award by the losing party." American Arbitration Association, *A Guide For Commercial Arbitrators* at 16 ("No Written Opinion Required")(undated).

40. *See* Federal Arbitration Act, 9 U.S.C. § 9 (1982); UNIF. ARBITRATION ACT, § 11, 7 U.L.A. 133 (1985).

41. The first four of the bases of judicial review listed in the text are set forth explicitly in the FAA. *See* 9 U.S.C. § 10(a)-(d). The fifth "manifest disregard" ground has been implied by the courts. *See* Shearson/American Express, Inc. v. McMahon, 107 S. Ct. 2332, 2355 (1987).

42. *See* American Almond Prods. v. Consolidated Pecan Sales, 144 F.2d 448, 451 (2d Cir. 1944).

43. 9 U.S.C. § 2. Certain contracts of employment are expressly excluded from FAA coverage. *Id.* § 1. For example, § 1 excludes coverage of arbitrations involving workers in transportation industries. Miller Brewing Co. v. Brewery Workers Local Union No. 9, 739 F.2d 1159, 1162 (7th Cir. 1984). But conventional private arbitrations between white collar employees and employers are covered by the FAA so long as the employment relation affects interstate commerce. *See* GAF Corp. v. Werner, 66 N.Y.2d 97, 495 N.Y.S.2d 312, 485 N.E.2d 977 (1985) (construing arbitration agreement between CEO of public corporation and corporation under FAA), *cert. denied*, 475 U.S. 1083 (1986). Employment-related arbitration under collective bargaining agreements, meanwhile, is governed by § 301 of the Labor-Management Relations Act of 1947, 29 U.S.C. § 185 (1982). *See* United Steelworkers of Am. v. Warrior & Gulf Navigation Co., 363 U.S. 574, 580 (1960).

44. *See* Bernhardt v. Polygraphic Co. of Am., 350 U.S. 198, 200-01, 203 (1956); Conley v. San Carlo Opera Co., 163 F.2d 310 (2d Cir. 1947). Every state has adopted a statute that assures that arbitration agreements made within its borders will be enforceable. Shell, *supra* note 23, at 636 n.64. State arbitration laws are also used to supplement the FAA in procedural areas on which the FAA is silent. *See, e.g.*, Volt Information Sciences, Inc. v. Trustees of Leland Stanford Junior Univ., 109 S. Ct. 1248 (1989) (holding that parties to interstate contract may elect to apply state arbitration law procedure regarding stays even though FAA has no such procedure).

The FAA's keystone is section 2.[45] This provision makes enforceable any "written provision in any . . . contract evidencing a transaction involving commerce to settle by arbitration" any existing or future dispute.[46] An arbitration agreement may be repudiated only on "such grounds as exist at law or in equity for the revocation of any contract."[47]

In the past five years, the Supreme Court has revolutionized practice under section 2. Three decisions by the Court are particularly relevant to the issues addressed in this Article and illustrate the transformation of the FAA from a procedural statute applicable only in federal court into a national charter favoring liberal enforcement of arbitration agreements. First, in *Southland Corp. v. Keating*[48] the Court stated that the FAA preempts state rules limiting arbitration and embodies federal substantive law that must be enforced by both state and federal courts.[49] The *Southland* Court ruled that a California court was required to enforce an arbitration clause between a franchisee and franchisor even though the state franchise investment statute that formed the basis of the franchisee's claim reserved to the franchisee the right to bring an action in court. The Court insisted on arbitration of the state claim because Congress, in passing the FAA, "withdrew the power of the states to require a judicial forum for the resolution of claims which the contracting parties agreed to resolve by arbitration."[50]

In 1987 the Court reiterated its *Southland* holding in *Perry v. Thomas*.[51] In *Perry* the Court ordered a stockbroker to arbitrate a claim against his employer for withheld commissions.[52] The stockbroker argued that a state statute expressly gave workers the right to maintain a judicial action for wages and commissions "without regard to the existence of any private agreement to arbitrate"[53] and that this very statute had been upheld by the Court against an earlier claim of preemption by the federal labor laws.[54] The Court nevertheless

45. 9 U.S.C. § 2 (1982). Section 3 of the FAA provides that a federal district court, on motion by any party, must stay its proceeding on any issue it determines to be within the scope of a valid agreement to arbitrate. *Id.* § 3. If the parties are unable to agree on the selection of arbitrators, the FAA also provides a means of resolving this question. *Id.* § 5.

46. *Id.* § 2.

47. *Id.* Section 2 incorporates state contract law, and both state and federal courts refer to state common law to determine when an agreement to arbitrate is revocable. State courts are not free to fashion special contract rules for the revocation of arbitration clauses, however, since such rules would conflict with the overall policy of the FAA to favor enforcement of arbitration agreements. *See* Perry v. Thomas, 107 S. Ct. 2520, 2527 n.9 (1987). Moreover, the "revocation" limitation has been interpreted narrowly by the Supreme Court. A claim that the contract containing the arbitration clause was induced by fraud will not defeat a motion to compel arbitration. Rather, the claimant must demonstrate that the arbitration clause itself was fraudulently induced. *See* Prima Paint Corp. v. Flood & Conklin Mfg., 388 U.S. 395 (1967).

48. 465 U.S. 1 (1984).

49. The Court had earlier stated that the FAA constituted a body of "federal substantive law." *Id.* at 12; *see* Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24 (1983).

50. *Southland*, 465 U.S. at 10.

51. 107 S. Ct. 2520 (1987).

52. *Id.* at 2523.

53. CAL. LABOR CODE § 229 (West 1971).

54. *Perry*, 107 S. Ct. at 2523 (citing Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware, 414 U.S. 117 (1973)).

held that this statutory reservation of rights was a nullity under section 2 of the FAA.[55]

Most recently, in *Shearson/American Express, Inc. v. McMahon*,[56] the Court stated that federal statutory claims under section 10(b) of the Securities Exchange Act of 1934 (the 1934 Act)[57] and the civil liability provisions of the Racketeer Influenced and Corrupt Organizations Act (RICO)[58] must be arbitrated when raised in cases by securities customers against their brokers. Answering arguments that arbitration of federal statutory rights would dilute important protections provided by Congress, the Court stated that the FAA "mandates enforcement of agreements to arbitrate [federal] statutory claims"[59] unless Congress explicitly exempts such claims from the FAA. The Court explained that it would deduce such exemptions from the text or legislative history of the disputed statute or from "an inherent conflict between arbitration and the statute's underlying purposes."[60] Finding no such conflicts between the FAA and either the 1934 Act or RICO, the Court ordered arbitration to proceed under securities industry arbitration rules.[61]

As will be developed at more length in part II of this Article, these developments in the interpretation of the FAA have opened the door to the possibility of arbitrating shareholder claims involving public corporations. Where formerly the idea of arbitrating such disputes was almost unthinkable, it now appears that arbitration of shareholder claims is a clear possibility as an alternative to litigation.[62]

II. Arbitration and the Close Corporation

A. *The Close Corporation*[63]

Although arbitration of shareholder claims is a novelty for the public cor-

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55. *Id.* at 2525.

56. 107 S. Ct. 2332 (1987).

57. 15 U.S.C. § 78j(b) (1982).

58. 18 U.S.C. § 1964(c) (1982).

59. *McMahon*, 107 S. Ct. at 2337.

60. *Id.*

61. *Id.* at 2343, 2345-46; Shell, *supra* note 2, at 407-13.

62. Courts have traditionally been more willing to honor arbitration awards resulting from agreements by parties to submit *existing* disputes to arbitrators than awards resulting from enforcement of *predispute* arbitration clauses in contracts. *See, e.g.*, Wilko v. Swan, 346 U.S. 427, 438-39 (1953) (Jackson, J., concurring) (discussing the importance of this distinction in the context of claims under § 12(2) of the Securities Act of 1933); Coenen v. R. W. Pressprich & Co., 453 F.2d 1209, 1215 (2d Cir.) (holding that arbitration of existing claims under federal antitrust laws does not violate public policy), *cert. denied*, 406 U.S. 949 (1972). The same receptive attitude would probably hold for arbitrating corporate derivative disputes if parties chose to submit an existing derivative claim to arbitrators. The new legal environment described in part II of this Article makes possible the enforcement of predispute arbitration agreements placed in corporate governing documents.

63. The term "close corporation" has come to have a special meaning in recent years under statutes designed to give new rights to privately held businesses that elect "close corporation" status. *See, e.g.*, *Close Corporation Supplement to the Model Business Corporation Act*, 39 Bus. Law. 1031 (1983). In this Article, the term "close corporation" will be used interchangeably with and is intended to mean the same thing as the more general term "closely held" or "privately held" corporation.

poration, this dispute resolution system is well established in the context of another class of corporate entities, that of the privately held or "close" corporation.[64] The close corporation is the predominant form of corporate enterprise in the United States. Only about 4,000 corporations have securities listed on a national securities exchange.[65] Another 4,000 corporations are unlisted but report regularly to the SEC.[66] That leaves an estimated 2,500,000 corporations that do not fit into either of these regimes.[67] Close corporations differ in four principal ways from their public counterparts. First, close corporations tend to be small businesses with few assets, whereas public corporations tend to be very large multi-faceted enterprises.[68] Second, ownership and control of the close corporation are often integrated. The stock of close corporations tends to be held by a few individuals, most of whom are actively involved in the management of the business.[69] By contrast, public shareholders typically play no role in the management of the corporation. Third, because the stockholders are the managers, the stock of close corporations is usually "restricted," that is, stockholders may not sell it without first offering the stock for sale to the remaining stockholders. It follows that, in contrast to the highly liquid nature of the public shareholder's investment, there is no readily available market for close corporation shares. The absence of such a market makes valuation of shares difficult for both insiders and would-be purchasers, leads to conflicts over dividend and distribution policies, and eliminates the discipline of an active market for corporate control of the close corporation.[70] Finally, the owners of close corporations, while legally entitled to the benefit of limited liability, in practice must frequently waive this protection to gain access to credit markets.[71] Thus, shareholders of a close corporation, unlike public shareholders, risk losing con-

64. *See* R. KESSLER, NEW YORK CLOSE CORPORATIONS § 16.06 (1968); F. O'NEAL & R. THOMPSON, O'NEAL'S CLOSE CORPORATIONS § 9.16 (3d ed. 1988); Note, *Arbitration as a Means of Settling Disputes Within Close Corporations*, 63 COLUM. L. REV. 267 (1963).

65. Garth, Nagel & Plager, *Empirical Research and the Shareholder Derivative Suit: Toward a Better-Informed Debate*, 48 LAW & CONTEMP. PROBS. 137, 150 n.102 (Summer 1985).

66. *Id.*

67. *Id.*

68. Demsetz & Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 J. POL. ECON. 1155, 1167 (1985) (finding that "[s]ize of firm, as measured by the market value of equity, is negatively related to ownership concentration"). There are exceptions to every generalization about corporations, however. Some very large corporations in the United States are still family-owned close corporations. DeAngelo & DeAngelo, *Managerial Ownership Of Voting Rights*, 14 J. FIN. ECON. 33, 61-68 (1985) (listing sample of companies). In addition, public corporations that "go private" through leveraged buyouts become, for a period of time, giant close corporations held primarily by large institutional investors and management. McCune & Van Kirk, *Leveraged Buyouts by Management*, 16 REV. SEC. REG. 769 (1983); Anders, *Leveraged Buy-Outs Make Some Companies Tougher Competitors*, Wall St. J., Sept. 15, 1988, at 1, col. 6.

69. Easterbrook & Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 273 (1986).

70. *Id.* at 275-77.

71. H. HAYNSWORTH, SELECTING THE FORM OF A SMALL BUSINESS ENTITY § 2.02 (1985) ("In many small corporations . . . limited liability is more illusory than real because lenders will often require that the principal shareholders guarantee payment of any loan to the corporation or pledge their own assets as collateral for the loan."); *cf.* Hamilton, *The Corporate Entity*, 49 TEX. L. REV. 979, 985 (1971) (noting that contract creditors with small businesses must seek personal guarantees if they have questions about the solvency of the enterprise).

siderably more than their investment should the enterprise fail.[72]

In the language of transaction cost economics,[73] close and public corporations represent polar extremes on an institutional scale of economic enterprise. Close corporations are extremely "relational" in character. Many are family businesses,[74] and most depend on the close cooperation of the shareholders for success. Close corporation shareholders care almost as deeply about *who* owns and runs the business as *how* it is being run. Public corporation shareholders, by contrast, have little or no relationship with one another or the corporation beyond their shared hope for a positive investment return. The public shareholder's relationship with the enterprise is mediated by the stock market, and changes in the specific personnel who manage the corporation or in the list of fellow shareholders matter little unless such changes affect the market price of shares.

Surprisingly, in light of the facts that close and public corporations are entirely distinct forms of business enterprise and close corporations greatly outnumber public corporations, states have until recently chosen to regulate all corporations with a single set of rules drafted "almost exclusively" with large, public corporations in mind.[75] Thus, close corporations have been subject to the same corporate laws as public corporations for the greater part of the last 100 years and have had to cope, as best they could, with statutory norms that have sometimes proven to be ill-suited to their economic needs. In recent years many states have moved to provide close corporations with specially tailored statutory rules. Legislatures have added flexibility to general corporation statutes,[76] legal experts have drafted entire model codes dedicated solely to close corporations,[77] and courts have developed corporate common-law rules applicable only to close corporations.[78] The story of how arbitration has come to be an acceptable rem-

72. Close corporations are often called "incorporated partnerships." *See, e.g.*, Suckewer & Heftler, *Disputes Among Shareholders and Directors in Closely Held Corporations*, in ARBITRATION: COMMERCIAL DISPUTES, INSURANCE AND TORT CLAIMS 11 (A. Widiss ed. 1979); Hornstein, *Arbitration in Incorporated Partnerships*, 18 ARB. J. 229 (1963). Unlike partnerships, however, corporations owned by more than one shareholder cannot be dissolved at will by any single owner. *See, e.g.*, REVISED MODEL BUSINESS CORP. ACT § 14.02 (1985); DEL. CODE ANN. tit. 8, §§ 275, 355 (1983). Thus, dissatisfied shareholders face the prospect of being locked into an investment they would prefer to liquidate. This prospect leads many close corporation planners to advise shareholders in close corporations to find a mutually agreeable means of exit from the corporation through buyouts. Hetherington & Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1, 38 (1977).

73. *See infra* notes 302-27 and accompanying text (exploring transaction cost economics).

74. *See* Haynsworth, *The Effectiveness of Involuntary Dissolution Suits as a Remedy for Close Corporation Dissension*, 35 CLEV. ST. L. REV. 25, 55 (1987) (40% of 1984-85 involuntary dissolution cases studied involved family-owned businesses).

75. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 268 (1967).

76. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 341-354 (1983); R. HAMILTON, CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS 514-15 (3d ed. 1986).

77. Model Statutory Close Corp. Supp., 3 MODEL BUS. CORP. ACT ANN. 1803-79 (3d ed. 1985).

78. *See, e.g.*, Tillis v. United Parts, Inc., 395 So. 2d 618, 619 (Fla. App. 1981) (recognizing special fiduciary duties of majority shareholders in close corporations in treatment of minority shareholders), *aff'd*, 432 So. 2d 675 (Fla. App. 1983); Wilkes v. Springside Nursing Home, Inc., 370 Mass. 842, 848-49, 353 N.E.2d 657, 663-64 (1976) (same); Donahue v. Rodd Electrotype Co., 367

edy for close corporations exemplifies this legal evolution.

B. *Legalizing Arbitration: The New York Experience*

Although commentators have questioned the utility of arbitration in the close corporation setting,[79] investors in close corporations have included arbitration clauses in negotiated shareholder agreements for many decades.[80] Repeated legislative and judicial reforms have been needed, however, to establish arbitration as a legitimate means of dispute resolution in the close corporation context. A brief history of the legal development of corporate arbitration in the state of New York is illustrative of the hurdles that close corporation shareholders have had to overcome. Despite the differences between close and public corporations, some of these same issues will arise when public corporations attempt to use the arbitration remedy.

Prior to 1920 neither New York nor the United States had a statute regulating the use of arbitration. Hence, common-law rules regarding arbitration provided the only guidelines for its use. Under common-law arbitration rules, agreements to arbitrate future disputes were deemed against public policy because they "ousted the jurisdiction of the courts."[81] Even agreements to arbitrate existing disputes were revocable at any time prior to the rendering of an arbitration award.[82] Thus, corporate arbitration in these early days was used successfully only when the shareholders agreed to submit their existing dispute to the arbitral forum and no party changed his mind prior to the moment when the arbitrators made their award.

Mass. 578, 587, 328 N.E.2d 505, 516 (1975) (same); Russell v. First York Savings Co., 218 Neb. 112, 116, 352 N.W.2d 871, 874 (1984) (same); 68th St. Apts., Inc. v. Lauricella, 142 N.J. Super. 546, 559-60, 362 A.2d 78, 86 (1976) (same), *aff'd*, 150 N.J. Super. 47, 374 A.2d 1222 (1977).

79. Some commentators have said that arbitration is effective only for resolving "discrete, nonrecurring disagreements" and that it "cannot restore consensus." Hetherington & Dooley, *supra* note 72, at 37. Although there is truth in this assertion, case law reveals instances in which arbitration has been used more than once to resolve disputes in a single close corporation. *See, e.g.*, *In re* Denihan, 119 A.D.2d 144, 506 N.Y.S.2d 39 (1986) (describing family corporation that had been involved in a total of six arbitrations over a 15-year period), *aff'd*, 69 N.Y.2d 725, 504 N.E.2d 694, 572 N.Y.S.2d 367 (1987); *cf. In re* Darman, 105 A.D.2d 1028, 483 N.Y.S.2d 469 (1984) (describing the successful use of arbitrators to draft a comprehensive buy-sell agreement to govern ongoing relationship among parties). Other commentators have counseled that arbitration poses risks for close corporation shareholders because arbitrators may substitute their business judgment for that of the managing shareholder or, worse still, may render a compromise award "that is unsatisfactory to both sides." Haynsworth, *supra* note 74, at 29.

80. *See, e.g.*, *In re* Carl, 263 A.D. 887, 32 N.Y.S.2d 410 (1942); Lumsden v. Lumsden Bros. & Taylor Inc., 242 A.D. 852, 275 N.Y.S. 221 (1934). Typically, close corporation arbitration clauses are found in shareholder agreements entered into at the formation stage of the enterprise but not, curiously, in corporate charters. Research reveals no American cases involving an arbitration provision found solely in the charter of a close corporation. However, commentators have for years recommended that arbitration clauses be placed in both shareholder agreements and the articles of incorporation of new close corporations. *See, e.g.*, Hornstein, *Stockholders' Agreements in the Closely Held Corporation*, 59 YALE L.J. 1040, 1054 (1950); Kessler, *Arbitration of Intra-Corporate Disputes Under New York Laws*, 19 ARB. J. 1, 19 (1964). It seems likely therefore that some corporate charters have contained such provisions.

81. Shell, *supra* note 23, at 635.

82. Shell, *supra* note 23, at 635; *see also* Note, *Arbitrability of Disputes Under the Federal Arbitration Act*, 71 IOWA L. REV. 1137, 1139 (1986) (tracing history of arbitration prior to adoption of FAA).

Even after the passage in 1920 of New York's landmark arbitration statute,[83] which mandated judicial enforcement of agreements to arbitrate future disputes, the New York Court of Appeals frustrated attempts by shareholders to bypass the courts. In *In re Fletcher*[84] the court held that an agreement among close corporation shareholders for arbitrators to determine the transfer price of closely held shares was not enforceable under the New York statute because valuations and appraisals were not "controversies" subject to statutory arbitration.[85] The New York legislature overruled *Fletcher* in 1952 by amending its arbitration statute to cover "questions arising out of valuations, appraisals or other controversies which may be collateral, incidental, precedent or subsequent to or independent of any issue between the parties."[86]

Similarly, the New York courts were reluctant to approve the use of arbitration for control and management disputes within close corporations because such controversies were "nonjusticiable" matters that could not be heard in a court.[87] Once again the New York legislature amended the arbitration statute to make such disputes arbitrable "without regard to the justiciable character of the controversy."[88]

83. Act of Apr. 19, 1920, ch. 275, 1920 N.Y. Laws 803 (codified as amended at N.Y. CIV. PRAC. L. & R. §§ 7501-7514 (McKinney 1980)).

84. 237 N.Y. 440, 143 N.E. 248 (1924).

85. *Id.* at 448, 143 N.E. at 250-51. The 1920 statute made agreements to arbitrate future disputes specifically enforceable by providing that two or more persons may "contract to settle by arbitration a controversy thereafter arising between the parties to the contract." Act of Apr. 19, 1920, ch. 275, § 2, 1920 N.Y. Laws 803, 804.

86. Act of Apr. 15, 1952, ch. 757, 1952 N.Y. Laws 1632 (amending Civil Practice Act, ch. 925 § 1448, 1920 N.Y. Laws 486 (replaced by N.Y. CIV. PRAC. L. & R. § 7501 (McKinney 1981))); *see* O'Neal, *Resolving Disputes in Closely Held Corporations: Intra-Institutional Arbitration*, 67 HARV. L. REV. 786, 796-97 (1954). The present New York arbitration statute omits this language because it was felt that the broad language of N.Y. CIV. PRAC. L. & R. § 7501 clearly encompassed valuation and appraisal questions. R. KESSLER, *supra* note 64, § 16.09, at 497 (citing legislative history).

87. *See In re* Burkin, 1 N.Y.2d 570, 136 N.E.2d 862, 154 N.Y.S.2d 898 (1956). In *Burkin* the New York Court of Appeals held that a broad arbitration agreement between shareholders of a close corporation did not cover a dispute over removal of a shareholder-director because New York did not recognize a private right of action to remove a corporate director, and the state arbitration statute suggested that controversies were arbitrable only if they "might be the subject of an action." *Id.* at 571, 136 N.E.2d at 864, 154 N.Y.S.2d at 900 (quoting Act of Apr. 15, 1952, ch. 757, 1952 N.Y. Laws 1632 (amending Civil Practice Act, ch. 925 § 1448, 1920 N.Y. Laws 486 (replaced by N.Y. CIV. PRAC. L. & R. § 7501 (McKinney 1981)))); *see also In re* Ades, 12 Misc. 2d 913, 914, 177 N.Y.S.2d 582, 584 (1958) (motion to compel arbitration to remove director denied since only attorney general has right to remove director); *In re* Scuderi, 265 A.D. 1054, 1054, 39 N.Y.S.2d 422, 423 (1943) (refusing to permit arbitration regarding the validity of the election of a member of the board because the election "was governed by the by-laws of the corporation," not the shareholders' agreement).

88. N.Y. CIV. PRAC. L. & R. § 7501 (McKinney 1980 & Supp. 1988). There is evidence that this change to the New York arbitration statute was in process before the *Burkin* decision was handed down and was responsive to a general sense that the restrictive language in the statute served no justifiable purpose. Note, *supra* note 64, at 279 n.72. In the famous case of Ringling Brothers, Barnum & Bailey Combined Shows, Inc. v. Ringling, 29 Del. Ch. 610, 53 A.2d 441 (1947), the Delaware court exhibited a reluctance to give full effect to an arbitration agreement between close corporation shareholders regarding the election, rather than the removal, of directors. In *Ringling* a group of shareholders making up a majority block entered into a voting agreement that provided for arbitration in the event of a dispute. *Id.* at 614, 53 A.2d at 443. After a dispute arose over the election of directors and an arbitrator had rendered a decision, the losing party refused to vote as directed by the arbitrator. *Id.* at 616, 53 A.2d at 444. The court recognized the validity of the arbitration agreement, but refused to require the shareholder to vote as the arbitrator directed. *See*

A third obstacle to the enforcement of arbitration agreements arose from the rigid statutory requirement that corporate affairs be managed solely by a board of directors.[89] Courts have refused to permit shareholders to use governance structures, including arbitration, more tailored to their individual needs[90] on the ground that such structures "sterilize the board."[91]

The New York Court of Appeals decision in *Long Park, Inc. v. Trenton-New Brunswick Theatres Co.*[92] is a classic application of the sterilization doctrine in the arbitration context. In *Long Park* the court examined a close corporation governance structure under which the shareholders (all of whom were corporations) designated one of their number to manage the affairs of the entity.[93] The nonmanaging shareholders were granted the right to apply to an

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id. at 623, 53 A.2d at 448. This resulted in the total frustration of the voting agreement and in legislative action in Delaware and elsewhere to make such agreements specifically enforceable. In New York the result in *Ringling* has been legislatively overruled by § 620(a) of the corporation act, which recognizes the right of shareholders in a close corporation to agree to vote their stock by means of any agreed procedure, including arbitration in which the arbitrator is given irrevocable proxies. *See* N.Y. BUS. CORP. LAW §§ 620(a), 609(f)(5) (McKinney 1986).

89. *E.g.*, N.Y. BUS. CORP. LAW § 701 (McKinney 1986); *see also* DEL. CODE ANN. tit. 8, § 141(a) (1983) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation."); REVISED MODEL BUSINESS CORP. ACT § 8.01(b) ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation."). Several reasons have been advanced to explain why the board of directors is the statutorily mandated institution of choice in corporate governance. One explanation for the board, based on an economic understanding of the origins of the modern corporation, views this institution as a means of centralizing management and accountability in order to facilitate the raising of capital. Manne, *supra* note 75, at 260-61. Another explanation, derived from transaction cost economics, explains the board as a contractual governance structure protecting the investment expectations of the corporation's residual risk bearers (equity holders) and the owners of firm-specific human capital (senior managers). Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1209-11, 1215-20 (1984).

90. *See* Long Park, Inc. v. Trenton-New Brunswick Theatres, 297 N.Y. 174, 77 N.E.2d 633 (1948); McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934); Manson v. Curtis, 223 N.Y. 313, 119 N.E. 559 (1918).

91. *See* Manson v. Curtis, 223 N.Y. 313, 323, 119 N.E. 559, 562 (1918); H. HENN & J. ALEXANDER, LAWS OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES § 267 (3d ed. 1983); Bulloch, *Shareholder Agreements in Closely Held Corporations: Is Sterilization an Issue?*, 59 TEMPLE L.Q. 61, 62 (1986).

92. 297 N.Y. 174, 77 N.E.2d 633 (1948). The New York courts have exhibited confusion on the question of when an arbitration agreement sterilizes the board. In one early case involving the removal of a shareholder as an officer and director of a close corporation, a New York court refused to enforce an arbitration agreement on the grounds that "the duty of the board of directors to manage the affairs of the corporation in accordance with their best judgment would be wholly abrogated in all cases" if arbitration prevailed. *In re* Allied Fruit & Extract Co., 243 A.D. 52, 56, 276 N.Y.S. 153, 157 (1934). Less than 10 years later, however, another New York court held on nearly identical facts that the removal of a shareholder as an officer and employee of a close corporation was properly subject to arbitration under a shareholder agreement. Martocci v. Martocci, 2 Misc. 2d 330, 42 N.Y.S.2d 222, *aff'd*, 266 A.D. 840, 43 N.Y.S.2d 279 (1944). Other New York cases have approved arbitration involving a variety of management issues without regard to the sterilization issue. *See, e.g.*, *In re* Lane, 50 N.Y.2d 864, 407 N.E.2d 1337, 430 N.Y.S.2d 41 (1980) (compensation and employment dispute); *In re* Glekel, 30 N.Y.2d 93, 281 N.E.2d 171 (1972) (agreement regarding registration of shares for a public offering); *In re* Groval Knitted Fabrics, Inc., 72 Misc. 2d 513, 339 N.Y.S.2d 58 (1971) (dispute over termination of salary and "freeze out" of minority shareholder), *aff'd*, 31 N.Y.2d 796, 291 N.E.2d 395, 339 N.Y.S.2d 117 (1972); Crandall v. Master-Eagle Photoengraving Corp., 27 Misc. 2d 475, 211 N.Y.S.2d 535 (1960) (claim of excessive compensation being paid to manager-shareholders), *aff'd*, 13 A.D.2d 726, 217 N.Y.S.2d 469 (1961).

93. *Long Park, Inc.*, 297 N.Y. at 177, 77 N.E.2d at 634.

arbitrator should they wish to take over the management of the corporation themselves.[94] The court held that this attempt to divest the board of its authority both to name and remove the management of the company "sterilized" the board in violation of New York law.[95]

The sterilization issue was finally put to rest when the New York legislature passed legislation in 1965 that overruled *Long Park*.[96] Section 620(b) of the New York corporation law provides that, so long as all shareholders approve and the clause is placed in the certificate of incorporation, provisions transferring "all or any part" of the management authority in a close corporation to "one or more shareholders or to one or more persons or corporations to be selected by him or them" are legal despite being restrictive of board discretion.[97] This statutory safe harbor sanctions agreements to arbitrate virtually any sort of business policy dispute in close corporations.[98]

A fourth close corporation arbitration problem that has vexed the New York courts is whether shareholder derivative claims may be arbitrated. A number of early New York cases suggested that arbitration of derivative suits

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94. *Id.* at 178, 77 N.E.2d at 634.

95. *Id.* at 179, 77 N.E.2d at 635.

96. N.Y. BUS. CORP. LAW § 620(b) (McKinney 1986). In addition, also in 1965, a New York appellate court, later affirmed by the New York Court of Appeals, enforced arbitration between two owners of a close corporation over an important, but arguably conventional, business decision. In *Application of Vogel*, 25 A.D.2d 212, 268 N.Y.S.2d 237 (1966), *aff'd*, 19 N.Y.2d 589, 224 N.E.2d 738, 278 N.Y.S.2d 236 (1967), the two 50% owners of a close corporation were split over whether their corporation should exercise an option to purchase a warehouse that the corporation leased. One of the owners, Vogel, had a conflict of interest in that he owned another corporation that would be adversely affected if the option were exercised. The other owner demanded arbitration of the dispute pursuant to an agreement between the two men and the corporation. The court enforced the arbitration clause, holding that the exercise of the option was a "fundamental" matter that involved the "continued [corporate] existence" and that both parties were aware that the option might become an issue when they signed the arbitration agreement. Quoting a treatise on New York arbitration law, the court noted that arbitrators could be useful in resolving disputes involving " 'business judgment so long as they are not required to assume a continuing burden of management.' " 25 A.D.2d at 216, 268 N.Y.S.2d at 242 (quoting 8 J. WEINSTEIN, H. KORN & A. MILLER, NEW YORK CIVIL PRACTICE § 7501.18). However, the court indicated that, absent compliance with § 620, it might not enforce an arbitration clause when the dispute related to routine matters of business judgment. *Id.* at 216, 268 N.Y.S.2d at 241.

97. N.Y. BUS. CORP. LAW § 620(b) (McKinney 1986). The requirement that sterilizing provisions be included in the certificate of incorporation has not been strictly enforced on the theory that, when there is no dispute that all the shareholders agreed to the provision, the certificate can be judicially reformed to comport with the agreement. *See* Zion v. Kurtz, 50 N.Y.2d 92, 102-03, 405 N.E.2d 681, 685-86, 428 N.Y.S.2d 199, 204 (1980) (interpreting Delaware law but stating that the same result would obtain in New York); Adler v. Svingos, 80 A.D.2d 764, 765, 436 N.Y.S.2d 719, 721 (1981) (upholding unanimous consent agreement among shareholders even though agreement not placed in certificate of incorporation). Some states, including Delaware, permit sterilizing agreements in close corporations entered into by a majority of the shareholders. ALA. CODE § 10-2A-307 (1987); DEL. CODE ANN. tit. 8, § 350 (1983); KAN. STAT. ANN. § 17-7210 (1981); 15 PA. CONS. STAT. ANN. § 1381 (Purdon Supp. 1988).

98. R. KESSLER, *supra* note 64, § 16.06, at 483-84; F. O'NEAL & R. THOMPSON, *supra* note 64, § 9.16, at 63-65; Coffee, *supra* note 12, at 967-68. Other states have not been so indirect in approving the use of arbitration to resolve intracorporate disputes and have explicitly approved the use of arbitration by close corporation shareholders. *See, e.g.*, ALA. CODE § 10-2A-311 (1987); ARIZ. REV. STAT. ANN. § 10-206 (1977); CONN. GEN. STAT. ANN. § 33-339 (West 1987); ILL. ANN. STAT. ch. 32, para. 1211-11(7) (Smith-Hurd Supp. 1988); ME. REV. STAT. ANN. tit. 13A, §§ 616(4), 617(3), 618(1)(F) (1964) (appraisal, voting agreements, management agreements); MINN. STAT. ANN. § 302A.457, subd. 2(a) (West 1985 & Supp. 1988); N.C. GEN. STAT. § 55-73(a) (1982); OHIO REV. CODE ANN. § 1701.591(C)(11) (Page 1985 & Supp. 1987).

violated public policy.[99] Other cases found a more technical means of avoiding arbitration by focusing on the fact that the corporation, on whose behalf the derivative claim is brought, was not a party to the shareholder arbitration agreement.[100]

Legal commentators quickly devised a means of solving the technical problem: have the corporation sign the arbitration agreement.[101] As to the public policy argument, recent cases have refused to draw a distinction between close corporations and their shareholders and have thus permitted derivative suits to be arbitrated.[102] These courts have found that derivative claims of managerial waste and misappropriation are, realistically, disputes among the shareholders, not between the corporation and the alleged wrongdoer. The public policy of litigating derivative claims has therefore now given way to the policy of encouraging arbitration.[103]

A final problem involving the arbitration of close corporation disputes concerns dissolution. Early New York cases refused to enforce arbitration when the stockholder resisting arbitration sought to petition for dissolution of the corporation.[104] Subsequent decisions, however, have made clear that arbitration can be compelled even in the face of a petition for dissolution[105] and, indeed, that

99. *See, e.g.*, Pfeiffer v. Berke, 4 Misc. 2d 918, 920, 121 N.Y.S.2d 774, 777 (1953) ("An agreement to arbitrate the issues arising in a shareholder's derivative suit [is] unenforcible [sic] as against public policy."); *Application of* Diamond, 80 N.Y.S.2d 465, 467 (1948), ("The issues involved in the stockholder's derivative action are not referable to arbitration under the contract, and . . . [even if they were], they would be unenforceable as against public policy . . . ."), *aff'd*, 274 A.D. 762, 79 N.Y.S.2d 924 (1948); Lumsden v. Lumsden Bros. & Taylor, Inc., 242 A.D. 852, 275 N.Y.S. 221, 222 (1934) ("It does not appear how there could be an agreement to arbitrate a controversy of this nature made in advance . . . ."). *But see In re* Carl, 263 A.D. 887, 32 N.Y.S.2d 410 (1942) (enforcing arbitration agreement on petition by defendant in derivative action); Note, *supra* note 64, at 281-83.

100. *See* Hotcaveg v. Lightman, 27 Misc. 2d 573, 574, 211 N.Y.S.2d 533, 534 (1960); *Diamond*, 80 N.Y.S.2d at 466-67. Corporate arbitration clauses are frequently contained in shareholders' agreements to which the corporations are not parties. Thus, there is no written agreement to arbitrate binding the corporation.

101. *See* F. O'NEAL & R. THOMPSON, *supra* note 64, § 9.19, at 86.

102. Siegal v. Ribak, 43 Misc. 2d 7, 13, 249 N.Y.S.2d 903, 909 (1964) ("From a logical and practical viewpoint, the conclusion is irresistible that in a close corporation a dispute concerning acts of waste is a matter involving stockholders *inter se*. To say that the corporate entity is the real party is to disregard reality.")

103. *Id.* ("On broad principles of practicality, the courts should encourage arbitration to dispose of the problems created by disputes within close corporations. Arbitration avoids the delay inherent in litigation and weeds out from our courts the very type of time consuming dispute that we have in the instant case."). *See also* Bayly, Martin & Fay, Inc. v. Glaser, 92 A.D.2d 850, 852, 460 N.Y.S.2d 575, 577 (Silverman, J., dissenting in part) (derivative claims of misappropriation, conversion and waste of income and corporate assets held suitable for arbitration), *aff'd*, 60 N.Y.2d 577, 454 N.E.2d 124, 467 N.Y.S.2d 43 (1983); *In re* Lane, 70 A.D.2d 838, 839, 418 N.Y.S.2d 25, 26 (1979) ("Arbitration of claims of a derivative nature are [sic] not against public policy in a close corporation."), *aff'd*, 50 N.Y.2d 864, 407 N.E.2d 1337, 430 N.Y.S.2d 41 (1980).

104. *In re* Cohen, 183 Misc. 1034, 1035, 52 N.Y.S.2d 671, 671 (1944) ("The disputes between these parties . . . may be decided by arbitration, but arbitration cannot compel a stockholder holding [50%] of the stock to desist from seeking its dissolution. No stockholder is required to continue in a state of constant legal warfare with the remaining [50%] interest."), *aff'd*, 269 A.D. 663, 53 N.Y.S.2d 467 (1945); Matter of Becopa Glove Mills, Inc., 122 N.Y.L.J. 1790 (Sup. Ct. 1949); Matter of Dome Trading Corp., 114 N.Y.L.J. 514 (Sup. Ct. 1945); Matter of Hess, 108 N.Y.L.J. 555 (Sup. Ct. 1942); Note, *supra* note 64, at 283-84 & n.96.

105. *See In re* Levy, 79 A.D.2d 684, 434 N.Y.S.2d 39 (1980); *In re* Moskowitz, 30 A.D.2d 820, 292 N.Y.S.2d 748 (1968).

arbitrators have broad authority to order both dissolution and buyouts as remedies in arbitration.[106]

In summary, after nearly seventy years of legal evolution, arbitration is now utilized in New York as a close corporation remedy for virtually every kind of corporate dispute. Indeed, detailed case administration statistics compiled by the American Arbitration Association reveal that between 1984 and August 1988 the AAA received over one thousand claims and counterclaims worth over $118,000,000 under its case administration category dealing with close corporation disputes. These claims include disputes regarding stock valuation and appraisal, allegations of breach of contract, mismanagement, misrepresentation, wrongful discharge, and breach of fiduciary duty.[107]

The few exceptions to the present pro-arbitration policy that may remain in New York or elsewhere are now subject to a new challenge. As noted earlier, the Supreme Court has recently reinterpreted the FAA as preempting attempts by the states to preclude access to the arbitral forum.[108] When parties can convince a court that their close corporation dispute involves interstate commerce,[109] they may be able to bypass even express statutory restrictions on arbitration, such as the New York requirement that an arbitration clause appear in the charter.[110] Not only do FAA standards facilitate enforcement of arbitration clauses, federal law also supports confirmation of corporate arbitration awards involving attorneys' fees, punitive and multiple damages, and other extraordinary relief that might be prohibited under state law.[111]

106. *In re* Denihan, 119 A.D.2d 144, 506 N.Y.S.2d 39 (1986) (ordering arbitration of dissolution dispute), *aff'd*, 69 N.Y.2d 725, 504 N.E.2d 694, 512 N.Y.S.2d 367 (1987); *In re* Berman, 31 Misc. 2d 830, 222 N.Y.S.2d 716 (1961) (upholding arbitrator dissolution award); Application of Hega Knitting Mills, 124 N.Y.S.2d 115 (1953) (same); *In re* Astey, 19 Misc. 2d 1059, 189 N.Y.S.2d 2 (1959) (upholding arbitrator order requiring buy-out); *cf. In re* Darman, 105 A.D.2d 1028, 483 N.Y.S.2d 469 (1984) (upholding arbitration award that included comprehensive buy-sell agreement and corporate control provision).

107. Letter from Barbara L. Brady, AAA Case Administration Department Coordinator, to Professor G. Richard Shell (Sept. 1, 1988) (on file with author) (attaching computer data printout on shareholder cases filed for period 1984 through August 1988).

108. *See supra* notes 48-62 and accompanying text.

109. Many close corporations involve wholly intrastate commerce. Thus, state arbitration law would be the correct source of rules for interpreting arbitration agreements involving such entities. *See supra* notes 43-44 and accompanying text. But when equity funds have been raised from out-of-state residents, when the corporation transacts business across state lines, or where the dispute at issue involves the use of interstate mails, telephones, or other means of communication, it is arguable that the arbitration provision is in a contract that involves interstate commerce and that the FAA should apply. *See* West Point-Pepperell, Inc. v. Multi-Line Indus., 231 Ga. 329, 201 S.E.2d 452 (1973); Burke County Pub. Schools Bd. of Educ. v. Shaver Partnership, 303 N.C. 408, 279 S.E.2d 816 (1981); Allison v. Medicab Int'l, Inc., 92 Wash. 2d 199, 597 P.2d 380 (1979). It could also be argued that an arbitration clause, viewed as a governance device, should be interpreted according to the corporate and arbitration laws of the state in which the entity is incorporated. The "internal affairs doctrine" declares that corporations should be subject in their internal governance to the law of only one state, the state of incorporation. H. HENN & J. ALEXANDER, *supra* note 91, § 86. The internal affairs doctrine, however, is a choice of law rule distinguishing among sources of *state* law. The question of which arbitration statute to apply, by contrast, is an issue of federalism, involving the supremacy of federal over state law in matters involving congressional statutes that regulate interstate commerce. Thus, so long as the close corporation affects interstate commerce, the FAA should apply to the enforcement of any arbitration provision and the confirmation of any award.

110. N.Y. BUS. CORP. LAW § 620(b) (McKinney 1986).

111. For example, the Uniform Arbitration Act, enacted in many states, forbids the award of

III. ARBITRATION AND PUBLIC SHAREHOLDER DISPUTES: LEGAL ISSUES AND PUBLIC POLICIES

Legal developments over the past four decades have transformed arbitration of close corporation disputes from a hotly contested issue into a matter of everyday practice. With the Supreme Court's decisions in *Southland*,[112] *Perry*,[113] and *McMahon*,[114] shareholders in public corporations stand at the threshold of a similar legal revolution.[115]

A. *Shareholder Litigation and Corporate Governance*

Given the seeming advantages of arbitration and the Supreme Court's enthusiastic endorsement of this dispute resolution mechanism, what objection could there be to using arbitrators to settle the complaints that public shareholders bring against their corporation and its managers and directors? The answer to this question lies in the existing legal model of state control over the large corporation. Lawsuits brought by disgruntled shareholders against incumbent managers and directors occupy a prominent place in the current model of public corporate governance. This model would be profoundly altered by the use of arbitrators in place of judges to resolve public shareholder claims.

Most legal scholars agree that rules of law play an important role in regulating the conduct of public corporations and their managers.[116] In the large

attorneys' fees in arbitration. *See* Floors, Inc. v. B.G. Danis, Inc., 380 Mass. 91, 401 N.E.2d 839 (1980); UNIF. ARBITRATION ACT § 10, 7 U.L.A. 131 (1985) ("Unless otherwise provided in the agreement to arbitrate, the arbitrators' expenses and fees, together with other expenses, not including counsel fees, incurred in the conduct of the arbitration, shall be paid as provided in the award."). The FAA has been interpreted to contain no such prohibition on awards of fees. Willoughby Roofing & Supply Co. v. Kajima Int'l, Inc., 598 F. Supp. 353 (N.D. Ala. 1984), *aff'd*, 776 F.2d 269 (11th Cir. 1985) (per curiam); Shell, *The Power To Punish: Authority of Arbitrators to Award Multiple Damages and Attorneys' Fees*, 72 MASS. L. REV. 26, 31 (1987). Similarly, state law sometimes prohibits arbitration awards of punitive damages. *See* Garrity v. Lyle Stuart, Inc., 40 N.Y.2d 354, 353 N.E.2d 793, 386 N.Y.S.2d 831 (1976). Once again, the FAA has been interpreted to contain no such limitation. *See Willoughby*, 598 F. Supp. at 353; Stipanowich, *Punitive Damages in Arbitration—* Garrity v. Lyle Stuart, Inc. *Reconsidered*, 66 B.U.L. REV. 953 (1986).

112. *See supra* notes 48-50 and accompanying text.

113. *See supra* notes 51-55 and accompanying text.

114. *See supra* notes 56-61 and accompanying text.

115. Indeed, Professor John C. Coffee, Jr. has speculated that arbitration of public shareholder claims is the "issue for the future" for shareholder litigation. Coffee, *supra* note 12, at 953. *See also* Ribstein, *Edited Transcript of Proceedings of the Business Roundtable/Emory University Law and Economics Center Conference on Remedies Under the ALI Proposals: Law and Economics*, 71 CORNELL L. REV. 357, 388-89 (1986) (Professor Daniel Fischel remarking that "I've been troubled for a long time about why there isn't more of that type of dispute resolution [arbitration]. So I think it is interesting to have some discussion about what the costs are of [arbitration] so that people don't use it more frequently.").

116. For the monitoring of corporate managers, economists tend to favor reliance on markets rather than mandatory rules of law. *See, e.g.*, Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); Fischel, *Labor Markets and Labor Law Compared with Capital Markets and Corporate Law*, 51 U. CHI. L. REV. 1061 (1984); Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U.L. REV. 913, 944 (1982) ("The function of corporation law . . . is rather limited. Apart from minimizing transaction costs and possibly facilitating the operation of market forces that discipline management, corporation law has little role to play."); Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 117 (1979). By contrast, more traditional legal scholars tend to suspect that markets lack the efficiency to provide adequate regulation and

public corporation, control over corporate assets is centralized in the hands of relatively few corporate policymakers.[117] These decision makers may have some stake in the company, but the majority of shares are owned by people and institutions that have little interest in directly managing the business. Control of the corporation is therefore effectively separated from ownership of corporate assets.[118] This situation creates inevitable "agency costs" in that managers have opportunities to dissipate corporate assets through mismanagement and to misappropriate shareholders' wealth through a variety of both overt and subtle self-serving strategies.[119]

The conventional wisdom is that legal rules are needed to protect shareholders from such managerial opportunism. Shareholders thus have two major legally sanctioned means, in addition to their right to simply sell their shares and reinvest their money,[120] to influence management of the publicly held corporation. First and foremost, shareholders have the right to vote in corporate affairs.[121] The highest decision makers in the corporation—the members of the

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therefore lean toward more legal restrictions. *See, e.g.*, Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1404 (1985) (economic theory of corporation sometimes "serves the ideological function of legitimating substantially unaccountable managerial discretion to determine corporate activities and to serve itself at the expense of investors"); Cox, *supra* note 9, at 752; Branson, *Countertrends in Corporation Law and Principles of Corporate Government & Structure: Model Business Corporation Act Revision, British Company Law Reform*, 68 MINN. L. REV. 53, 56-72 (1983). Both groups, however, recognize the need for legal regulation under some circumstances. *Compare* Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 701 (1982) (recognizing need for shareholder suits to deter and compensate for "one-shot" frauds) *with* Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 326-27 (1981) (advocating strengthening of shareholder suit to deter violations of all fiduciary duties) *and* Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 TEX. L. REV. 591, 596-602 (1983) (demonstrating that shareholder derivative actions are currently ineffective and calling for reforms to strengthen remedies used by courts).

117. The statutory model posits that this decision making authority rests with the board of directors. *See supra* note 89. In fact, however, the board is frequently controlled to a greater or lesser extent by top management in the corporation. Top management sits on the board, sets the agenda for most meetings, and controls the flow of information to board members. *See, e.g.*, Brudney, *The Independent Director: Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 612, 633-34 (1982); Cox & Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83 (Summer 1985).

118. This situation was brought to the attention of legal and political commentators in the 1930s by Professors Berle and Means. *See* A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1933). A great deal of modern corporate law theory and practice derives from the "separation of ownership and control" thesis stated in this classic book. In recent years, economists have criticized both the data and the analysis of this work. *See, e.g.*, Stigler & Friedland, *The Literature of Economics: The Case of Berle and Means*, 26 J.L. & ECON. 237, 249 (1983) (demonstrating that management salaries in firms with concentrated ownership were no different from those firms with diffuse ownership during the periods studied by Berle and Means); Demsetz & Lehn, *supra* note 68, at 1175-76 (arguing that firms with diffuse ownership structures are no less profitable than firms with concentrated ownership structures and therefore the separation of ownership from control does not affect management performance).

119. *See* Brudney, *supra* note 116, at 1427-43.

120. The shareholder's option simply to sell out when the shareholder disagrees with management policy is popularly known as the "Wall Street Rule." Note, *Corporate Governance and the Shareholders' Derivative Action: Rules and Remedies for Implementing the Monitoring Model*, 3 CARDOZO L. REV. 627, 635 & n.40 (1982).

121. In the context of public corporations the voting machinery of corporate governance is strictly regulated by federal rules regarding proxy solicitations. L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 449-97 (2d ed. 1988). Shareholders also have the right under state law to

board of directors—are elected to office by a vote of the shareholders and may be removed at regular intervals through new elections.[122] In addition, shareholder approval is needed to implement certain fundamental changes in the corporate charter and economic structure.[123]

The right of shareholders in a public corporation to vote on such matters as the election and removal of directors is important for two reasons. First, it gives shareholders a voice in the ongoing management of the business insofar as major decisions affecting the identity of the enterprise are concerned. Second, it makes possible the aggregation of voting blocks by interested parties outside the corporation who think they can improve the return on investment offered by incumbent managers. This latter use of the voting system is most visible in the context of the hostile tender offer conducted pursuant to federal and state law.[124]

Despite the importance of shareholders' right to vote, this control mechanism is viewed by many as an ineffective governance device, and some have said that corporate "democracy" is simply a myth.[125] Critics point out that widely dispersed public shareholders are unable, as a practical matter, to combine their votes, and that management is therefore in full control of the election machinery.[126] The utility of takeovers as a governance device has been called into question in recent years by the widespread, successful use by target company managers of defensive tactics such as "poison pills"[127] and "shark repellent" charter amendments[128] to defeat hostile takeover attempts.[129] State antitake-

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inspect the corporate books and records under certain circumstances. *E.g.*, REVISED MODEL BUSINESS CORP. ACT § 16.02.

122. REVISED MODEL BUSINESS CORP. ACT § 8.03; DEL CODE ANN. tit. 8, § 141(d) (1983).

123. *E.g.*, REVISED MODEL BUSINESS CORP. ACT §§ 10.01-10.09 (charter amendments), 11.03 (mergers), 12.02 (sale of assets other than in the ordinary course). Shareholders also have a right to an appraisal and repurchase of their shares by the corporation under certain circumstances. *Id.* §§ 13.01-13.03.

124. The subject of hostile tender offers is complex and well beyond the scope of this Article. Nevertheless, it is generally agreed that managers are rendered accountable to shareholders to some degree because of the possibility that an acquiring firm will seek control of the company through share purchases. *See, e.g.*, Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965); Coffee, *supra* note 6; Easterbrook & Fischel, *supra* note 116. The Williams Act governs hostile tender offers on the federal level. *See* 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1981). Note, *SEC Takeover Regulation Under the Williams Act*, 62 N.Y.U. L. REV. 580 (1987). State takeover statutes also regulate this area. The Supreme Court has held that the Williams Act does not preempt all state attempts to regulate takeovers. *See* CTS Corp. v. Dynamics Corp. of Am., 107 S. Ct. 1637 (1987).

125. Note, *supra* note 120, at 635 n.40; Pound, *Proxy Contests and the Efficiency of Shareholder Oversight*, 20 J. FIN. ECON. 237 (1988) (testing sample of 100 proxy contests and finding significant evidence that shareholder monitoring is inefficient).

126. A. BERLE & G. MEANS, *supra* note 118, at 47-116; Brudney, *supra* note 116, at 1412 n.23; *see also* C. STONE, WHERE THE LAW ENDS: THE SOCIAL CONTROL OF CORPORATE BEHAVIOR 47-48 (1975) (discussing fragmentation of public corporation shareholdings and the resulting self-perpetuation of management); Branson, *The American Law Institute Principles Of Corporate Governance And The Derivative Action: A View From The Other Side*, 43 WASH. & LEE L. REV. 399, 411 n.68 (1986) (same).

127. A "poison pill" is a special type of redeemable option issued to shareholders in a target corporation that gives the shareholders the right to purchase shares in either the target or the acquiring firm at a greatly discounted price in the event of a hostile takeover. R. CLARK, *supra* note 19, § 13.6, at 574; *see* Ryngaert, *The Effect of Poison Pill Securities on Shareholder Wealth*, 20 J. FIN. ECON. 377 (1988) (finding that adoption of poison pill is associated with declines in stock price of subject corporation).

128. "Shark repellent" charter amendments generally make it more difficult for a hostile acquir-

over legislation has also made hostile takeovers more difficult.[130] Such imperfections in corporate democracy have thus focused attention on the second means of direct shareholder control over managers: the shareholder suit.

Shareholders have the right to sue the board and corporate officers for alleged violations of legal duty.[131] Members of boards of directors and officers of corporations are governed by legal standards of conduct, called fiduciary duties, that set the threshold of acceptable behavior for the discharge of corporate offices. Corporate directors have two fiduciary duties to the corporation: a duty of care and a duty of loyalty.[132] The duty of care requires directors to be reasonable and prudent in their decision making and to give business matters an appropriate degree of attention before exercising their authority.[133] The duty of loyalty differs significantly from the duty of care. The duty of loyalty requires directors to refrain from self-dealing (such as misappropriating corporate opportunities) and conflict-of-interest transactions unless such activities are approved by and are fair to the corporation.[134] Virtually the only source of cases that give operational meaning to these fiduciary standards are judicial opinions rendered

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ing firm to gain control of the board of a target company even though the acquiror may have obtained a majority of the target firm's shares. Charter provisions staggering the terms of board members and increasing the number of shareholder votes needed to replace board members are examples of such amendments. R. CLARK, *supra* note 19, § 13.6, at 576; *see* DeAngelo & Rice, *Antitakeover Charter Amendments and Stockholder Wealth*, 11 J. FIN. ECON. 329 (1983) (finding negative, but statistically insignificant abnormal stock returns when corporation announces proposed antitakeover charter amendments).

129. *See, e.g.*, Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981).

130. Since the *CTS* decision, more than one-half the states have enacted some form of statute that imposes rules and limitations on hostile takeovers of companies incorporated within their jurisdictions. Hanks & Stec, *Charting the Rising Tide of State Takeover Legislation*, 2 INSIGHTS 22, 22-23 (1988) (listing states). *See, e.g.*, DEL. CODE ANN. tit. 8, § 203 (1983 & Supp. 1988); Butler, *Corporation-Specific Anti-Takeover Statutes and the Market for Corporate Charters*, 1988 WIS. L. REV. 365; Langevoort, *The Supreme Court and the Politics of Corporate Takeovers: A Comment on CTS Corp. v. Dynamics Corp. of America*, 101 HARV. L. REV. 96 (1987); Macey, *State Anti-Takover Legislation and the National Economy*, 1988 WIS. L. REV. 467; Posen, *The New Round of State Tender Offer Statutes*, 53 BROOKLYN L. REV. 89 (1987).

131. R. CLARK, *supra* note 19, § 15.1; H. HENN & J. ALEXANDER, *supra* note 91, § 360, at 1044.

132. Special Project, *Director and Officer Liability*, 40 VAND. L. REV. 599, 606 (1987).

133. REVISED MODEL BUSINESS CORP. ACT § 8.30(a)(2) (1984); N.Y. BUS. CORP. LAW § 717 (McKinney 1986 & Supp. 1988); Smith v. Van Gorkum, 488 A.2d 858, 873 (Del. 1985); Special Project, *supra* note 132, at 606-13. In practice, courts consider themselves less qualified than business people in making business decisions and are reluctant to interfere in ordinary business affairs in response to claims that a board has violated the duty of care. Auerbach v. Bennett, 47 N.Y.2d 619, 630, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926 (1979) ("courts are ill equipped . . . to evaluate what are and must be essentially business judgments"); Special Project, *supra* note 132, at 616. Thus, unless a shareholder can demonstrate that directors have exhibited "gross negligence" or worse, boards may invoke a legal doctrine known as the "business judgment rule" under which a court will simply refuse to review the substance of a business decision. Special Project, *supra* note 132, at 613-18.

134. Special Project, *supra* note 132, at 623-28. In contrast with the duty the care, judicial review of breaches of the duty of loyalty is strict, and corporate managers are not entitled to protection under the business judgment rule for such offenses. Fliegler v. Lawrence, 361 A.2d 218, 221 (Del. Ch. 1976); Guth v. Loft, Inc. 23 Del. Ch. 255, 270, 5 A.2d 503, 510 (Del. 1939). Directors must satisfy a court that conflict-of-interest dealings were approved by a majority of disinterested directors or shareholders and/or that the transaction was objectively fair to the corporation. *See, e.g.*, CAL. CORP. CODE §§ 310(a)(2),(b)(2) (West 1977 & Supp. 1987); DEL CODE ANN. tit. 8, § 144

in response to shareholder lawsuits against management.[135]

The corporation itself has a primary right to enforce directors' and officers' fiduciary duties.[136] The corporation, however, may choose not to vindicate its rights. The company may not know of the violations; it may simply look the other way when violations come to light; or the wrongdoers may have control of the decision apparatus for filing such lawsuits. State corporation laws therefore provide individual shareholders with a remedy to sue "derivatively" on behalf of the corporation if the shareholder believes that directors and officers have breached a fiduciary duty.[137] Shareholders may file a derivative action in the name of the corporation to seek relief for alleged wrongs to the enterprise committed by directors and officers.[138]

To a large extent, attorneys rather than shareholders are the real parties in interest in derivative actions involving public corporations.[139] Except in extraordinary circumstances, no individual shareholder stands to recover more than nominal damages in most derivative suits.[140] Because no individual shareholder has an incentive to sue, special rules are needed to encourage such actions.[141] The American legal system has answered this need through rules regarding the award of attorneys' fees to successful plaintiffs' lawyers. When a derivative action results in a monetary settlement or judgment, the plaintiffs' attorneys are entitled to a substantial fee drawn from the common fund created by the successful litigation.[142] It is the lawyers' pursuit of a lucrative fee, there-

(1983 & Supp. 1986); N.Y. BUS. CORP. CODE § 713(a) (McKinney 1986); REVISED MODEL BUSINESS CORP. ACT § 8.31(a) (1984); Special Project, *supra* note 132, at 624.

135. R. CLARK, *supra* note 19, § 15.9, at 663 ("The kinds of suits that are derivative in nature include most cases based on breach of fiduciary duties of care and loyalty.").

136. R. CLARK, *supra* note 19, § 15.2, at 640 (pointing out that shareholders must make a demand on the corporation before proceeding with a derivative action and that "[i]f the directors respond affirmatively, as by suing the parties that allegedly caused harm to the corporation or taking other corrective action, their action usually precludes a shareholder-initiated suit.").

137. Note, *supra* note 120, at 637 n.43 (listing state statutes that permit derivative suits). Derivative suits frequently involve claims against officers and directors, but shareholders may also press claims against third parties such as customers and suppliers when the corporation has such claims but has failed to pursue them. *See, e.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).

138. R. CLARK, *supra* note 19, § 15.1, at 639-40. In addition to the derivative action for wrongs done to the corporation, the shareholder may also bring a direct action for damages or injunctive relief when some activity by the corporation or its decision makers causes direct injury to the shareholder. *Id.* at 640. Such actions can be styled as either individual suits or as class actions when the same injury is alleged to have been suffered by a group of similarly situated shareholders. *Id.* In practice, there is no bright line that distinguishes between direct and derivative actions. *Id.* § 15.9, at 662. A shareholder who wishes to sue a manager for having defrauded him into buying or selling shares must usually bring an individual or class action. *Id.* at 663. A shareholder who wishes to allege that a director usurped a corporate opportunity, by contrast, must probably sue derivatively because the injury is primarily suffered by the corporation. *Id.* Shareholder class actions are a complex form of litigation in their own right. Such suits require plaintiffs to 1) obtain class certification; 2) secure judicial approval of suitable class representatives; 3) fulfill complicated notice procedures; and 4) obtain judicial approval of settlements. *See, e.g.*, FED. R. CIV. P. 23.

139. Coffee, *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action*, 54 U. CHI. L. REV. 877, 882-85 (1987); Coffee, *Understanding the Plaintiff's Attorney*, *supra* note 10, at 669, 677; Garth, Nagel & Plager, *supra* note 20, at 376-77.

140. R. CLARK, *supra* note 19, § 15.8, at 659.

141. R. CLARK, *supra* note 19, § 15.8, at 659.

142. *See* Boeing Co. v. Van Gemert, 444 U.S. 472, 478-81 (1980) (discussing "common fund" doctrine); R. CLARK, *supra* note 19, § 15.8, at 660; Hornstein, *The Counsel Fees in Stockholders'*

fore, that motivates most shareholder litigation in the public corporation arena.[143]

Because of a fear that shareholders' attorneys will abuse this remedy by filing "strike suits" based on frivolous allegations, both state and federal law stipulate a number of procedural hurdles the plaintiff must overcome before proceeding with a derivative action.[144] First, the plaintiff must have been a shareholder at the time the wrong in question occurred.[145] Second, in about one-third of the states, the plaintiff must post a security bond to insure the corporation against expenses should the claim prove to be without merit.[146] Third, the plaintiff must give notice of the suit to the corporation by making a demand on the board of directors or the shareholders to pursue the claim before the plaintiff can pursue the suit.[147] Such a demand is "excused," however, when the shareholder can prove that, due to direct conflicts of interest on the part of a majority of the board, a demand would be futile.[148] Upon receipt of a demand or notice

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Derivative Suits, 39 COLUM. L. REV. 784 (1939). It has been estimated that plaintiffs' attorneys receive roughly 20% of the judgment or settlement amount in derivative and class action cases. R. CLARK, *supra* note 19, § 15.8, at 661-62.

143. Because plaintiffs' attorneys take a risk that they will lose the suit and recover nothing, they tend to select and file a "portfolio" of lawsuits in the hopes that the cases in which they recover a fee will pay for the cases in which they recover nothing. Coffee, *supra* note 10, at 704-12. The fee incentives for plaintiffs' attorneys suggest a number of important implications. First, plaintiffs' lawyers will seek out lawsuits that have a reasonably good chance of generating some sort of positive award and that require a minimum of preliminary research by the attorney. *Id.* at 681-82. Empirical work on derivative and class actions confirms these hypotheses. Although the data is subject to interpretation, shareholder suits typically "piggyback" on major publicly disclosed corporate events such as bankruptcies, civil administrative investigations, criminal indictments, and takeover announcements. *Id.*; Garth, Nagel & Plager, *supra* note 20, at 376-78. Second, the incentive structure suggests that most shareholder cases should settle. If the plaintiff's attorney can get a percentage of the settlement, then he has every incentive to do very little work and take his fee on that basis. If the fee is based on hours worked, the plaintiff's lawyer will bill the number of hours he feels the case can sustain and then press for settlement to avoid the risk of an adverse judgment that will render all his work for naught. Again, empirical research reveals that over 70% of shareholder cases settle. Jones, *supra* note 21, at 545. Indeed, in a 1980 study, Professor Jones found that of 531 derivative and class actions studied during the period from 1970 to 1978, only 15 cases were litigated to judgment and, of these, the plaintiff prevailed in two and the defendants won 13. *Id.* at 544-45; Kennedy, *Securities Class and Derivative Actions in the United States District Court for the Northern District of Texas: An Empirical Study*, 14 HOUS. L. REV. 769, 811 (1977) (noting that 83% of cases under study settled).

144. During the 1940s, the New York State Chamber of Commerce commissioned a report revealing that plaintiffs recovered in only 13 of 573 derivative suits filed between 1932 and 1942 involving public corporations. *See* F. WOOD, SURVEY AND REPORT REGARDING STOCKHOLDERS' DERIVATIVE SUITS 32 (1944); Coffee, *supra* note 10, at 698. This report led to the adoption of many procedures to discourage the filing of frivolous derivative suits.

145. *See, e.g.*, FED. R. CIV. P. 23.1; REVISED MODEL BUSINESS CORP. ACT § 7.40(a); Harbrecht, *The Contemporaneous Ownership Rule in Shareholders' Derivative Suits*, 25 UCLA L. REV. 1041 (1978).

146. *See, e.g.*, N.Y. BUS. CORP. LAW § 627 (McKinney 1986); R. CLARK, *supra* note 19, § 15.5, at 652.

147. REVISED MODEL BUSINESS CORP. ACT § 7.40(b); R. CLARK, *supra* note 19, § 15.2, at 640; Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 HARV. L. REV. 746 (1960). A majority of jurisdictions technically require that plaintiffs make demand on both the board and shareholders prior to bringing a derivative action. W. CARY & M. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 1011 (6th ed. 1988). The more important corporate law states such as Delaware, California, and New York, however, have eliminated the requirement of a demand on shareholders and require demand on the board only. *See, e.g.*, CAL. CORP. CODE § 800(b)(2) (West 1987); DE. CH. CT. RULE 23.1; N.Y. BUS. CORP. LAW § 626 (McKinney 1986).

148. *See, e.g.*, FED. R. CIV. P. 23.1; REVISED MODEL BUSINESS CORP. ACT § 7.40(b); R.

that a derivative action has been filed, the board may, in some jurisdictions, appoint a "special litigation committee" composed of independent directors who have no conflict of interest with respect to the subject matter of the complaint to review the matter.[149] This committee may ask the court to dismiss the suit if, after a good-faith investigation, it finds that the corporation would be best served by dismissal.[150]

Protection is also provided to shareholders by judicial supervision of derivative suit settlements. Most statutes require that any settlement or dismissal be approved by the court to prevent collusion between the corporation and the plaintiff's attorney that might adversely affect other shareholders who have not participated in the action.[151]

Derivative suits have been strongly criticized in recent years.[152] For example, economists have studied the empirical effects of both the filing and termination of shareholder suits on the price of the subject company's shares. They have found that the announcement of a suit moves stock price downward,[153] while the termination of a suit, with or without a recovery for the corporation, has no material effect on price.[154] In the legal arena, shareholder suit reforms appear to be restricting rather than expanding the scope of these actions. For example, the Supreme Court has forbidden use of the federal securities laws in shareholder suits that are based on a managerial breach of fiduciary duty unless some managerial fraud can be shown.[155] In addition, the Court has discouraged use of attorneys' fee award formulae that place emphasis on the riskiness of the

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CLARK, *supra* note 19, § 15.2.1, at 641 ("demand is considered futile where the alleged wrongdoers *comprise* or *control* a majority of the directors").

149. *See, e.g.*, Joy v. North, 692 F.2d 880 (2d Cir. 1982) (applying Connecticut law), *cert. denied*, 460 U.S. 1051 (1983); Aronson v. Lewis, 473 A.2d 805 (Del. 1984); Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981); Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994 (1979); Note, *Director Independence and Derivative Suit Settlements*, 1983 DUKE L.J. 645. *But see* Miller v. Register and Tribune Syndicate, 336 N.W.2d 709, 718 (Iowa 1983) (rejecting use of special litigation committee when committee was appointed by defendants in the derivative action).

150. Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project*, 1982 DUKE L.J. 959, 963 n.13 (survey finding no case in which the Special Litigation Committee failed to recommend dismissal of action against incumbent directors); Note, *The Propriety of Judicial Deference to Corporate Boards of Directors*, 96 HARV. L. REV. 1894, 1905 (1983).

151. FED. R. CIV. P. 23.1; REVISED MODEL BUSINESS CORP. ACT § 7.40(c); R. CLARK, *supra* note 19, § 15.7, at 657.

152. This criticism has been led by law and economics scholars who question the efficiency of the derivative action as a monitoring device. *See supra* notes 7-11 and accompanying text.

153. Jaffe & Westerfield, *supra* note 17, at 16.

154. Fischel & Bradley, *supra* note 17, at 282-83.

155. Sante Fe Indus. v. Green, 430 U.S. 462 (1977). The Court in *Sante Fe* indicated its disapproval of any use of rule 10b-5 in corporate cases involving a breach of fiduciary duty. *Id.* at 478. Lower courts have subsequently permitted claims by minority shareholders alleging breaches of fiduciary duty under rule 10b-5, however, when the breach of duty is accompanied by some misrepresentation or omission. *See, e.g.*, Healey v. Catalyst Recovery of Pennsylvania, Inc., 616 F.2d 641, 647 (3d Cir. 1980); Goldberg v. Meridor, 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978). The Court has also cut back on the remedies available to shareholders using the class action remedy as a means to sue corporate managers by imposing standing limitations, *see* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), and by raising proof requirements, *see* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), in actions under section 10(b) of the 1934 Act. *See generally* R. CLARK, *supra* note 19, § 8.10, at 316-40 (discussing *Hochfelder*, *Blue Chip*, and the effects since 1975 of a conservative Supreme Court on private actions under rule 10b-5).

litigation, favoring instead a conservative "lodestar" approach that compensates plaintiffs' lawyers calculated on the basis of hours actually billed on the case.[156] Moreover, the advent of the special litigation committee as a means of dismissing derivative suits makes it more difficult for plaintiffs to get the merits of a claim before a court.[157] Finally, in response to a perceived "liability crisis" that was threatening to empty the boardroom of outside directors, the majority of states have recently passed special statutes exempting directors from personal liability for most violations of the duty of care and have thus limited to some degree the sources from which a damage award may be recovered.[158] These trends appear to signal a widespread attitude among courts and legislatures that shareholder litigation is in no need of further encouragement and may in fact need to be curbed.

B. *Arbitration of Public Shareholder Disputes: A New Legal Environment*

The debate regarding shareholder litigation has only just begun to include serious discussion of arbitration as an alternative remedy.[159] Indeed, until recently scholars and practitioners alike simply assumed that arbitration of shareholder suits was a legal impossibility. First, derivative actions often contain allegations that the federal securities laws have been violated and, until 1987, such claims were beyond the jurisdiction of arbitrators.[160] Second, prior to 1984 most state courts applied their own rules regarding the enforcement of arbitration agreements, and all state laws approving the use of arbitration as a remedy for corporate governance disputes were carefully limited to close corporations.[161] As discussed earlier, the Supreme Court's decisions in *Southland*, *Perry*, and *McMahon* have overturned the assumptions on which both of these analyses proceeded.[162] In addition, the scholarly debate on the efficacy of derivative litigation has taken place within a set of implicit assumptions regarding the necessity of a judicial forum for the resolution of shareholder disputes. Although scholars disagree about the appropriate content of the duties of care and loyalty, their commentary on these issues has been addressed, at least in part, to courts.[163] The driving force behind the derivative suit is the plaintiffs'

156. Blum v. Stenson, 465 U.S. 886, 897 (1984); Hensley v. Eckerhart, 461 U.S. 424, 434 (1983). These Supreme Court cases were rendered in the context of the Civil Rights Attorney's Fees Awards Act of 1976, 42 U.S.C. § 1988 (1982), but they "will likely impact class and derivative actions." Coffee, *supra* note 10, at 675 n.15.

157. *See supra* notes 149-50 and accompanying text.

158. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (1983 & Supp. 1988); Gelb, *Director Due Care Liability: An Assessment of the New Statutes*, 61 TEMPLE L.Q. 13 (1988); Hanks, *Recent State Legislation on D&O Liability Limitation*, 43 BUS. LAW. 1207 (1988); Hanks, *Update on State Legislative Responses to the Director Liability Crisis*, 21 REV. SEC. & COMM. REG. 23 (1988).

159. *See supra* notes 12-14 and accompanying text.

160. *See supra* notes 56-61 and accompanying text.

161. *See supra* notes 96-98 and accompanying text. Section 620(c) of New York's Business Corporation Law, for example, expressly stipulates that no corporation that takes advantage of its more liberal governance provisions may have shares that are "listed on a national securities exchange or regularly quoted in an over-the-counter market." N.Y. BUS. CORP. LAW § 620(c) (McKinney 1986).

162. *See supra* notes 48-61 and accompanying text.

163. Only one student commentator, for example, has called for the abolition of the derivative

lawyer, whose fee must be set by the court under existing rules.[164] Finally, the statutes that govern derivative actions all mandate judicial approval of settlements and dismissals.[165] Given these background assumptions, it is no surprise that arbitration of public shareholder claims has not received serious consideration.

The Supreme Court's reinterpretation of the Federal Arbitraton Act, however, has significantly strengthened the legal arguments favoring arbitration. In the subsections below, this Article traces the arguments and counterarguments that would be raised in any attempt to enforce an arbitration provision in a public corporation's charter. This exercise illustrates the interaction between the new arbitration law principles and the old corporate law objections to arbitration. It also highlights several questions that remain in the wake of the Supreme Court's recent pro-arbitration decisions.

For purposes of this discussion, the Article assumes that a public corporation, either in its original charter or via a valid, duly approved amendment to its articles of incorporation, has included in its charter[166] a provision that requires all shareholders of the corporation to use arbitration in suits brought by shareholders against or on behalf of the corporation. The stock certificates issued by the corporation reference the charter in general terms and incorporate its provisions fully.

1. What Arbitration Law Applies?

The first issue confronting a court asked to enforce such a provision would

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action. *See* Comment, *supra* note 11, at 902-05. Law and economics scholars, meanwhile, feel the derivative suit is overemphasized but recognize that it "definitely answers a special need." Manne, *supra* note 75, at 273.

164. *See supra* notes 139-43 and accompanying text.

165. *See supra* note 151 and accompanying text.

166. One might argue that an arbitration provision placed in the corporation's bylaws, rather than the charter, should be enforceable. Management might prefer a bylaw provision because a shareholder vote is generally not required to amend the bylaws, whereas such a vote is required to amend the charter. *See, e.g.*, REVISED MODEL BUSINESS CORP ACT §§ 10.03(b)(2) (charter), 10.20 (1984) (bylaws). Moreover, the bylaws of a corporation are sometimes said to give rise to contractual rights between the shareholders and the corporation. *See, e.g.*, Norris v. South Shore Chamber of Commerce, 98 Ill. App. 3d 32, 424 N.E.2d 76, 77 (1981); Swanson v. Shockley, 364 N.W.2d 252, 255 (Iowa 1985); Toler v. Clark Rural Elec. Coop., 512 S.W.2d 25, 26 (Ky. 1974); Golden v. Oahe Enter., 240 N.W.2d 102, 108 (S.D. 1976); Field, *Resolving Shareholder Disputes and Breaking Deadlocks in the Close Corporation*, 58 MINN. L. REV. 985, 1001 (1974). As a matter of corporate law, however, the bylaws are subordinate to the charter and would have correspondingly less contractual force under the FAA. 1 E. FOLK, R. WARD & E. WELCH, FOLK ON THE DELAWARE GENERAL CORPORATION LAW § 109.7.1 (2d ed. 1988). In addition, most corporate statutes provide explicitly that substantial variations from the conventional model of corporate governance be included in the charter, and bylaw provisions are not an adequate substitute under these laws. *See* DEL. CODE ANN. tit. 8, § 141(a) (1983). *Cf.* Datapoint Corp. v. Plaza Sec. Co., 496 A.2d 1031 (Del. 1985) (invalidating attempt to alter statutory "consent" procedure by imposing stipulations in bylaws and stating that such alterations in statutory "consent" rights must be contained in charter). Thus, a governance provision such as an arbitration clause, which substantially affects the statutory rights of shareholders to bring derivative actions, would have to be placed in the charter to satisfy the requirements of corporate law. Once a corporation had such a charter provision, however, the shareholders might have an interest in seeing that the bylaws contain an analogous section in order to strengthen their argument that the directors and officers were as bound as they to the arbitration agreement. *See infra* note 216 and accompanying text.

be: what arbitration law governs?[167] It seems clear that the FAA, as opposed to state arbitration law, would be the source of governing norms for questions of arbitrability. The shares of public corporations are sold in interstate commerce; such entities conduct the great majority of their business in interstate and foreign commerce, and the disputes that give rise to most shareholder claims involve the use of interstate communication systems. Factors such as these have led courts to apply the FAA in a variety of commercial contexts[168] and would doubtless lead to the choice of the FAA as governing law for public corporation arbitration.

The fact that federal arbitration law applies is crucial to any legal case seeking enforcement of a corporate charter arbitration provision. As demonstrated in the context of the close corporation, a host of state public policy concerns have been and could be raised to defeat arbitration if enforcement is sought solely on the basis of state arbitration law.[169]

2. Is the Corporate Charter a "Contract" Under the FAA?

The first and most vexing substantive question to arise under the FAA would be whether a charter provision mandating arbitration constitutes a "written provision in [a] . . . contract" pursuant to section 2.[170] The arbitration provision would be in writing, so the question would be whether the corporate charter, as incorporated by reference in the shareholder's stock certificate, is a "contract" under the FAA.

There is no general federal common law of contract, and the FAA therefore looks to state law to determine whether section 2 has been satisfied.[171] As a matter of state corporate law, courts have traditionally viewed the corporate charter as a three-way contract between the corporation and the state, between the shareholders and the corporation, and among the shareholders *inter se*.[172] It

167. The question of whether state or federal arbitration law applies to the enforcement of the arbitration agreement is distinct, of course, from the question of whether state or federal substantive law forms the basis of the shareholders' claim. The applicable arbitration statute addresses the issues of whether the arbitration clause should be enforced and whether the award should be confirmed. *See supra* notes 41-47 and accompanying text. The underlying claim forms the basis for a damage award by an arbitration panel.

168. *See supra* note 109 and accompanying text.

169. *See supra* notes 92-103 and accompanying text.

170. 9 U.S.C. § 2 (1982) ("A written provision in any . . . contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction . . . shall be valid, irrevocable, and enforceable . . . ."). It appears that the drafters of the FAA were considering primarily conventional commercial contracts when they wrote § 2. *See, e.g.*, *Arbitration of Interstate Commercial Disputes, Joint Hearings on S. 1005 and H.R. 646 before the Subcommittees of the Committees on the Judiciary*, 68th Cong., 1st Sess., 38 (1924) (statement of Mr. Cohen, American Bar Association) ("An agreement for arbitration is in its essence a business contract. It differs in no essential from other commercial agreements.").

171. Perry v. Thomas, 107 S. Ct. 2520, 2527 n.9 (1987) ("state law, whether of legislative or judicial origin, is applicable *if* that law arose to govern issues concerning the validity, revocability, and enforceability of contracts generally"). If state law devises a special contract rule to govern arbitration agreements, however, then the federal policy inherent in the FAA may preempt such a rule if it is hostile to arbitration. *Id.* *See supra* note 47 and accompanying text.

172. The corporate charter little resembles the usual commercial agreement for the sale of goods or services. Nevertheless, commentators, courts, and legislatures have relied extensively on contract terminology to describe the charter and its legal effects. A. BERLE & G. MEANS, *supra* note 118, at

could be argued that this corporate doctrine satisfies the FAA's threshold requirement of a contract and provides an easy answer to section 2.[173]

Even in the context of close corporation arbitration, however, scholars have been reluctant to rely exclusively on the charter as a sufficient basis for enforcing an agreement to arbitrate. Rather, small business advisors have suggested that the arbitration clause be included in *both* the charter and the shareholder agreement.[174] Moreover, in the context of public corporations, any close analysis of the "charter as contract" question quickly reveals a number of troublesome issues that lie just below the surface of the doctrine.[175] Indeed, the issue of whether the charter is a literal contract raises fundamental questions about the very nature of the corporation.

To some law and economics scholars, the corporation has no identity apart from the contracts that link its various stakeholders, including shareholders, to one another.[176] As the hub of the relationships between the shareholders and

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129-30 ("each corporate 'charter' was [viewed by the law as] the product of a threefold negotiation involving the state and the combined associates, and between the groups of associates acting for themselves. [The charter] was recognized as a 'contract' and has been consistently so dealt with in American law"). *See* Wylain v. TRE Corp., 412 A.2d 338, 344 (Del. Ch. 1979) ("the corporate charter, 1) is a contract between the state and the corporation . . . ; 2) is a contract between the corporation and its stockholders . . . ; and 3) is a contract between the stockholders inter se . . . ."). A number of state corporation statutes codify this notion by expressly referring to the charter as a "contract." *See, e.g.*, MD. CORPS. & ASS'NS CODE § 2-602(a)(3) (1985) (granting appraisal right to shareholders if an amendment to the charter "alters the contract rights, as expressly set forth in the charter, of any outstanding stock, and the charter does not reserve the right to make the amendment"); N.C. GEN. STAT. § 55-174 (1982) (reserving power of the state to amend or repeal the charter of any corporation and stating that the corporation statute "is a part of the charter contract between the shareholders"). In England, the Companies Act expressly provides that the articles of a corporation are to be construed as a contract between each of the shareholders and the company. Companies Act, 1985, ch. 6, § 14.

173. Coffee, *supra* note 12, at 964 (stating that "corporate law clearly considers the corporate charter to be a contract" but "divergent answers are possible" on the issue of whether the charter would be construed as a binding agreement to arbitrate by shareholders based on "implied-in-fact" acceptance by the shareholder).

174. *See, e.g.*, R. KESSLER, *supra* note 64, at 19; F. O'NEAL & R. THOMPSON, *supra* note 64, at 812.

175. A. BERLE & G. MEANS, *supra* note 118, at 129-30 (the notion that the charter is a contract "does not bear analysis"). The "contract" between the corporation and the state, for example, is of dubious validity. In the early nineteenth century, courts treated the issuance of a corporate charter by the state as a contractual act, but modern corporation statutes have left this concept behind. *See* Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518, 592 (1819); Butler, *General Incorporation in Nineteenth Century England: Interaction of Common Law and Legislative Processes*, 6 INT'L REV. L. & ECON. 169 (1986). In *Dartmouth College* the Court held that the state of New Hampshire violated the contract clause of the U.S. Constitution by attempting to revoke a royal charter granted to Dartmouth College before the American Revolution. Justice Story opined that the Constitution would not be offended by changes in state corporation law if the state conditioned the granting of its charters with a reserved power to alter or amend the corporate statute. *Dartmouth College*, 17 U.S. (4 Wheat.) at 675, 712 (Story, J., concurring). This lawyerly advice led to enactment of "reserve power" clauses in all state corporation statutes under which states reserved the right to alter, amend, or repeal provisions of their corporate codes without constitutional limitation. H. HENN & J. ALEXANDER, *supra* note 91, § 340, at 952-53. More importantly, as a matter of policy, the state does not "contract" with the corporation when it grants a charter any more than it "contracts" with buyers of goods by enacting warranty laws.

176. Butler & Ribstein, In Defense of Private Ordering in the Corporation 1 n.1 (1988) (unpublished manuscript on file with the author) ("The corporation may, indeed, be viewed as a bundle of interrelated contractual relationships, but there is no conceptual justification for reifying this interrelationship.").

between the shareholders and the corporation, the charter qualifies as a literal "contract" with as much force as any other commercial agreement.[177] State law is simply one aspect of this contract—an aspect that may be easily changed by shareholders through the process of reincorporating in a state with rules that suit their purposes.[178]

If an individual shareholder gives scant thought to the charter as a contractual document, this inattention takes nothing away from the charter's contractual status. Consumers pay no more attention to many sales agreements, and public investors in corporate bonds are no more aware of the complex terms of bond indentures.[179] Moreover, the bundle of rights assembled in the charter of a public corporation have been efficiently priced by the stock market. The shareholder essentially "gets what he pays for" without having to search the charter for the terms of the purchase.[180] Certainly, if one accepts the economists' view of the charter as a literal contract, section 2 is not a problem. The arbitration provision, as part of the charter, has been "priced" by the market, and the shareholder has "accepted" the provision simply by agreeing to pay the market price for the shares.

When courts speak of the charter as a contract,[181] however, they do so within a frame of reference restricted to corporate law. Charter provisions such as shareholder preferences, voting rights, and antitakeover mechanisms delineate aspects of the bundle of property interests that make up shareholders' economic stake in the corporation, but such provisions owe their existence to state corporate law and are not subject to common-law contract principles. For example, in a conventional contract, one party does not have the right unilaterally to alter the terms of the agreement to suit itself without either paying additional consideration or being in breach.[182] Corporation statutes, by contrast, permit

177. Professors Butler and Ribstein have gone so far as to argue that, despite the reserved power of the state to alter corporate law, states should be constitutionally prohibited from interfering with the charter through amendments to the law governing shareholder relationships. *See* Butler & Ribstein, *State Anti-Takeover Statutes and the Contract Clause*, 57 U. CIN. L. REV. 611 (1988).

178. Baysinger & Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J. L. & ECON. 179, 179 (1985).

179. Butler & Ribstein, *supra* note 176, at 15-19.

180. Butler & Ribstein, *supra* note 176, at 46-49. This analysis depends heavily on acceptance of some version of the "efficient market hypothesis" of finance theory. *See* Jensen, *Some Anomalous Evidence Regarding Market Efficiency*, 6 J. FIN. ECON. 95, 96-97 (1978); Jensen, *Random Walks in Stock Market Prices*, 21 FIN. ANALYSTS J. No. 5, 55, 56 (Sept.-Oct. 1965). This hypothesis has been criticized in a number of recent articles. Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891, 898-900 (1988).

181. *E.g.*, Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 313-14, 93 A.2d 107, 118 (1952) ("the stockholders of a Delaware corporation may by contract embody in the charter a provision departing from the rules of the common law, provided that it does not transgress a statutory enactment or a public policy").

182. Such a modification would lack consideration. E. FARNSWORTH, CONTRACTS § 4.21, at 271 (1982). In an earlier era, shareholders were said to have "vested rights" in certain characteristics of their shares and such rights could not be altered without the express consent of each shareholder. H. HENN & J. ALEXANDER, *supra* note 91, at 953-55. Thus, the corporation could not extinguish or alter dividend rights, liquidation preferences, or voting rights without unanimous consent of the shareholders. Coffee, *supra* note 12, at 962 & n.90 (citing cases). This vested rights doctrine is now obsolete. REVISED MODEL BUSINESS CORP. ACT § 10.01(b) (1984) ("A shareholder of the corporation does not have a vested property right resulting from any provision in the articles of incorporation . . . .").

liberal, unilateral alteration of many shareholder rights by management[183] or by majority vote of the shareholders without giving dissenting shareholders a right to relief for breach of contract.[184]

Traditional corporate law scholars are also reluctant to speak of the public corporation's charter as a literal contract for reasons of policy.[185] These scholars are more skeptical than economists about the efficiency of the stock market and insist more rigorously on evidence of explicit consent by shareholders to major changes in corporate governance before giving documents such as the charter contractual force.[186] Thus, courts considering whether a charter arbitration provision satisfies section 2 may need to look beyond corporate law for an answer.

Even if the courts reject the idea of the charter as a literal contract, arbitration law supports the recognition of documents like the charter, which do not fit the model of conventional commerical agreeements, as having contractual force. Charters operate as organizational constitutions that bind their members to general sets of rights and duties, and the common law recognizes such constitutions as contracts.[187] Therefore, courts have frequently upheld arbitration provisions contained in bylaws or constitutions of private associations,[188] even when the member has not signed a separate agreement to be bound by the rules of the association.[189] The constitutions or bylaws of labor organizations,[190] religious groups,[191] realty boards,[192] and securities exchanges[193] have all been held to

183. Management may affect shareholder interests unilaterally through amendments to bylaws or by taking action permitted by statutory rule. *See, e.g.*, REVISED MODEL BUSINESS CORP. ACT § 10.20 (1984) (amendment of bylaws), § 11.04 (merger of subsidiary into parent corporation when parent corporation owns at least 90% of subsidiary's stock).

184. R. CLARK, *supra* note 19, § 10.2.4.

185. Brudney, *supra* note 116, at 1412 (concept of a "contract" stretched "beyond recognition" if used to describe relations between public shareholders and management).

186. Brudney, *supra* note 116, at 1423-24; Cox, *supra* note 9, at 747-48.

187. *See, e.g.*, Watson v. Jones, 80 U.S. (13 Wall.) 679, 683 (1871); Rachford v. Indemnity Ins. Co., 183 F. Supp. 875, 879 (S.D. Cal. 1960); Local Union, U.M.W. v. Cikra, 86 Ohio App. 41, 90 N.E.2d 154 (1949); 6 AM. JUR. 2D *Associations and Clubs* § 8, at 435 (1963) ("The constitution, rules, and bylaws of an unincorporated association . . . constitute a contract between the members which the courts will enforce.").

188. Fox v. Merrill Lynch & Co., 453 F. Supp. 561, 564 (S.D.N.Y. 1978) ("A party who agrees to abide by the rules of an organization [the New York Stock Exchange] is bound by its subsequently adopted rule calling for arbitration."); M. DOMKE, *supra* note 23, § 7.02, at 87-88.

189. Brown v. Gilligan, Will & Co., 287 F. Supp. 766, 769 (S.D.N.Y. 1968) (whether a member of a securities exchange signs the exchange constitution or not, "every member, by virtue of his admission, contracts to be governed by the conditions of membership which the exchange has imposed").

190. Willard Alexander, Inc. v. Glaser, 31 N.Y.2d 270, 273, 290 N.E.2d 813, 338 N.Y.S.2d 609, 611 (1972) (orchestra leader who was member of American Federation of Musicians bound by arbitration provision in union constitution and bylaws because "when a person becomes a member of a labor organization, or any other association, he thereby agrees, as a matter of law, to abide by the duly enacted provisions of its constitution and bylaws unless they are contrary to good morals or public policy or otherwise illegal"), *cert. denied*, 410 U.S. 983 (1973).

191. Matter of Koppel, 52 A.D.2d 676, 382 N.Y.S.2d 143 (1976). In *Koppel* members of a religious congregation bought bonds from the organization to raise funds for the acquisition of a building. At the time most of the bonds were issued the congregation had adopted a governing structure consisting of all those who owned at least one bond. The rules of the governing body called for resolution of all disputes between bondholders by a panel of arbitrators consisting of the president, vice-president, and treasurer of the organization, with a right of appeal to the entire governing

bind members to arbitration provisions contained within these governing documents.[194]

Assuming the "charter as constitution" argument brings the charter into the realm of enforceable documents, under section 2, there remains the question whether public shareholders have "accepted" a charter arbitration clause by purchasing shares in the corporation. In most membership organizations, members share important professional, personal, or religious interests. Consent to arbitration can therefore be implied from the member's general willingness to be subject to the prevailing professional or organizational norms. In the public corporation, literally millions of shareholders share no common ground other than their investment preference.

Therefore, consent to arbitration must be inferred from the circumstances surrounding the shareholder's decision to become and remain an investor in the particular public corporation.[195] In practical terms, the issue of acceptance comes down to a question of effective notice to shareholders that they are buying shares in a company that has opted for arbitration. For example, the fact that the corporate arbitration provision is not spelled out on the stock certificate but is incorporated by reference may give a shareholder grounds to argue that section 2 has not been satisfied. Courts have refused to order arbitration when the only contractual basis for arbitrating was an obscure reference in the agreement to "rules" of an association or to the terms of another contract.[196] Shareholders should not be bound by arbitration provisions unless their stock certificates reference the charter arbitration clause in specific terms.[197]

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body. The bonds themselves, however, did not refer to these bylaws and made no mention of arbitration. On these facts, the court enforced the arbitration provision.

192. King v. Larsen Realty, Inc., 121 Cal. App. 3d 349, 357, 175 Cal. Rptr. 226, 231 (1981); Bastone v. Dial-A-House, Inc., 100 Misc. 2d 1026, 1027, 420 N.Y.S.2d 467, 467 (1979); Keith Adams & Assoc. v. Edwards, 3 Wash. App. 623, 477 P.2d 36 (1970).

193. Perry v. Thomas, 107 S. Ct. 2520, 2523 (1987) (noting that arbitration agreement was incorporated by reference in stockbroker's employment agreement); Fox v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 453 F. Supp. 561, 564 (S.D.N.Y. 1978); Brown v. Gilligan, Will & Co., 287 F. Supp. 766, 769-70 (S.D.N.Y. 1968).

194. California State Univ., Hayward v. NCAA, 47 Cal. App. 3d 533, 541, 121 Cal. Rptr. 85, 89 (1975) ("the relationship between the members [of the Association] and the group is determined by contract, the terms of which find expression in the constitution and by-laws"). *But see* Westlake Community Hosp. v. Superior Court, 131 Cal. Rptr. 90, 98-99, 551 P.2d 410, 418-19 (1976) (refusing to enforce hospital bylaws that precluded access to court for physicians claiming wrongful termination of privileges).

195. As the Supreme Court stated in a recent commercial arbitration opinion, "Arbitration under the [FAA] is a matter of consent, no coercion . . . ." Volt Information Sciences, Inc. v. Trustees of Leland Stanford Junior Univ., 109 S. Ct. 1248, 1255 (1989).

196. *See, e.g.*, Western Vegetable Oils Co. v. Southern Cotton Oil Co., 141 F.2d 235, 236-37 (9th Cir. 1944); Windowmaster Corp. v. B.G. Danis Co., 511 F. Supp. 157, 160 (S.D. Ohio 1981); Pillsbury v. Blumenthal, 58 N.M. 422, 426, 272 P.2d 326, 328-29 (1954); Riverdale Fabrics Corp. v. Tillinghast-Stiles Co., 306 N.Y. 288, 291-92, 118 N.E.2d 104, 106 (1954); Matter of General Silk Importing Co., 200 A.D. 786, 791-93, 194 N.Y.S. 15, 19-21, *aff'd*, 234 N.Y. 513, 138 N.E. 427 (1922); Transamerica Ins. Co. v. Yonkers Contracting Co., 49 Misc. 2d 512, 513-14, 267 N.Y.S.2d 669, 671 (Sup. Ct. 1966); American Rail & Steel Co. v. India Supply Mission, 308 N.Y. 577, 579-80, 127 N.E.2d 562, 562-63 (1955).

197. The weight of modern authority on the question of incorporating arbitration agreements by reference favors enforcement of the referenced arbitration clause. *See, e.g.*, Exchange Mutual Ins. Co. v. Haskell, 742 F.2d 274, 276 (6th Cir. 1984); J & S Constr. Co. v. Travelers Indemnity Co., 520 F.2d 809, 810 (1st Cir. 1975); Bigge Crane & Rigging Co. v. Docutel Corp., 371 F. Supp. 240, 243

Even if stock certificates are embossed with the words "subject to arbitration," there may still be a problem of actual notice to shareholders. Shareholders do not sign any document signaling their acceptance of the charter, and most investors hold their shares through nominees and thus would never see the stock certificates that might explicitly discuss the arbitration provision.[198] Finally, whatever information the stockholder does receive is received after the purchase of the stock is complete.

The notice problem makes it difficult to predict whether the courts would find that public shareholders "accepted" arbitration when they purchased shares in the corporation. Corporations could allay this concern by taking affirmative steps to bring the arbitration provision to the attention of shareholders in meaningful ways. At a minimum, the arbitration clause should appear prominently on share certificates. In addition, the corporation should inform shareholders of the provision in annual reports, SEC filings and like communications, and by periodically notifying the professional investment community of this feature of the charter. Because shareholders are free to sell their shares and invest in other ventures if they strongly disagree with the arbitration provision, such notification would go a long way toward addressing the policy concerns implicit in section 2 and would give both the "charter as contract" and "charter as constitution" arguments a basis in traditional contract and arbitration law.

3. Would Enforcement of an Arbitration Provision Be Unconscionable?

Section 2 of the FAA exempts from enforcement arbitration agreements that are revocable under common-law contract principles.[199] This exemption includes arbitration clauses that are induced by fraud[200] and those that are "unconscionable."[201] If management misrepresented the impact of arbitration in its

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(E.D.N.Y. 1973); Richards v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 64 Cal. App.3d 899, 904 n.3, 135 Cal. Rptr. 26, 28 n.3 (1977). Better Bldg. Materials Co. v. Kirschner, 142 Conn. 1, 6-7, 110 A.2d 464, 468 (1954); Fidelity & Deposit Co. v. Parsons & Whittemore Contractors, 48 N.Y.2d 127, 132-33, 397 N.E.2d 380, 381, 421 N.Y.S.2d 869, 870 (1979). The older cases refusing to enforce incorporated arbitration agreements construed such contracts strictly, in part, as a means of guarding the courts' jurisdiction. Wilson v. Fremont Cake & Meal Co., 77 F. Supp. 364, 368-69 (D. Neb. 1948) (reviewing and criticizing older New York cases). When dealing with a novel use of arbitration such as this Article discusses, however, strict construction of the notice requirement of contract law seems appropriate.

198. R. HAMILTON, *supra* note 76, at 540-42 (quoting Final Report of the Securities and Exchange Commission on the Practice of Recording the Ownership of Securities in the Records of the Issuer on Other Than the Name of the Beneficial Owner of Such Securities (1976)).

199. 9 U.S.C. § 2 (1982) (agreements to arbitrate are valid and enforceable "save upon such grounds as exist at law or in equity for the revocation of any contract").

200. The fraud claim must go specifically to the arbitration clause itself. Claims that the contract as a whole was induced by fraud are not grounds for refusing enforcement of an arbitration clause. *See supra* note 47 and accompanying text.

201. Unconscionability is a general defense to contract enforcement based on the unfairness and oppression that would result if a contract provision is given effect. Stanley A. Klopp, Inc. v. John Deere Co., 510 F. Supp. 807, 810 (E.D. Pa. 1981) ("[u]nconscionability is the rubric under which the judiciary may refuse to enforce unfair or oppressive contracts in the absence of fraud or illegality"), *aff'd*, 676 F.2d 688 (3d Cir. 1982); U.C.C. § 2-302 (1978); RESTATEMENT (SECOND) OF CONTRACTS § 208 (1981); Spanogle, *Analyzing Unconscionability Problems*, 117 U. PA. L. REV. 931 (1969). This concern with "fairness" has two dimensions: the fairness of the bargaining relationship between the parties at the time the contract was made and the fairness of enforcing a particular

proxy materials for obtaining shareholder approval of an arbitration clause, for example, it might be argued that the provision is unenforceable because consent to it was fraudulently induced.[202]

The question of unconscionability would also raise a substantial issue in an action seeking enforcement of a public corporation's charter arbitration provision. Even assuming the corporation institutes the notification procedures suggested above, the passive nature of public shareholder ownership assures that many shareholders will be unaware of a charter arbitration provision and, even if aware of it, will have accepted arbitration without meaningful bargaining. These shareholders may argue that the charter of a public corporation is a "contract of adhesion"[203] and should not be enforced.

There can be little doubt that, if the charter is a contract at all, it is adhesive in character. Public shareholders have no meaningful choice when presented with the option of buying the corporation's stock: either they buy the stock with the existing charter or they do not buy the stock at all. The corporation does not bargain over the content of the charter except in highly unusual circumstances.[204]

In addition, the use of arbitration in the context of public shareholder disputes is unprecedented. Arbitration may therefore be characterized as an unfair surprise to the shareholder who wakes up to find that her right to bring a derivative action in court has been spirited away through the magic of a charter amendment.[205]

Finally, the corporation has vastly superior bargaining power with respect to charter amendments as compared to most individual shareholders.[206] Such a

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contract term at the time the agreement is to be implemented. These two aspects of unconscionability have been labeled "procedural" unconscionability and "substantive" unconscionability. *See* Leff, *Unconscionability and the Code: The Emperor's New Clause*, 115 U. PA. L. REV. 485, 487 (1967).

202. Such misrepresentations by management would also be grounds for legal actions under the federal securities laws. *See* J.I. Case Co. v. Borak, 377 U.S. 426, 430-31 (1964) (recognizing an implied cause of action on behalf of shareholders for violations of federal proxy rules).

203. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1173, 1177 (1983) (listing a number of characteristics of adhesion contracts including the use of standard forms drafted by one side in a transaction that anticipates using the form with many parties, and the acceptance by the other side without bargaining or substantial alteration). Because the shareholder does not sign the charter, however, it does not resemble so much the classic adhesive contract studied by Professor Rakoff as certain unsigned "documents" such as warranties that are simply presented to the adhering party. *Id.* at 1179 & n.12. *See* Note, *Contract Clauses in Fine Print*, 63 HARV. L. REV. 494 (1950) (collecting cases).

204. Charter amendments may form part of the negotiations between companies and shareholders in a merger, takeover, or bankruptcy, *e.g.*, Sullivan & Petzinger, *Ichan Seeks to File His Own Proposal To Revamp Texaco*, Wall. St. J., Jan. 6, 1988, at 3, col. 3 (Carl Ichan, Texaco's largest shareholder, seeking to remove antitakeover charter provisions to facilitate takeover), but corporations do not negotiate such amendments with everyday shareholders and successfully resist most shareholder proposals presented at annual meetings. Liebeler, *A Proposal to Rescind the Shareholder Proposal Rule*, 18 GA. L. REV. 425, 425-26 (1984) (stating that, according to the SEC, only two shareholder proposals not supported by management had been approved by shareholders prior to 1984 under SEC rule 14a-8).

205. U.C.C. § 2-302, comment 1 (1978) ("the principle [of unconscionability] is one of the prevention of oppression and unfair surprise").

206. Superior bargaining strength is often cited as a factor in unconscionability analysis. Henningsen v. Bloomfield Motors, Inc., 32 N.J. 358, 389-91, 161 A.2d 69, 86-87 (1960); Kessler, *Contracts of Adhesion: Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629, 632 (1943);

great disparity in bargaining strength, combined with the adhesive nature of the agreement and its surprising consequences, add up to a strong case for refusing to enforce an arbitration clause under the "revocation" exception contained in section 2. As strong as this argument is, the unconscionability issue is not likely to block enforcement of public corporation arbitration. The courts have been singularly unreceptive to claims by investors that arbitration clauses in standard form adhesive contracts are unconscionable. In the wake of the *McMahon* decision, securities customers have repeatedly sought judicial relief from arbitration clauses contained in standard broker-customer agreements based on unconscioinability principles but have failed in virtually every case.[207] The unstated premise behind such claims, after all, is that there is something unfair or inferior about arbitration as a means of resolving commercial disputes. The Supreme Court has stated in the strongest possible terms that it believes this premise to be false.[208] If courts routinely force shareholders to abide by unnoticed arbitration clauses contained in boilerplate on the back of margin agreements, there seems little reason to believe that a different result will obtain just because the arbitration clause appears in a corporate charter.

In addition, disparities in bargaining power are not favored as grounds for refusing to enforce contracts,[209] and shareholders do not present the most sympathetic case for an exception to this rule. Unconscionability is most often found in the consumer context and operates to relieve unwary, disadvantaged consumers from onerous contract terms imposed by more powerful business parties.[210] People who have sufficient funds and sophistication to invest in the equity securities of individual corporations do not fit this mold comfortably and may, in many cases, be quite wealthy. Thus, although such investors may not have bargaining power equal to their corporations', they are probably sophisticated enough to bear the risk of being bound by otherwise legal provisions in a corporate charter.

Finally, a ruling that a corporate charter arbitration clause is unenforceable as an adhesive provision would set an alarming precedent in the area of corporate governance. An arbitration provision will not be in place unless it was contained in the original charter or adopted as a charter amendment by a vote of the shareholders. The clause will thus have the same status as every other provision in the charter. Although shareholders may not see or inquire about an arbitration provision in the corporation's charter prior or subsequent to purchasing their shares, they are likely to be equally ignorant of every other provision in the charter. Unless a court is willing to strike down an arbitration clause on the

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Kronman, *Contract Law and Distributive Justice*, 89 YALE L.J. 472, 479 & n.23 (1980). *But see* U.C.C. § 2-302, comment 1 ("The principle [of unconscionability] is . . . not of disturbance of allocation of risks because of superior bargaining power.").

207. *See, e.g.*, Cohen v. Wedbush, Noble, Cooke, Inc., 841 F.2d 282 (9th Cir. 1988); Rush v. Oppenheimer & Co., 681 F. Supp. 1045 (S.D.N.Y. 1988); Shell, *supra* note 2, at 427-30.

208. Shearson/American Express, Inc. v. McMahon, 107 S. Ct. 2332, 2337 (1987); Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 627 (1985).

209. *See* U.C.C. § 2-302 comment 1 (1978); *supra* note 206.

210. *See* Note, *Commercial Decency and the Code: The Doctrine of Unconscionability Vindicated*, 9 WM. & MARY L. REV. 1143, 1144-45 (1968).

broad ground that all charter provisions are "adhesive" and subject to claims by shareholders for special exemptions, no part of the charter should be subject to challenge on this basis. The Supreme Court has made clear that "special" rules discriminating against arbitration clauses are preempted by the FAA.[211]

4. What Parties Would Be Bound By or Could Seek to Enforce an Arbitration Provision?

Assuming a charter arbitration provision would be subject to enforcement under the FAA, who among corporate stakeholders would be entitled to enforce the provision against whom? It would appear that arbitration charter provisions could be drafted to bind both the corporation and its shareholders in disputes among themselves. Such a provision would simply declare that all disputes between shareholders and the corporation or among the shareholders *inter se* regarding corporate activities are to be arbitrated.[212] For such a provision to encompass derivative actions, the clause would have to be expanded to include suits brought by shareholders on behalf of the corporation.

Surprisingly, directors and officers who are likely to be defendants in some derivative actions have available to them a technical argument that they should not be bound by the arbitration provision. Directors and officers are, respectively, trustees and agents of the corporation and are sued as such for breaches of fiduciary duty.[213] Whatever the contractual status of the charter, it has not been traditionally viewed as a contract between the shareholders and the corporation's management elite.[214] Therefore, a director might argue that he should not be bound by the charter to arbitrate any more than a third party, such as a supplier, would be bound on a contract or tort claim brought against it by the corporation.[215]

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211. Perry v. Thomas, 107 S. Ct. 2520, 2527 n.9 (1987); *supra* note 49 and accompanying text.

212. Such a provision would clearly mandate that direct actions by shareholders against the corporation and actions by the corporation against its shareholders be arbitrated. Direct actions by shareholders are frequently brought in the form of class actions and would call for special arbitral procedures that are beyond the scope of this Article, which focuses on the arbitration of derivative claims. There is precedent for the arbitration of class actions, however. *See infra* notes 268-69 and accompanying text.

213. Officers are in a classic agency relationship with the corporation, while directors have a "special" agency status similar to that of a trustee. Loft v. Guth, 23 Del. Ch. 138, 167, 2 A.2d 225, 238 (Del. Ch. 1938), *aff'd*, 23 Del. Ch. 255, 5 A.2d 503 (Del. 1939); RESTATEMENT (SECOND) OF AGENCY § 14C comment a (1958) (board of directors closely resembles both agent and non-agent trustee but qualifies for neither status under strict application of agency law); R. CLARK, *supra* note 19, § 3.3, at 114. *Cf.* N.C. GEN. STAT. § 55-35 (1982) ("Officers and directors shall be deemed in a fiduciary relation to the corporation and to its shareholders . . . .").

214. *See supra* note 175 and accompanying text.

215. In the leading English case involving the arbitration of intracorporate disputes, the court refused to permit a director to invoke a charter provision calling for arbitration when he was named as a defendant in a derivative suit. Beattie v. E. & F. Beattie, Ltd., 1 Ch. 708, 719-20 (C.A. 1938). English law is explicit about the contractual nature of the articles of incorporation. Section 14 of Company Act 1985 provides that "the . . . articles shall, when registered, bind the company and the members thereof to the same extent as if they respectively had been signed and sealed by each member, and contained covenants on the part of each member to observe all the provisions of the . . . articles." Company Act, 1985, ch. 6, § 14. Whether this statutory provision can be relied on to form the basis of a contract right when the articles stipulate for the employment of particular individuals has been the subject of lively debate among English academics. *See* Goldberg, *The Contro-*

This argument is unpersuasive. Directors and officers are much more intimately associated with the corporation than outside suppliers, other contracting parties, or even lower-level employees of the corporation. As the individuals who govern the corporation, they should be bound by any dispute resolution system provided for in the charter just as they must honor any charter rules determining the number of seats on the board, voting requirements for removal of directors, or other basic governance matters.

The binding nature of the corporation's basic documents on officers and directors is well settled, although most of the law in this area has concerned the corporate bylaws rather than the charter.[216] Indeed, as a precautionary measure, drafters of corporate arbitration clauses may wish to include reference to the duty of officers and directors to arbitrate shareholder derivative claims in the bylaws as well as the charter. In this way, the duty to arbitrate will be brought home to those who may find themselves defendants in such actions.

Another means of eliminating any dispute regarding the duty of directors and officers to arbitrate would be through the use of signed employment agreements between them and the corporation calling for arbitration or referencing the duty to arbitrate set forth in the charter and bylaws.[217] With an explicit contract in hand, the shareholders suing on behalf of the corporation would have the strongest possible grounds for insisting on arbitration.[218]

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versy on the Section 20 Contract Revisited, 48 MOD. L. REV. 158 (1985). Yet, the English court held that the director could not enforce an arbitration clause since the director is, in essence, an employee of the company and the articles do not constitute a contract between the company and parties serving as employees or agents. This was held to be the case even though the director was also a shareholder, because the director was being sued in his capacity as an agent of the company, not in his capacity as a shareholder. *Beattie*, 1 Ch. at 714.

216. *See, e.g.*, Yarnall Warehouse & Transfer, Inc. v. Three Ivory Bros. Moving Co., 226 So. 2d 887, 890 (Fla. Dist. Ct. App. 1969) ("The corporation and its directors and officers are bound by and must comply with the charter and bylaws."); Diedrick v. Helm, 217 Minn. 483, 497, 14 N.W.2d 913, 921 (1944) ("By-laws have the same force and effect as provisions of the charter or articles of incorporation and must be obeyed by the corporation, its directors, officers, and stockholders."); Golden v. Oahe Enter., 90 S.D. 263, 274, 240 N.W.2d 102, 108 (1976) ("In addition to the corporation and its stockholders, the bylaws are binding upon the directors . . . ."); 8 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 4197, at 751 (Rev. perm. ed. 1966).

217. A number of public corporations have arbitration clauses in contracts with senior executives that have resulted in reported litigation. *See supra* note 4 and accompanying text. The presence of such agreements raises an intriguing possibility. An executive who has an arbitration clause in his contract with the corporation, and who has been named a defendant in a derivative action, might be able to seek enforcement of the arbitration clause and divert the derivative action into the arbitral forum without reference to a charter provision. The corporation, after all, is a nominal party in the derivative action, *see* 13 W. FLETCHER, *supra* note 216, § 5997, and it is the corporation to which officers and directors owe their fiduciary duties and to which recoveries in the derivative action must go, Sternberg v. O'Neil, 532 A.2d 993, 998-99 (Del. Ch. 1987). It could be argued that the corporation and those suing on its behalf should be bound under an employment agreement to arbitrate all disputes with the executive regarding his performance, including breaches of fiduciary duty. One problem with this theory is that the corporation is a nominal defendant in a derivative action and thus is a co-party with the officers and directors rather than an opposing party. *See infra* note 220. Nevertheless, the cause of action asserted in a derivative suit belongs to the corporation, and it would seem that contractual agreements limiting access to the courts to resolve disputes with managers would bind shareholders suing on the corporation's behalf no less than the corporation itself.

218. *See, e.g.*, Wilson v. McGrow, Pridgeon & Co., 298 Md. 66, 79, 467 A.2d 1025, 1032 (1983) (upholding arbitration of breach of loyalty claims by business firm against former officer and director based on employment agreement); Magnus v. Magnus Organ Corp., 71 N.J. Super. 363, 368-69, 177 A.2d 55, 58 (1962) (upholding arbitration agreement between corporation and chief executive of-

By the same token, directors, officers, and the corporation itself would have standing to demand that plaintiff shareholders abide by the charter arbitration agreement.[219] Since the corporation is joined in a derivative action as a nominal defendant,[220] it could easily move to compel arbitration of any derivative claim brought improperly by shareholders.[221]

5. Would Arbitration of Public Shareholder Disputes Violate "Public Policy"?

The final legal question that might be raised in a challenge to enforcement of an arbitration agreement in a corporate charter is the most intriguing: would such a provision violate public policy? The arguments under this broad heading would spring from both state and federal sources.

As a matter of state corporation law, the arbitration of shareholder claims poses a threat to public policy for several reasons, some of which were reviewed previously in the materials on close corporations. First, arbitration might "sterilize the board" by removing from board discretion certain matters of business policy that the statutory model reserves to the board of directors.[222] Corporate statutory provisions expressly permitting unlimited invasion of board discretion, including arbitration of governance disputes, are restricted to close corporations and do not apply if the shares of the corporation are listed on any securities exchange or quoted on the over-the-counter market.[223] This legislative distinction signals a strong preference for strict maintenance of the traditional model of board governance for public corporations.

Procedurally, arbitration appears to sidestep the entire array of statutory protections involving contemporaneous ownership, security bonds, demand requirements, and court-approved settlements.[224] Because arbitration lacks mandatory discovery, rules of evidence, and other formalities of court litiga-

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ficer); Faberge Int'l, Inc. v. Di Pino, 109 A.D.2d 235, 239, 491 N.Y.S.2d 345, 348 (1985) (staying litigation pending arbitration of claims between corporation and executive vice president); *cf.* White v. White, 81 A.D.2d 550, 550-51, 438 N.Y.S.2d 311, 312 (1981) (former corporate officer was not obliged to arbitrate a dispute with his corporation's majority shareholder because his contractual arbitration agreement was with the corporation, not the shareholder).

219. Even if the corporation was unwilling to enforce the arbitration agreement, officers and directors might have standing to insist that the agreement be honored. First, their status as corporate stakeholders makes them parties to the agreement with equal standing to enforce its provisions. Second, even as third parties, they are beneficiaries of the arbitration contract and may have beneficial standing to assert their rights. *See* Kaplan v. Peat, Marwick, Mitchell & Co., 540 A.2d 726, 730 (Del. 1988) (third party may invoke demand requirement in derivative suit and insist that corporation either endorse or reject claim against third party).

220. R. CLARK, *supra* note 19, § 15.1, at 639-40 ("Although each derivative suit is now very definitely treated in the courts as a single case, the historical conception survives in the customs of making the corporation a nominal defendant in the action and allowing it to raise various objections to the suit.").

221. Such claims would not be limited to actions against officers and directors for breach of fiduciary duty but would extend to derivative actions seeking to assert the corporation's rights against any third party. *See supra* note 137.

222. *See supra* notes 89-98 and accompanying text.

223. *See, e.g.*, N.Y. BUS. CORP. LAW § 620(c) (McKinney 1986).

224. *See supra* notes 144-51 and accompanying text.

tion,[225] it may also be seen as inadequate to process complex derivative suits touching the rights of many parties not in the hearing room.

Even as a matter of state law, such arguments are subject to debate. Given the fact that a corporate arbitration provision would be placed in the charter, corporate statutes themselves suggest that arbitration would not sterilize the board. Most corporate statutes qualify the mandatory nature of board governance with open-ended language permitting all corporations to use modified governance structures so long as the structure is spelled out explicitly in the articles of incorporation.[226] Legislatures would not leave the matter of governance open if they did not anticipate variations on the traditional model such as arbitration.[227]

Most of the procedural protections included in derivative suit statutes were placed there to prevent frivolous suits[228] and should be waivable by the corporation. More importantly, arbitrators would be free to impose the traditional demand and contemporaneous ownership requirements of state law as part of the accepted framework for resolving corporate disputes, and they would very likely do so.[229] With respect to court approval of settlements and the possibility of collusion in its absence, state rules regarding the res judicata and collateral estoppel effects of arbitration can be manipulated by courts to prevent injustice.[230]

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225. *See supra* notes 26-42 and accompanying text.

226. *E.g.*, DEL. CODE ANN. tit. 8, § 141(a) (1983) (corporation to be managed by directors, "except as otherwise provided . . . in its certificate of incorporation"). For example, Delaware's statute explicitly permits corporations to include in their charters "any provision for the management of the business and for the conduct of the affairs of the corporation; if such provisions are not contrary to the laws of this State." *Id.* § 102(b)(1); *see* Providence and Worcester Co. v. Baker, 378 A.2d 121, 124 (Del. 1977) (charter provision restricting voting is not prohibited by statute and is therefore permitted by § 102(b)(1)).

227. The leading commentators on Delaware corporate law have stated that devices such as appointing a director to serve as an "arbitrator" have already been approved under section 141(a) of the Delaware Code. *See* 1 E. FOLK, R. WARD, & E. WELCH, *supra* note 166, § 141.1, at 96-97 (2d ed. 1988) (discussing Lehrman v. Cohen, 222 A.2d 800 (Del. 1966)).

228. *See supra* note 144 and accompanying text.

229. The arbitration provision could stipulate that some or all of those protections remain in force. The Supreme Court has recently held that courts interpreting the FAA should give effect to various state procedural rules when they are referred to by the parties as part of their arbitration agreement. *See* Volt Information Sciences, Inc. v. Trustees of Leland Stanford Junior Univ., 109 S. Ct. 1248 (1989). An interesting question would be posed if a public corporation adopted an arbitration provision in its charter, successfully asserted this provision to force a derivative action from court into arbitration, and then attempted to have the derivative claim dismissed by arbitrators on the basis of a report by a special litigation committee (SLC). Could the corporation enjoy the benefits of deference to a SLC in addition to the advantages of having arbitrators rather than judges decide the case? Since the parties have agreed to arbitrate their disputes, deference by arbitrators to the conclusions of another tribunal would appear to violate the mandate of the arbitration provision. A report by a SLC could certainly be received by the arbitrators as evidence. The presence of an arbitration agreement, however, strongly suggests that the parties intended neutral arbitrators, not directors of the corporation, to hear and decide the merits of their dispute.

230. The chief danger of a collusive settlement lies in the possibility that the settlement will be formalized in a judgment that will have res judicata effects on shareholders who have not taken part in the litigation. The motive for the corporation to enter into such a settlement is to obtain, for a minimal price, a strong defense against any further litigation on the subject matter of the claim. The settlement of a lawsuit provides the context for such preclusion by enabling the parties to stipulate to the entry of a final judgment in favor of the corporation or to a dismissal of the suit "with prejudice." While a final arbitration award may have res judicata effects similar to the effects of a final court judgment, *see* Shell, *supra* note 23, at 639-47, the *settlement* of an arbitration need not have preclu-

Moreover, courts may fashion, as they have in the context of class actions, special procedures to review arbitration settlements.[231]

More importantly, arguments based exclusively on state law and policy would carry little weight under the FAA and reflect an outdated suspicion of a forum that the Supreme Court has deemed an "adequate substitute" for the courts for the resolution of complex statutory claims.[232] After the Supreme Court's decisions in *Southland* and *Perry*, state public policy arguments simply do not apply in the analysis of enforcement questions under the FAA. In passing the FAA, Congress "withdrew the power of the states to require a judicial forum for the resolution of claims which the contracting parties agreed to resolve by arbitration."[233] The Court has left no room for distinguishing state shareholder protection polices from the franchisee and employee protection policies that were at issue in *Southland* and *Perry*.[234]

The force of this counterargument is underscored by the fact that the New York Court of Appeals has already held that the FAA preempts state law respecting corporate and derivative remedies against corporate officers and directors. In *GAF Corp. v. Werner*[235] the chairman of the board of GAF, Jesse Werner, was sued by shareholders in five separate derivative actions in which plaintiffs alleged waste, mismanagement, and self-dealing. Soon thereafter Werner lost a proxy fight for control of GAF and was terminated. His compensation contract with GAF contained an arbitration clause and, when the new management refused to honor that contract, Werner demanded arbitration. The corporation's new management group, meanwhile, elected to pursue the derivative claims against Werner and moved to stay his employment contract arbitration pending resolution of this litigation.[236]

The court refused to grant the stay. The court held that the arbitration clause was governed by the FAA, and that recent Supreme Court decisions had "emphasized again and again the overriding force of the policy favoring arbitration . . . ."[237] Moreover, the court rejected GAF's argument that arbitration would deny shareholders and the corporation their right to a judicial forum guaranteed by section 720 of the New York Business Corporation Law.[238] The

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sive effects. Under the AAA rules, arbitrators may enter a "consent award" based on a settlement by the parties if requested to do so. *See* AAA RULE 44. If such a settlement were converted into a consent award solely for the purpose of unfairly prejudicing nonparty plaintiffs, however, the award could be challenged under the FAA by other shareholders as having been procured by "fraud or undo means." 9 U.S.C. § 10(a) (1982).

231. *See infra* notes 268-69 and accompanying text.

232. Shearson/American Express, Inc. v. McMahon, 107 S. Ct. 2332, 2338-39 (1987).

233. Southland Corp. v. Keating, 465 U.S. 1, 10 (1984).

234. *See supra* notes 48-50 and accompanying text.

235. 66 N.Y.2d 97, 485 N.E.2d 977, 495 N.Y.S.2d 312 (1985).

236. *Id.* at 99-101, 485 N.E.2d at 979, 495 N.Y.S.2d at 314.

237. *Id.* at 101, 485 N.E.2d at 980, 495 N.Y.S.2d at 315.

238. Section 720, entitled "Action against directors and officers for misconduct," creates a private right of action on behalf of shareholders, the corporation, and others to sue officers and directors for mismanagement and self-dealing. *See* N.Y. BUS. CORP. LAW § 720 (McKinney 1986). GAF argued that this statute "was intended to protect shareholders of a publicly held corporation against the waste, overreaching and misconduct of corporate officers and directors, against which

court, citing *Southland*, held that the FAA preempted section 720 and ordered the arbitration to go forward.[239]

While state-originated policies may not stand in the way of enforcement of public shareholder arbitration under the FAA, the Supreme Court has stated that "[l]ike any statutory directive, the Arbitration Act's mandate may be overridden by a contrary congressional command."[240] If another federal statute evidences a congressional intent to restrict the force of the FAA, therefore, arbitration can be avoided. Such legislative intent can be discerned from 1) the statutory text, 2) legislative history, or 3) "an inherent conflict between arbitration and the statute's underlying purposes."[241] The question thus arises as to whether there are policies underlying any federal statute that might be enlisted to defeat an arbitration provision in a corporate charter. It could be argued, for example, that Congress has scrupulously drafted legislation that regulates public corporations so as to avoid preempting state laws relating to corporate governance. Implicitly, this legislative strategy has furthered a public policy of federal noninterference with corporate internal affairs.[242] Thus, if states would forbid arbitration of shareholder suits,[243] the FAA might be read to reflect this preference.[244]

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such shareholders are ill equipped to protect themselves." *Werner*, 66 N.Y.2d at 103, 485 N.E.2d at 981, 495 N.Y.S.2d at 316.

239. The court stated that public shareholders were no more helpless or disadvantaged than the franchisees seeking a judicial forum in the *Southland* case:

> Neither the public shareholder nor the franchisee has much bargaining power, but both the franchisor and the directors and officers of a publicly held corporation are subject to governmental oversight. We conclude, therefore, with respect to Business Corporation Law § 720, that the Supreme Court decisions, and particularly the *Southland* decision, foreclose according it the effect for which GAF contends.

66 N.Y.2d at 103, 485 N.E.2d at 981, 495 N.Y.S.2d at 316. *See also* Wydel Assocs. v. Thermasol, 452 F. Supp. 739, 742 (W.D. Tex. 1978) (holding that § 9(3)(e) of the Uniform Partnership Act, which states that arbitration clauses entered into by less than all the partners are unenforceable, is preempted by FAA because § 9(3)(e) limits arbitration with rules "not applicable to other contracts").

240. Shearson/American Express, Inc. v. McMahon, 107 S. Ct. 2332, 2337 (1987).

241. *Id.*

242. *See, e.g.*, Burks v. Lasker, 441 U.S. 471, 478 (1979) ("state law . . . is the font of corporate directors' powers. By contrast, federal law in this area is largely regulatory and prohibitory in nature—it often limits the exercise of directorial power, but only rarely creates it."); Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 480 (1977) (holding that § 10(b) of the 1934 Act could not be used in cases involving simple claims of breach of fiduciary duty by shareholders against managers). It should be noted, however, that the Court in *Burks* was careful to point out that "specific aberrant or hostile state rules" in opposition to a firm federal policy "will not be applied." *Burks*, 441 U.S. at 479-80 (quoting United States v. Little Lake Misere Land Co., 412 U.S. 580, 596 (1973)). The federal policy favoring liberal enforcement of arbitration clauses is arguably such a policy, and state rules forbidding arbitration might be construed as hostile to that policy.

243. Research reveals no express statutory prohibitions in state corporation statutes forbidding arbitration.

244. *Cf.* Swenson v. CDI Corp., 670 F. Supp. 1438, 1441 (D. Minn. 1987), *rev'd in part on other grounds sub nom.* Swenson v. Management Recruiters Int'l, Inc., 858 F.2d 1304, 1309 (8th Cir. 1988) (but reaching a similar conclusion).

> It is not inconceivable that Congress through the express language of a federal statute or the supporting legislative history, could articulate an intent to preclude waiver of judicial remedies not only for violations of federal statutory rights but also for violation of similar state statutory rights, thereby exempting these particular state statutes from the provisions of the Federal Arbitration Act.

An implied repeal of the FAA based on an absence of congressional action is legally unsound and would mean that the FAA should not apply to claims in a variety of subject areas Congress has left to the states. Such an interpretation of congressional intent would be unduly hostile to arbitration and would directly contradict the broad edict of section 2.[245] Indeed, courts are reluctant to find a repeal of the FAA even in subject areas that Congress has *expressly* left to the states. For example, Congress has left the field of insurance regulation largely to the states,[246] yet courts have ruled that the FAA governs arbitration agreements involving insurance companies.[247] Where Congress has not explicitly spoken, as is the case in the corporate governance area, it seems even less likely that courts would reject application of the FAA.[248]

Although the implied repeal argument would not justify a blanket exemption from section 2, the door is still open to specific exemptions for federal claims where there is evidence of a congressional intent to bar arbitration.[249] One federal statute, section 16 of the 1934 Act,[250] creates a federal right to bring derivative actions and might be a candidate for such an exemption. Section 16 provides shareholders with a unique federal right of action to sue certain statutorily defined "insiders" on behalf of the corporation to recover trading profits from so-called "short-swing" trades, matching purchases and sales or sales and purchases of a company's stock that take place within any six month time period.[251] Section 16(b) differs from the traditional derivative action in that it is governed exclusively by federal law, which does not require shareholders to post any type of security bond, force shareholders to prove that they were owners at the time the alleged insider trading occurred, or permit corporations to dismiss suits based on reports by special litigation committees.[252]

Prior to *McMahon*, courts might have relied on the 1953 Supreme Court decision in *Wilko v. Swan*[253] to hold that section 16(b) actions may not be arbitrated. In *Wilko* the Court interpreted the nonwaiver provision of the Securities

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Id. at 1441.

245. Section 2 of the FAA applies to all contracts affecting interstate, foreign, or maritime commerce. *See supra* notes 43-44 and accompanying text.

246. The McCarren-Ferguson Act expressly declares that the business of insurance should continue to be subject to the laws of the several states. 15 U.S.C. § 1012 (1982); *see* R. KEETON, INSURANCE LAW § 8.1(a), at 538 (1971) (explaining the purpose of the Act and the political forces behind its enactment).

247. *See* Hart v. Orion Ins. Co., 453 F.2d 1358, 1360 (10th Cir. 1971) (FAA applies unless it "invalidates, impairs or supercedes a state law regulating the business of insurance"); Bernstein v. Centaur Ins. Co., 606 F. Supp. 98, 101-02 (S.D.N.Y. 1984). *But see* Washburn v. Corcoran, 643 F. Supp. 554, 557 (S.D.N.Y. 1986) (holding that McCarran-Ferguson Act bars application of FAA because there is a state law regulating insurance).

248. Indeed, given the substantial federal control over proxy solicitations, other communications with shareholders, and the issuance of securities as embodied in the federal securities laws and the rules of the SEC, it is arguable that no clear federal policy dictates that corporate governance issues be left exclusively to the states. *See supra* note 242.

249. *See supra* note 241 and accompanying text.

250. 15 U.S.C. § 78p (1982); Samuelson, *The Prevention of Insider Trading: A Proposal for Revising Section 16 of the Securities Exchange Act of 1934*, 25 HARV. J. LEGIS. 511 (1988).

251. R. CLARK, *supra* note 19, § 8.6.1, at 293-96; Samuelson, *supra* note 250, at 511-12.

252. R. CLARK, *supra* note 19, § 8.6.1, at 294.

253. 346 U.S. 427 (1953).

Act of 1933 (the 1933 Act), section 14,[254] as an expression of congressional intent to exempt claims under that statute from the FAA.[255] The 1934 Act has a similar nonwaiver provision,[256] and both section 16(b) of the 1934 Act and the liability section at issue in *Wilko*, section 12(2) of the 1933 Act,[257] are express rights of action.

In *McMahon*, however, the Court refused to extend *Wilko* to claims under section 10(b) of the 1934 Act,[258] and nothing in either the text or legislative history of section 16(b) suggests that this provision of the 1934 Act should be treated differently from section 10(b).[259] Section 16(b) is designed to compensate the corporation for a certain defined set of insider trading violations.[260] Arbitrators would appear to be perfectly capable of determining when such violations have occurred and of calculating damages. There thus appears to be no ground for arguing that section 16(b) derivative claims are nonarbitrable.

One might also argue that an inherent conflict between Federal Rule of Civil Procedure 23.1 and the arbitration of shareholder claims demonstrates congressional intent to bar arbitration.[261] Rule 23.1 is the federal analogue to state statutes governing derivative claims and provides the procedures by which such actions must proceed when they are brought in a federal court. Under rule 23.1 the complaint in a derivative suit must be verified, the plaintiff must prove that he was a shareholder at the time of the transaction at issue and that he is an adequate representative of other shareholders similarly situated, a proper demand must be made or its absence explained, and both court approval and notice to other shareholders is required before an action may be dismissed or settled.[262] The use of arbitration would frustrate the policies inherent in this rule by eliminating the stipulated procedural safeguards and bypassing judicial approval of settlements.

This argument has several limitations. First, it would only apply in cases brought in federal court, because state courts operate under their own civil rules and, as noted previously, states lack the authority to refuse enforcement of an

254. 15 U.S.C. § 77n (1982).

255. *Wilko*, 346 U.S. at 432-35.

256. 15 U.S.C. § 78cc (1982).

257. *Id.* § 77l(2).

258. *McMahon*, 107 S. Ct. at 2341.

259. It could be argued that there is some distinction between § 16(b) and § 10(b) liability in that § 16(b) creates an express right of action while § 10(b) liability is implied. *See* Brown, Shell & Tyson, *supra* note 2, at 17-18. This distinction does not appear to make a difference on the question of arbitrability, however. The Supreme Court now has under consideration a case squarely addressing whether the express civil liability provision addressed in *Wilko*, § 12(2) of the 1933 Act, is arbitrable. Rodriguez De Quijas v. Shearson/Lehman Bros., Inc., 845 F.2d 1296 (5th Cir.), *cert. granted sub nom.* Rodriguez De Quijas v. Shearson/American Express, Inc., 109 S. Ct. 389 (1988). Most commentators agree that the Court will overrule *Wilko* and hold that this express liability provision is arbitrable. Shell, *supra* note 2, at 415 n.118.

260. Samuelson, *supra* note 250, at 513-17.

261. The federal rules, while procedural, have the force of law. 4 C. WRIGHT & A. MILLER, Federal Practice and Procedure § 1030 (2d ed. 1987) ("The Federal Rules of Civil Procedure have the effect of law. Statutes enacted prior to the rules [1938] that are inconsistent with them are superceded.").

262. FED. R. CIV. P. 23.1.

otherwise valid arbitration agreement.[263] Second, rule 23.1 is primarily a procedural rule of court,[264] whereas the FAA is a body of "federal substantive law."[265] It seems unlikely that a court would find that the requisites of a procedural rule outweigh the policies of a conflicting substantive law. Third, there may in fact be no inherent conflict between arbitration and the procedural hurdles that characterize rule 23.1. As noted earlier,[266] statutory derivative suit procedures are largely designed to protect *the corporation* from the threat of frivolous claims by shareholders, not to give the shareholder any special remedies. Corporations should thus be free to waive the protections embodied in rule 23.1 when they choose to substitute arbitration for litigation under a derivative suit statute. Moreover, and perhaps more importantly, both arbitration procedures and judicial rules may be adjusted to take account of the policies underlying rule 23.1. Arbitrators hearing a derivative claim should adopt those portions of rule 23.1 that are appropriate under the circumstances to avoid any conflict. For example, arbitrators should require the plaintiff shareholder to prove that she owned shares at the time of the alleged wrongdoing and that the plaintiff is an adequate representative of shareholder interests.[267]

Finally, courts may make adjustments to traditional arbitration practice to avoid any possible conflict with the requirements of rule 23.1. State courts have recently approved the concept of conducting class actions as arbitrations.[268] Under the California procedure the court handles the preliminary issues of class certification and notice before sending the case to an arbitration panel for trial.

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263. *See supra* notes 232-34 and accompanying text.

264. *See* Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 555-56 (1949) (holding that New Jersey derivative suit securities-for-expenses statute was substantive in character and must be applied by a federal court hearing a derivative claim under its diversity jurisdiction and commenting that rule 23's procedural requirements, which "neither create nor exempt from liabilities," do not conflict with such state substantive laws). The issue of whether rule 23.1 is substantive or procedural is not finally settled. For example, if the applicable state law had no contemporaneous ownership requirement, would a federal court hearing a derivative claim under its diversity jurisdiction be permitted to dismiss the claim of a noncontemporaneous owner under rule 23.1? If the contemporaneous ownership aspect of rule 23.1 is procedural, the answer is "yes." Erie R.R. v. Tompkins, 304 U.S. 64 (1938). If this requirement, or a lack thereof, is substantive in character, however, the federal court would be obligated under *Erie* to apply the state rule. Commentators have argued that rule 23.1 should be considered procedural in such circumstances, but they admit the matter is not free of doubt. *See* 7C C. WRIGHT, A. MILLER & M. KANE, FEDERAL PRACTICE & PROCEDURE § 1829 (2d ed. 1986).

265. Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24 (1983).

266. *See supra* note 144 and accompanying text.

267. Indeed, where both federal and state law require that the plaintiff in a derivative action be a contemporaneous shareholder, arbitrators who entertain a claim from a noncontemporaneous shareholder would probably be acting in "manifest disregard" of applicable law. *See supra* note 41 and accompanying text.

268. *See* Keating v. Superior Court, 31 Cal. 3d 584, 608-15, 645 P.2d 1192, 1206-10, 183 Cal. Rptr. 360, 374-78 (1982), *rev'd on other grounds sub nom.* Southland Corp. v. Keating, 465 U.S. 1, 17 (1984) (Supreme Court refused to address issue of whether class actions were permitted under FAA); Stevenson v. Commonwealth, 489 Pa. 1, 3-4, 413 A.2d 667, 669 (1980) (approving class action arbitration by state lottery winners against state); Gainey v. Occidental Land Research, 186 Cal. App. 3d 1051, 1053-56, 231 Cal. Rptr. 249, 250-52 (1986) (approving use of class action arbitration by limited partners against general partner for breach of fiduciary duty); Note, Keating v. Superior Court: *Oppressive Arbitration Clauses in Adhesion Contracts,* 71 CALIF. L. REV. 1239, 1250-53 (1983); Note, *Classwide Arbitration: Efficient Adjudication or Procedural Quagmire?,* 67 VA. L. REV. 787 (1981).

The case then returns to the court for confirmation if there is a settlement or award.[269] There is no reason why similar procedures might not be adopted with respect to derivative claims under the federal rules in order to further the liberal policy of the FAA favoring enforcement of arbitration agreements.

In sum, the legal arguments supporting the enforcement of a corporate arbitration provision appear capable of meeting every objection that might be raised under the FAA. These arguments, however, do not answer the policy objections that will be heard from scholars and others concerned about the effects arbitration might have on the traditional model of corporate governance and on the ability of the state to regulate the affairs of large corporations. The Article now returns to these concerns.

B. *Arbitration and the Public Corporation: The Policy Debate*

Scholars representing diverse points of view appear ready to accept arbitration as a means of resolving public shareholder disputes. Economist Daniel Fischel, while not advocating arbitration, has nevertheless expressed surprise that arbitration is not encountered in the public corporation setting.[270] Moreover, since economists tend to view shareholder litigation skeptically,[271] any step in the direction of reducing costs and distancing such suits from the courts is likely to meet with their approval.

Professor John Coffee, the Reporter for the American Law Institute's Corporate Governance Project section on "Remedies," has identified numerous practical and legal objections to the arbitration of public shareholder disputes based on current law and policy,[272] but he has nevertheless advocated that public corporations be permitted to adopt arbitration under certain conditions. He has proposed that arbitration be permitted so long as the process is adequately structured to protect shareholder and public interests.[273] Such protection should be assured, according to Coffee, by requiring corporations to adopt model arbitration provisions drafted and monitored by neutral groups such as the ALI.[274]

Other scholars favoring intrusive legal intervention in corporate affairs have not yet spoken on the issue of arbitration, but some are sure to criticize the arbitration alternative. Such critics are likely to raise a number of objections. Critics can be expected to echo the objections already discussed regarding sterilization of the board, the inadequacy of arbitration procedures to handle complex cases, and the possibility of collusive settlements if there is no oversight by a

269. Keating v. Superior Court, 31 Cal. 3d at 608-15, 645 P.2d at 1206-10, 183 Cal. Rptr. at 374-78.

270. Ribstein, *supra* note 115, at 388-89 (Professor Fischel remarking that "I've been troubled for a long time about why there isn't more use of [arbitration]."). Professor Fischel's observation is based on the model of the corporation utilized by economists.

271. *See supra* notes 7-9 and accompanying text.

272. Coffee, *supra* note 12, at 953-70.

273. Coffee, *supra* note 12, at 970-72.

274. Coffee, *supra* note 12, at 972-74.

court.[275]

On a practical level, critics may also argue that arbitration will result in prejudice to shareholders because courts are reluctant to grant injunctive relief in cases where arbitration has been stipulated.[276] In cases where mergers and takeovers are at issue, injunctions may be crucial in preserving the corporate status quo pending a resolution on the merits of the controversy. There is also danger that corporations will manipulate the manner in which arbitrators are named and "stack the deck" against shareholders to assure favorable results in arbitration.[277] Finally, arbitrators may refuse to award legal fees to successful plaintiffs' lawyers and remove the incentive for bringing derivative suits in the first instance.[278]

On a more fundamental level, critics may argue that arbitration threatens substantive shareholder rights and weakens the deterrent effects of fiduciary rules. Arbitration awards need not be based on or explained in terms of the law.[279] Fiduciary norms may therefore be subordinated to general equitable principles in arbitration, a result that would lead to inconsistent application of existing legal rules and a reduction in the deterrent value of such rules.[280] Arguably, shareholders would cease to have any meaningful legal rights under corporate law if the only decision makers to which they could apply for relief would be free to misapply the law.[281]

In addition, relegating a category of claims traditionally decided in public by courts to the sphere of private adjudication would deprive the community of shareholders and corporations of access to a developing body of legal norms with which to meet changing economic conditions. Arbitrators rarely write opinions.[282] With no authoritative statements by courts regarding the duties of management in changing economic circumstances, the law of fiduciary duty

275. Coffee, *supra* note 12, at 965-66; *supra* notes 261-69 and accompanying text.

276. *See* Karmel, *Injunctions Pending Arbitration and the Federal Arbitration Act: A Perspective from Contract Law*, 54 U. CHI. L. REV. 1373, 1375-86 (1987) (reviewing approaches of the courts in issuing injunctive relief); Note, *The United States Arbitration Act and Preliminary Injunctions: A New Interpretation of an Old Statute*, 66 B.U.L. REV. 1041, 1044 (1986) (noting that both federal and state courts are split on the issue of whether preliminary injunctions may be obtained pending arbitration).

277. Coffee, *supra* note 12, at 956-57 (suggesting that corporations may seek to have arbitration panels appointed from the ranks of disinterested directors or management-appointed experts).

278. *See supra* notes 139-43 and accompanying text.

279. *See supra* note 39 and accompanying text.

280. Note, *Mandatory Arbitration as a Remedy for Intra-Close Corporate Disputes*, 56 VA. L. REV. 271, 292 (1970) (arguing that arbitration of close corporation disputes involving breaches of fiduciary duty should be prohibited because "many legal rights and duties . . . would cease to exist. Fiduciary standards, for example, would be enforced by private ad hoc dispensations of equity which might be devoid of precedential consistency. As a result there would be no legal norms to govern and deter management misconduct . . . .").

281. Arbitrators may make errors of law without fear of judicial review, but they may not exhibit "manifest disregard" of legal rules. *See supra* notes 39-41 and accompanying text.

282. *See supra* notes 38-39 and accompanying text. Of course, parties may request that arbitrators write opinions, and there is evidence in caselaw that parties do so. *E.g.*, Raytheon Co. v. Computer Distrib., Inc., 632 F. Supp. 553 (D. Mass. 1986) (upholding award in which arbitrators rendered full opinion, including a concurrence and a dissent). The American Arbitration Association also provides for written opinions in international cases and, to a more limited extent, in securities cases. *See* AAA SUPPLEMENTARY PROCEDURES FOR INTERNATIONAL COMMERCIAL

would be frozen. The privacy and lack of legal accountability of arbitration might substantially weaken state regulation of large business enterprises.

These arguments have force, but they are unpersuasive when examined in the light of the forseeable realities of corporate arbitration. As noted above, the charge that enforcement of arbitration provisions will lead to "governance by arbitrators" is an empty threat. Arbitration of public shareholder disputes would not replace governance by boards of directors. Arbitration would be an alternative to the judicial forum for the resolution of discrete, relatively rare controversies. It has been estimated that on average a corporation experiences a shareholder action once every 6.7 years.[283] The use of arbitrators to decide these matters would not impinge on normal business decision making to any greater extent than do judicial decisions under current practice. Indeed, the relative informality of arbitration suggests that normal business operations would be less disrupted than is now the case during the pendency of the suit.

As for practical concerns regarding prejudice to shareholders, the difficulty of obtaining injunctive relief pending arbitration is overstated. Although several district courts have interpreted the FAA as forbidding the issuance of injunctions pending arbitration,[284] no appellate court has so held.[285] Rather, the circuit courts have adopted a variety of legal tests that to varying degrees permit the issuance of injunctions to maintain the status quo pending arbitrators' resolution of the dispute.[286] Given the trend of these decisions favoring injunctive relief, there is no reason to bar arbitration on policy grounds because of a fear that shareholders' rights will be prejudiced.

The charge that corporations could "stack the deck" by appointing arbitration panels sure to make findings favorable to management ignores the fact that the FAA, as well as other arbitration statutes, provides relief from awards that result from such obvious bias.[287] Moreover, charges that such bias is built into

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ARBITRATION RULES Rule 7 (effective Feb. 1, 1986); AAA SECURITIES ARBITRATION RULES Rule 42 (effective Sept. 1, 1987).

283. Jones, *An Empirical Examination of the Incidence of Shareholder Derivative and Class Action Lawsuits, 1971-1978*, 60 B.U.L. REV. 306, 313 (1980).

284. *See, e.g.*, Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Thompson, 575 F. Supp. 978, 979 (N.D. Fla. 1983); Merrill Lynch, Pierce, Fenner & Smith, Inc., v. Thompson, 574 F. Supp. 1472, 1478 (E.D. Mo. 1983). The argument that the FAA does not permit injunctive relief is premised on language in § 3 that requires the court, "on the application of one of the parties, [to] stay the trial of the action until such arbitration has been had." 9 U.S.C. § 3 (1982).

285. Karmel, *supra* note 276, at 1375.

286. *See, e.g.*, Teradyne, Inc. v. Mostek Corp., 797 F.2d 43 (1st Cir. 1986); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bradley, 756 F.2d 1048 (4th Cir. 1985); Guinness-Harp Corp. v. Jos. Schlitz Brewing Co., 613 F.2d 468 (2d Cir. 1980). *But see* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Hovey, 726 F.2d 1286 (8th Cir. 1984) (refusing to permit injunctions pending arbitration unless the parties' contract explicitly permits injunctive relief). Another panel of the Eighth Circuit subsequently decided an arbitration-injunction case using a different test than the one employed by the *Hovey* court. *See* Ferry-Morse Seed Co. v. Food Corn, Inc., 729 F.2d 589 (8th Cir. 1984) (employing traditional preliminary injunction test addressing likelihood of success on the merits); Karmel, *supra* note 276, at 1380.

287. 9 U.S.C. § 10(b) (1982); UNIF. ARBITRATION ACT, § 12(2), 7 U.L.A. 140 (1985). Professor Coffee points out that the securities industry arbitration system permits the industry to name arbitration panels in disputes with customers and expresses his fear that "many corporations will seek to provide for arbitration by either a panel of disinterested directors or by some other panel of management-appointed experts." Coffee, *supra* note 12, at 956. There are limits under the FAA to the

the system under which arbitrators are selected have a way of triggering vigorous public debate. In the securities area, for example, the industry has recently modified its rules governing the appointment of arbitrators in response to public criticism that its system was biased.[288] Indeed, both state[289] and federal[290] securities regulators are moving to ensure that the arbitrator selection system is fair. Were shareholder suits arbitrated on a widespread basis, similar public pressures and regulatory actions would likely develop to assure neutrality in the arbitrator selection process.

The concern over arbitrators' award of attorneys' fees invites two answers. First, the arbitration provision may contain an explicit promise of fees to successful plaintiffs as an inducement to provide adequate monitoring.[291] Second, even in the absence of such contractual provisions, arbitrators routinely award fees when the underlying cause of action so provides.[292] Because the derivative claim depends on fee awards for its very existence, arbitrators can be expected to award fees in derivative cases. If arbitrators refused to follow this practice, their award could be challenged under the FAA as being in "manifest disregard" of the law.[293]

The more basic policy arguments against arbitration are likewise unpersuasive. As for deterrence,[294] the effects under current practice of the vague legal

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types of arbitrators who may be appointed to hear cases. *See* Commonwealth Coatings Corp. v. Continental Casualty Co., 393 U.S. 145 (1968) (discussing rights of parties under the FAA to impartial tribunals). Even in securities industry arbitration, plaintiffs are given the opportunity to challenge arbitrators both with and without cause, and a majority of the arbitration panel must be drawn from a pool of "public [*i.e.* nonindustry] arbitrators." Moreover, the defendant securities exchange member does not appoint the panel. Rather, the Director of Arbitration for the securities exchange does so under rules approved by the SEC. Brown, Shell & Tyson, *supra* note 2, at 35-36 nn. 94-95; *see* Lipton, *Discovery Procedures and the Selection and Training of Arbitrators: A Study of Securities Industry Practices*, 26 AM. BUS. L.J. 435, 452-55 (1988). The arbitration system feared by Professor Coffee under which one party would appoint all the arbitrators appears to be unprecedented.

288. *See* Shell, *supra* note 2, at 422-27.

289. Harlan, *Massachusetts Says Brokers Can't Insist on Arbitration*, Wall St. J., Sept. 22, 1988, at 41, col. 5 (stating that a survey of the North American Securities Administrators Association reveals "a dozen or more states in the next six months expect to consider rules banning forced arbitration"). A federal district court in Massachusetts recently struck down the Massachusetts regulation on the grounds that it conflicted with the FAA. *See* Securities Indus. Ass'n v. Connolly, 1988 Fed. Sec. L. Rep. (CCH) ¶ 94, 107 (D. Mass. 1988).

290. 20 Sec. Reg. & L. Rep. (BNA) 1053 (describing federal bill introduced by Representative Boucher to improve securities arbitration practices and procedures); Shell, *supra* note 2, at 430-32.

291. *Cf.* Bernard v. Kuhn, 65 Md. App. 557, 501 A.2d 480 (1985) (shareholders agreed to arbitration provision containing attorneys' fee stipulation).

292. *See* Kamakazi Music Corp. v. Robbins Music Corp., 684 F.2d 228 (2d Cir. 1982) (approving award of attorneys' fees by arbitrators in Copyright Act claim); Hoellering, *Remedies in Arbitration*, 20 FORUM 516, 526-28 (1985); Shell, *supra* note 111, at 35-38. Under the Uniform Arbitration Act, arbitrators do not have the power to award attorneys' fees. *See* UNIF. ARBITRATION ACT § 10 ("Unless otherwise provided in the agreement to arbitrate, the arbitrators' expenses and fees, together with other expenses, not including counsel fees, incurred in the conduct of the arbitration, shall be paid as provided in the award."); Floors, Inc. v. B.G. Danis of New England, Inc., 380 Mass. 91, 401 N.E.2d 839 (1980). Parties who wish to assure that arbitrators will feel free to make awards should therefore take care to stipulate that the FAA is to govern this question.

293. *See supra* note 41 and accompanying text.

294. Although deterrence is an important goal of shareholder suits, derivative suits are, as a matter of law, primarily compensatory in nature. Courts have consistently rebuffed attempts to characterize the derivative suit as having deterrence as its primary purpose. *See* Bangor Punta Operations, Inc. v. Bangor & Aroostook R.R., 417 U.S. 703, 717-18 n.14 (1974); Coffee & Schwartz,

standards on the actual behavior of officers and directors are matters of considerable doubt. Corporate managers typically do not respond to each new judicial pronouncement regarding fiduciary duties. Rather, they rely on lawyers to inform them of their duties under the court decisions. In the area of fiduciary duties, however, even the most experienced legal advisors frequently make incorrect predictions regarding the application of the business judgment rule.[295] In short, the uncertainty of fiduciary law makes it unlikely that a reduction in judicial pronouncements will unduly hinder corporate decision making.

Moreover, arbitration may be capable of conveying at least some form of deterrent message. Even though arbitration proceedings are conducted privately and little or no explanation of awards is provided, the *fact* of an award and its amount frequently become public knowledge and may send a deterrent signal to the corporate community. Awards are sometimes reported in the press,[296] and when parties seek to vacate or confirm an award, courts publish opinions in which the names of the parties, the nature of the claims, and the amounts of the awards are made public. Were arbitration to become a common practice in the area of shareholder disputes, the pressure to systematize this sort of disclosure would doubtless grow, as is now happening in the securities industry with respect to public customer claims.[297]

Achieving consistent application of the law in derivative cases does not necessarily require litigation. The fiduciary standards applied by courts in corporate cases are essentially equitable principles that depend on contextual evidence and call for an intimate familiarity with corporate custom and practice for effective legal implementation. Expert arbitrators are as likely as judges to possess this familiarity, as demonstrated by the fact that arbitrators have been deciding close corporation disputes involving breaches of fiduciary duty for years.[298]

There is no doubt that arbitral resolution of shareholder disputes will reduce the occasions for courts to generate public fiduciary duty rules, but this is no reason for prohibiting arbitration. Quite simply, it is unlikely that all or even most public corporations will adopt arbitration. As discussed at more length in part IV of this Article, both structural and practical difficulties ensure that arbitration will not overtake litigation as the major forum for resolving public shareholder disputes in the public corporation. There will then be a continuing source of litigated cases involving public corporations from which to discern

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supra note 116, at 302 ("although a deterrent rationale for the derivative action has occasionally been recognized by the courts . . . it has never been the dominant rationale, and indeed some decisions appear frankly skeptical of it"); Cox, *supra* note 9, at 761-62; Comment, *supra* note 11, at 889 ("The law characterizes the derivative suit as a compensatory device.").

295. In a number of the most noted recent corporate takeover decisions, for example, even highly experienced counsel have been incorrect in their judgment regarding the legality of certain defensive tactics used by target companies. *See* Hanson Trust PLC v. SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

296. *See, e.g.*, Miller, *High-Tech World Sees IBM Case as a Way Out of the Copyright Maze*, Wall St. J., Sept. 18, 1987, at 1, col. 6 (reporting on IBM-Fujitsu arbitration award); *supra* note 3 and accompanying text.

297. Shell, *supra* note 2, at 427.

298. *See supra* notes 79-107 and accompanying text.

evolving legal norms. Even if arbitration were to become the dominant forum, the example of the close corporation suggests that the law is not likely to stagnate. The fiduciary duties of close corporation shareholders continue to exist and develop despite the fact that arbitration is widely used by such parties.[299] Finally, this argument against arbitration proves too much. Negotiated settlements also deprive the courts of opportunities to declare new rules, but few argue that settlements should be prohibited for this reason.[300]

In sum, the policy arguments against arbitration are based largely on doubtful behavioral assumptions and unwarranted skepticism about the efficacy of arbitration. Corporations bent on abusing arbitration would, of course, have opportunities to do so, but these same corporations may presently abuse the litigation system. It is not the fault of a dispute resolution system that parties use abusive tactics; but it is up to the dispute resolution system to adjust its procedures to minimize the likelihood that such tactics will succeed. Arbitration law is as capable as corporate law of making such adjustments to accommodate shareholder claims.

IV. PUBLIC SHAREHOLDER ARBITRATION: A REMEDY FOR THE FUTURE?

Assuming for the moment that the legal and policy arguments set forth above in favor of arbitration prevail, will the arbitration remedy become the wave of the future for shareholder disputes? If one assumes that the legal constraints formerly standing in the way of using arbitration have been the major factor in discouraging its use, the answer would seem to be "yes." Both a theoretical perspective based on transaction cost economics and the practical limitations on arbitral procedures, however, suggest that nonlegal factors are responsible for the total absence of precedent for arbitrating public derivative claims.[301]

A. *A Transaction Cost Model of Arbitration*

Oliver Williamson has developed a comprehensive conceptual model of contractual governance using an analytic tool called "transaction cost econom-

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299. Indeed, scholars analyzing the structural and economic differences between close and public corporations have concluded that the restricted nature of the markets in which a close corporation operates suggests a need for *stricter* fiduciary duties on managers and majority shareholders in the close corporation setting than in the context of a public corporation, which operates within active markets for corporate control, managerial labor, and the corporation's securities. Easterbrook & Fischel, *supra* note 69, at 291-97; Hetherington, *Defining the Scope of Controlling Shareholders' Fiduciary Responsibilities*, 22 WAKE FOREST L. REV. 9, 21-30 (1987). It is therefore arguable that close corporations are in even greater need of authoritative pronouncements by courts regarding fiduciary duties than public enterprises. Yet, as we have seen, arbitration is widely approved in the close corporation setting. If close corporations with a more urgent need for fiduciary norms can do without the courts, so can public corporations.

300. One prominent commentator has made this argument, however. *See* Fiss, *Against Settlement*, 93 YALE L.J. 1073 (1984).

301. It should be recalled that close corporation shareholders insisted on including arbitration clauses in their agreements even when the legal environment was hostile. *See supra* notes 75-107 and accompanying text. Research for this Article revealed no *attempt* by a public corporation to insert an arbitration clause in its charter.

ics."[302] Transaction cost economics is the study of the legal and nonlegal mechanisms[303] used by parties to reduce the costs of negotiating, monitoring, and performing mutually beneficial agreements. This theory suggests that there may be deep-seated, structural reasons why public corporations have not attempted to use arbitration as a substitute for litigation in the past and, therefore, will not use arbitration on a widespread basis in the future.[304]

Transaction cost economists focus on the human agents who make and perform commercial agreements to explore the world of private contracting. Transaction cost theory makes two basic assumptions about these human agents. First, human beings have "bounded rationality"—they are not capable of knowing, understanding, or providing for all possible contingencies in their relationships with others.[305] In practice, the attribute of bounded rationality means that people make contracts with less than perfect information about their contracting partners and the future. Second, people are, to varying degrees, opportunistic[306] and will, if the chance arises, serve their self-interests in preference to and at the expense of their contracting partners. Transaction cost theory does not assume that all people are opportunistic all of the time. It is enough that some people are inclined to "cheat" some of the time and that it is extremely difficult for the noncheating parties to know who the opportunists are in advance.[307]

To these two assumptions, transaction cost economics adds a principle that "the most critical dimension for describing transactions is the condition of asset specificity."[308] This means that, given the twin assumptions of bounded rationality and opportunism, the structure of contractual relations will vary most no-

302. O. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM (1986).

303. Oliver Williamson's work on transaction cost economics has emphasized nonlegal contractual governance mechanisms. *Id.* at 29 (property rights and mechanism design literature "work within the tradition of legal centralism," while "transaction cost economics disputes that court ordering is efficacious"). Contract law scholars have also used a transaction cost approach to explain why contract law doctrines serve, on occasion, to reduce the transaction costs of contracting within a legal system. *See, e.g.*, A. KRONMAN & R. POSNER, THE ECONOMICS OF CONTRACT LAW 4 (1979); Scott & Goetz, *Enforcing Promises: An Examination of the Basis of Contract*, 89 YALE L.J. 1261 (1980).

304. Williamson has explained that transaction costs "are the economic equivalent of friction in physical systems." O. WILLIAMSON, *supra* note 302, at 19. In a contractual relationship, examples of such friction include communicating about and negotiating an agreement, monitoring performance to assure that performance is as promised, dealing with unexpected contingencies, and enforcing the contract or obtaining compensation if the agreement breaks down before performance is complete. Some friction is inherent in the contracting process, but all parties to an agreement benefit to the extent that such costs can be reduced. Arbitration has long been recognized as an efficiency-enhancing contractual governance mechanism. *See, e.g.*, Llewellyn, *The Effect of Legal Institutions Upon Economics*, 15 AM. ECON. REV. 665, 675 (1925). It is only recently, however, that commentators have explicitly tied the use of arbitration to transaction cost theory. *See* O. WILLIAMSON, *supra* note 302, at 75; Fischel & Bradley, *supra* note 17, at 269.

305. O. WILLIAMSON, *supra* note 302, at 44-47. Many economic models assume for purposes of analysis that parties have perfect information regarding themselves, each other, and the world in which they operate. *E.g.*, Coase, *The Problem of Social Cost*, 3 J. LAW & ECON. 1 (1960). Transaction cost economics explicitly assumes that this is not the case.

306. Oliver Williamson has defined opportunism as "self interest seeking with guile," O. WILLIAMSON, MARKETS AND HIERARCHIES 26 (1975), and has recently written that "opportunism refers to the incomplete or distorted disclosure of information, especially to calculated efforts to mislead, distort, disguise, obfuscate, or otherwise confuse." O. WILLIAMSON, *supra* note 302, at 47.

307. O. WILLIAMSON, *supra* note 302, at 64-67.

308. O. WILLIAMSON, *supra* note 302, at 30.

ticeably when the transaction in question is accompanied by investments in assets—such as human skills, durable goods, or fixtures—that are specifically tailored to the use at hand.[309] Thus, a contract to build a nuclear power plant requiring specially trained labor and investments in structures that have no alternative uses should evidence a more complex contractual governance structure than a contract for a builder to erect a prefabricated home using journeyman carpenters and ordinary materials. Should the owner threaten to default in the construction of the prefabricated home, the builder can sell both the structure and his labor to another customer. Similarly, should the builder default, the owner can doubtless find another carpenter and order another prefabricated house. The parties building the nuclear plant, by contrast, face a significant risk of loss should either party act opportunistically and demand contractual concessions on price or performance once the project is well under way.[310] Both parties' investments in the nuclear plant have sharply lower values in most alternative uses.

Contractual governance structures also vary according to the frequency with which transactions recur between the same parties over an extended period of time. The more frequently and the longer parties repeat transactions with one another, the more likely they are to seek special contractual mechanisms to economize on the transaction costs of their repeated dealings.[311] When highly specific assets are at risk over a long period of time, the parties may move from a conventional contracting relationship toward integration into a single business entity, which will assure a maximum degree of monitoring and control over the transactions at issue.[312]

Summarizing the transaction cost landscape of contract with terminology borrowed from Professor Ian Macneil,[313] Williamson describes contracts as falling into one of three general categories: classical, neoclassical, and relational.[314] Classical contracts involve discrete transactions in generic goods or services and rely on markets for governance.[315] Neoclassical contracts involve cross-market

309. O. WILLIAMSON, *supra* note 302, at 53 ("Transactions that are supported by investments in durable, transaction-specific assets experience 'lock-in' effects, on which account autonomous trading commonly will be supplanted by unified ownership (vertical integration).").

310. Opportunism in the adjustment of long-term contracts has been the subject of a lively debate in the legal literature. *See, e.g.*, Gillette, *Commercial Rationality and the Duty to Adjust Long-Term Contracts*, 69 MINN. L. REV. 521 (1985); Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 NW. U.L. REV. 854 (1978); Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521 (1981); Scott, *Conflict and Cooperation in Long-Term Contracts*, 75 CALIF. L. REV. 2005 (1988).

311. O. WILLIAMSON, *supra* note 302, at 60.

312. O. WILLIAMSON, *supra* note 302, at 78; M. PORTER, COMPETITIVE STRATEGY 300-23 (1980) (discussing strategic advantages and risks of vertical integration under certain conditions).

313. Macneil, *supra* note 310. Professor Macneil is credited by many with founding and developing the "relational" theory of contracting. *See* Gordon, *Macaulay, Macneil, and the Discovery of Solidarity and Power in Contract Law*, 1985 WIS. L. REV. 565; Whitford, *Ian Macneil's Contribution to Contracts Scholarship*, 1985 WIS. L. REV. 545. He has been a pioneer in focusing the attention of the legal community on the human factors in contracting that profoundly affect the shape of legal rules and that sometimes make legal rules superfluous.

314. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J. L. & ECON. 233, 235-38 (1979).

315. *Id.* at 236-37. The classical market does not operate in a legal vacuum. Rather, the market

exchanges of more highly specified assets in which the parties are at risk for longer periods of time.[316] Examples of such contracts include complex construction projects and long-term requirements or supply contracts. Relational contracts involve integrated, continuous interactions between particular parties such as the exchanges that occur between organized labor and corporate management.[317] A relational contract is, in reality, "a minisociety with a vast array of norms beyond the norms centered on exchange and its immediate processes."[318]

According to Williamson, arbitration frequently is used as a contractual support mechanism in neoclassical and relational contracts where continuity (or at least completion of the contract) is valued more highly than the right to seek immediate enforcement of rights in a court.[319] In both neoclassical and relational contracts, public ordering through litigation is not an attractive option. First, in American culture, litigation is often a last resort and generally signals that a relationship is at an end.[320] Second, if the mere filing of a suit does not end the relationship, discovery, pretrial tactics, delays, and a formal public trial will drain away what little goodwill may remain between the litigants. Parties contemplating long-term relationships thus seek reassurance in their contracts that this form of legalized warfare will not be used against them.

Real-world practice seems to bear out Williamson's hypothesis. Neoclassical contracts such as long-term supply agreements, joint ventures, manufacturer-dealer relationships, and construction projects all frequently employ arbitration as a means of resolving disputes.[321] As noted at the outset of this Article, roughly ninety-five percent of the "relational" collective bargaining agreements between corporations and organized labor utilize grievance arbitration as a substitute for administrative and court ordering and strikes.[322]

Arbitration helps to reduce the transaction costs of "continuing exchange relation[s]"[323] in four primary ways. First, as noted above, the use of an arbitration clause helps to build an atmosphere of trust and goodwill and encourages

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utilizes the standard rules of contract and tort law to enforce simple promises and deter fraud. The parties invest little in customized rules and arrangements, however, because they can rely on the market to supply substitutes should their contracting partners default.

316. *Id.* at 237-38.

317. *Id.* at 238.

318. Macneil, *supra* note 310, at 901.

319. Williamson, *supra* note 314, at 238 ("One important purposive difference in arbitration and litigation that contributes to the procedural differences . . . is that, whereas continuity (at least completion of the contract) is presumed under the arbitration machinery, this presumption is much weaker when litigation is employed"). Arbitration may also be used as an alternative to the courts in classical contracting situations simply to save time, money, and resources. The use of arbitration to resolve consumer disputes is one example. *See, e.g.*, Abrams, *New York Lemon Law Arbitration Program: Annual Report-1987*, 43 ARB. J. 36 (Sept. 1988). Another example is arbitration of disputes between customers and brokers in the securities industry. *See supra* note 2 and accompanying text.

320. L. FRIEDMAN, CONTRACT LAW IN AMERICA 206 (1965); Williamson, *supra* note 314, at 238 n.21.

321. *See supra* note 5.

322. *See supra* note 1 and accompanying text.

323. Williamson, *supra* note 314, at 242.

negotiated settlements of disputes.[324] Second, arbitrators can expand the transaction resources available to the parties at negotiation and renegotiation stages by providing new information, ideas, and solutions to contractual impasses.[325] Third, arbitrators provide neutral "division services" to parties that reduce tension when the parties must divide the profits or losses resulting from their efforts.[326] Finally and most obviously, arbitrators provide speedy, credible enforcement services to deter opportunistic breaches of contract and to compensate the wronged party when such breaches occur.[327] The expertise of arbitrators, the informality and relative efficiency of arbitration procedures, and the ability of arbitrators to rest their decisions on relational norms peculiar to the parties—such as trade customs and courses of dealing—are attractive to parties seeking governance structures that will give them confidence in their relationships with one another.

In transaction cost terms, the corporation is a complex form of "relational" contract.[328] The corporate form of business enterprise offers equity investors and managers a secure governance structure designed to encourage shareholders to risk capital on relatively long-term projects selected and executed by corporate managers. Public and close corporations differ, however, along a critical axis posited by transaction cost theory: asset specificity.[329]

Close corporation shareholders' intimate involvement in management,[330] their inability to transfer ownership interests readily in a liquid market,[331] and their frequent risk of unlimited liability[332] significantly increases both the asset specificity and the potential duration of the shareholders' investments in the close corporation. By contrast, the public corporation shareholder has no human assets invested in the enterprise, the shareholder's financial contribution is liquid and may readily be shifted to other investments, and the shareholder's

324. *Cf.* F. O'NEAL & R. THOMPSON, *supra* note 64, § 9.11, at 37 ("The existence of arbitration procedures and the participants' knowledge that this quick method of settling controversies is readily available induces successful negotiation of disputes that might otherwise reach an impasse.").

325. *See, e.g.*, Matter of Darman, 105 A.D.2d 1028, 483 N.Y.S.2d 469 (1984) (when owners of close corporation reached impasse in negotiation regarding extent of equity of each shareholder, arbitrators provided both an answer to the equity question and a control mechanism for parties to resolve buy-out questions); Klein, Crawford, & Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J. L. & ECON. 297, 303, 315 (1978) (discussing use of arbitration to adjust long-term contracts and to facilitate management-union relations over term of collective bargaining agreement). Parties also turn to mediators when they seek additional ideas and resources to break bargaining impasses. In mediation, as distinguished from arbitration, the parties themselves retain control over the outcome of the negotiations. Silbey & Merry, *Mediator Settlement Strategies*, 8 L. & POLICY REV. 7, 7 (1986).

326. Heckathorn & Maser, *Bargaining and the Sources of Transaction Costs: The Case of Government Regulation*, 3 J. L. ECON. & ORG. 69, 84 (1987).

327. *Id.*

328. Macneil, *supra* note 310, at 885 (discussing corporate law as a variety of relational contract law); Williamson, *supra* note 314, at 238.

329. *See supra* note 308 and accompanying text.

330. The fact that shareholders perform management services for the close corporation is likely to mean that they have high "firm-specific human assets," including nontransferable skills and psychological commitments, invested in the firm. O. WILLIAMSON, *supra* note 302, at 313.

331. Easterbrook & Fischel, *supra* note 69, at 274-75.

332. *See supra* notes 71-72 and accompanying text.

personal wealth is not at stake beyond his or her equity contribution.[333] Transaction cost analysis suggests that these sharp differences between close and public shareholders in the degree of asset specificity in their investments and the potential duration of their relationship with the corporation will lead to different corporate governance structures. The close corporation structure will be more complex and will rely, to a greater degree than public entities, on devices such as arbitration to protect the relatively high level of asset specificity in the close corporation shareholder's investment. The public shareholder, by contrast, is more likely to rely on the market and to be satisfied with the standard menu of protections provided by corporate law. As we have seen, arbitration is frequently found in the close corporation setting but is not, as yet, a feature of public corporation governance.

The fact that public corporations have not turned to formal arbitration as a governance device does not mean that they lack the need for arbitral processes to protect shareholder interests. On the contrary, a close examination of public corporation practices reveals that with respect to shareholder suits a majority of public corporations already utilize a nontraditional form of arbitration that may take account of transaction cost concerns. The practice of using special litigation committees composed solely of independent nonparty directors to decide on the merits of shareholder actions represents an explicit attempt to bring a form of arbitral factfinding to the task of corporate governance.[334] Indeed, the courts have treated special litigation committees in large measure as arbitration panels. In two of the most important corporate law states, Delaware and New York, judicial review of committee recommendations is based, like review of an arbitration award, not so much on the merits of the decision as on a review of the committee's independence, good faith, and method of investigation.[335]

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333. *See supra* notes 66-74 and accompanying text.

334. *See supra* notes 149-50 and accompanying text. More generally, the institution of the board of directors is, in transaction cost terms, a complex "governance structure" for protecting the interests of shareholders, Williamson, *supra* note 89, at 1220, and most public corporations have a majority of nonmanagement, outside directors serving on their boards. *Id.* at 1219-20. This use of neutral outsiders to mediate the relationship between management and shareholders through the issuance of binding management policy decisions, while not a traditional form of arbitration, certainly reflects the spirit of using neutrals as a means of cementing relational contracts.

335. Zapata Corp. v. Maldonado, 430 A.2d 779, 788 (Del. 1981); Auerbach v. Bennett, 47 N.Y.2d 619, 623, 393 N.E.2d 994, 996, 419 N.Y.S.2d 920, 922 (1979). *But see* Alford v. Shaw, 320 N.C. 465, 358 S.E.2d 323 (1987) (rejecting *Zapata* and *Auerbach* approaches and holding that courts should review merits of report by special litigation committee). The Delaware approach gives the court the option of injecting its own "business judgment" in reviewing the special litigation committee's determinations, *Zapata*, 430 A.2d at 789, but the Delaware courts rarely utilize this form of review in practice. Instead, using a deferential review, the courts have shown that they are capable of detecting bias and conflicts of interest. *See, e.g.*, Lewis v. Fuqua, 502 A.2d 962 (Del. Ch. 1985) (rejecting report of a one-person special litigation committee because of potential bias due to conflict of interest). The criticism that such committees suffer from "structural bias," *see* Coffee & Schwartz, *supra* note 116, at 283, does not go to the institution of the special litigation committee itself, but rather to the fact that the members of this committee, unlike true arbitrators, may not be neutral. Significantly, commentators and at least one state have answered the "structural bias" problem with proposals to give courts the authority to appoint the "neutrals" who are to serve. *See* Miller v. Register and Tribune Syndicate, 336 N.W.2d 709 (Iowa 1983); Gevurtz, *Who Represents the Corporation? In Search of a Better Method for Determining the Corporate Interest in Derivative Litigation*, 46 U. PITT. L. REV. 265, 321-35 (1985) (recommending appointment of third-party neutrals as "provisional litigation directors" to serve on special litigation committees); American Law Institute,

There are, to be sure, public corporations where the asset specificity of certain shareholders' investment is high. In many public corporations, large institutional or other groups hold sufficient shares to influence decisions, while the public holds merely a passive, minority interest.[336] As a functional matter, the holder of a very large block of stock in a public corporation is not free to sell it at will any more than the holder of restricted stock in a close corporation.[337] The transaction cost model might predict, therefore, that corporations with such concentrated ownership would seek arbitration for some of the same reasons as close corporation shareholders.

It remains to be seen whether future developments will support this prediction. Institutional investors are not like close corporation shareholders in a number of important respects that might limit the application of the model. In general, institutional investors seek no role in the management of the corporations whose stock they own, and institutions have little psychological capital invested in their shares of stock. However, such investors may well decide that arbitration is desirable as a way to reduce the costs and disruptions of unwarranted shareholder suits, to reduce insurance premiums, and to signal confidence in management. The relatively high degree of professional monitoring of corporate affairs engaged in by institutional investors puts them in an exceptionally good position to make efficient decisions regarding arbitration.

In addition, a number of public corporations have dual classes of stock that give full control over the company to relatively few holders of the control class of shares, while the public owns nonvoting stock.[338] These control shares represent highly specific assets to their owners and are often subject to the same transfer restrictions one finds in a close corporation. By analogy to close corporations, one might expect to observe arbitration as a means of contractual governance among such controlling shareholders.

Even in dual class public corporations, however, the relationship between controlling and public shareholders continues to be governed by the same basic

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Corporate Governance Project § 7.03 (Tent. Draft No. 1 Apr. 1, 1982) (this proposal was later dropped by the ALI in favor of a provision more receptive of the board's authority to appoint special litigation committees); *see also* Rosengarten v. Buckley, 613 F. Supp. 1493, 1498-99 (D. Md. 1985) (holding that Maryland would likely apply *Zapata* test, placing burden of proving independence, good faith, and reasonable basis for its conclusions on corporation). A final step in the direction of traditional arbitration might be to let the parties select the special litigation committee using the rules of the American Arbitration Association.

336. *See, e.g.*, M. EISENBERG, THE STRUCTURE OF THE CORPORATION 20-24 (1976) (noting the importance of institutional investors in public corporations); Koppes & Gillan, *Shareholder Activism*, 2 INSIGHTS 11 (Dec. 1988) (discussing institutional investors' involvement in corporate governance process); Sullivan, *Two of Texaco's Institutional Holders To Seek a Role in Nominating Directors*, Wall St. J., Aug. 17, 1988, at 5, col. 1; Wallace, *Institutions Proxy Power Grows*, N.Y. Times, July 5, 1988, at D1, col. 3 (pension funds now own almost one-half of the stock of companies that make up the Standard & Poor's 500 Index and 23.2% of all corporate equities).

337. W. CARY & M. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 213 (5th ed. 1980) ("holdings [in public corporations] may be so large that [shareholders] are locked in").

338. *See, e.g.*, DeAngelo & DeAngelo, *supra* note 68. Indeed, many public firms have considered recapitalizing themselves as dual class firms as a means of protecting against hostile takeovers—a trend that recently prompted the SEC to issue a controversial new rule limiting the listing of such dual class firms on national security exchanges. *See* Gordon, *Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CALIF. L. REV. 1 (1988).

transaction cost incentives as prevail in the classic public corporation. The nonvoting shareholders still have access to a liquid market and have a relatively low level of asset specificity in their investment. Moreover, by having freely chosen their position in the company, they have signaled their willingness to take financial risk without the protection of even the traditional corporate governance structure. Arbitration would therefore not be sought by noncontrolling shareholders but may be imposed on them by the control group in these forms of public enterprise.

B. *Practical Constraints on the Use of Public Corporation Arbitration*

Practical as well as transaction cost factors suggest that arbitration in the public shareholder context will remain the exception rather than the rule. One might expect that the simplicity, speed, and decisional expertise offered by arbitration would be sufficient to make arbitration preferable to litigation even without any special "relational" concerns to encourage its use. In practice, however, arbitration of public shareholder disputes is quite likely to be anything but simple in many cases.

First, an arbitration charter provision may result in expensive, complex, and frustrating litigation in both arbitral and judicial forums. It seems likely that in some cases plaintiffs' lawyers will strongly resist the enforcement of arbitration provisions out of suspicion that arbitrators will not be as favorably inclined to award large judgments and that attorneys' fees would be placed in jeopardy. Protracted litigation over enforcement is therefore assured until some of the complicated legal questions analyzed above[339] are definitively sorted out by the courts. Moreover, as noted earlier, there may be problems getting all of the potential defendants into one arbitration forum.[340] If so, cases will have to proceed simultaneously in both the arbitral and judicial forums.

With respect to speed of resolution, studies have shown that arbitration is not clearly superior to court litigation for the resolution of complex claims. Complex arbitrations, like complex court cases, take a long time to resolve and can be just as expensive as court trials.[341] Moreover, a defendant takes the risk that an arbitrator will render an extraordinary award of punitive or multiple damages that will then be insulated from judicial review.[342] Indeed, those attorneys who are most experienced with arbitration have expressed the greatest dissatisfaction with arbitration in the complex setting. These attorneys have reported that arbitration and litigation are, at best, about equally attractive (or

339. *See supra* notes 167-269 and accompanying text.

340. *See supra* notes 212-21 and accompanying text.

341. Kritzer & Anderson, *supra* note 24, at 14-18; Stipanowich, *Rethinking American Arbitration*, 63 IND. L.J. 425, 452, 461-62 (1988). The American Arbitration Association is aware of the problems of arbitrating complex cases and is working to devise means of tailoring the arbitration process to suit the needs of litigants facing a complex arbitration. *See* Coulson, *Bringing Flexibility and Innovation to Complex Cases*, 43 ARB. J. 2 (Sept. 1988); Houck, *Complex Commercial Arbitration: Designing a Process to Suit the Case*, 43 ARB. J. 3 (Sept. 1988).

342. *See supra* notes 40-41 and accompanying text.

unattractive) for the adjudication of a complex case.[343]

Finally, on the issue of expertise, Delaware—the state in which many American public corporations are incorporated[344]—is known for having as judges some of the nation's leading experts in corporate matters. Arbitrators may be found who are qualified to decide public shareholder cases, but such individuals are not likely to know significantly more about corporate practice than the judges of the chancery and supreme courts of Delaware. Indeed, the Delaware courts and their expertise are a large measure of the reason that public corporations choose to incorporate in that state.

Given these incentives and realities, there seem to be no obvious forces driving either plaintiffs' lawyers or public corporations toward arbitration and few reasons to expect large numbers of public shareholder claims to be diverted from the courts. Nevertheless, with arbitration now a legal possibility, it seems likely that some experimentation will occur. This may take the form of the adoption of arbitration provisions in corporations with highly concentrated ownership structures or in firms with more diffuse ownership where management is seeking ways to limit the litigation expenses associated with shareholder claims. In addition, shareholders seeking to reduce the influence of special litigation committees over the disposition of derivative claims may come to the realization that arbitration offers an opportunity to reach the merits of the derivative dispute before a neutral tribunal. Such shareholders may urge corporations to adopt arbitration. If legislatures begin to view special litigation committees more skeptically and bar their use, corporate managers may seek arbitration as preferable to judicial control over shareholder claims. Finally, arbitration may take place in some instances pursuant to submission agreements between the parties when both sides seek a quick, efficient adjudication of a shareholder complaint.

V. CONCLUSION

This Article has demonstrated that recent developments in the law governing the interpretation of the Federal Arbitration Act have opened the door to arbitrating disputes between public shareholders and the directors and officers of public corporations. Shareholder suits occupy a prominent place in the conventional model of corporate governance and are the primary source of substantive law in areas such as the managers' duties of care and loyalty to the corporation. Corporate law commentators can be expected to argue, therefore, that arbitration of such claims jeopardizes shareholders' rights by denying shareholders access to the courts and by stunting judicial development of legal doctrines in this area. Arbitration also threatens to insulate corporations from regulation by the state through privatization of a major governance tool.

Interestingly, commentators have expressed fears very similar to these at virtually every stage of the development of modern commercial arbitration.

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343. Stipanowich, *supra* note 341, at 472 & n.249.

344. *See* Hays, *Delaware's New Anti-Takeover Law is Contested by Campeau, Black & Decker*, Wall. St. J., Feb. 3, 1988, at 26, col. 3 (reporting that 56% of the "Fortune 500" and 45% of all companies listed on the New York Stock Exchange are incorporated in Delaware).

Critics have worried that liberal enforcement of arbitration agreements would eventually lead to the setting up of abusive, insulated systems of "private law" operating outside the state's reach.[345] Such fears have seldom proved warranted.[346]

Close analysis of the challenges presented by arbitration in the corporate governance area reveals that fears of threats to shareholder rights are similarly overstated. Arbitration has been highly successful as a means of preventing and resolving disputes in the close corporation arena, and there is no reason to think that arbitrators could not do as good a job with public shareholder disputes. Nor does it appear that the legal development of close corporation shareholders' fiduciary duties has ceased because arbitration is available.

Arbitration is not without risk, and it is unlikely to be a panacea for the complexities and expense of public shareholder litigation. Should serious problems or abuses develop, shareholders have several means of correcting the system. First, shareholders may seek stricter judicial review of arbitration awards using existing doctrines. The FAA provides for review of awards rendered by biased tribunals and awards that are in "manifest disregard" of the law. Shareholders may also seek revocation of arbitration charter provisions through the proxy machinery. Finally, Congress has the power to exempt shareholder claims fully from the FAA.

Both organizational factors revealed by transaction cost analysis and practical concerns having to do with the complexity of shareholder cases and the specialized nature of corporate law indicate that arbitration of public shareholder claims will be, at best, a complement to traditional court remedies. The indications that arbitration will play only a limited role in corporate governance, however, further strengthens the arguments for its use. With both courts and arbitrators actively involved in deciding shareholder cases, there will be a continuing stream of judicial pronouncements to which arbitrators may refer in making arbitration awards.

The evidence regarding arbitration in close corporations reveals that the

345. *See, e.g.*, Kronstein, *Business Arbitration: Instrument of Private Government*, 54 YALE L.J. 36, 41, 60 (1944) (expressing fear that widespread use of commercial arbitration would lead to unfettered self-regulation by business and the decline of the rule of law as a constraint on commercial practice and stating that "historical precedent has shown that legislation designed to control corporate activities may be nullified through the use of arbitration and the substance of corporate law changed to the detriment of the public control of corporations"). The Supreme Court struck down a system of industry trade association arbitration in the motion picture business in 1930 on federal antitrust grounds. Paramount Famous Lasky Corp. v. United States, 282 U.S. 30 (1930). *Paramount* has not been followed in subsequent challenges to industry arbitration systems. *See, e.g.*, Drayer v. Krasner, 572 F.2d 348, 355 (2d Cir. 1978) (securities arbitration system upheld).

346. Arbitrators lack the rigor of "legal discipline" in their decision making. *See* Shell, *supra* note 2, at 421. More often than not, however, they do their best to apply the law fairly and render awards based on the merits of the dispute. Mentschikoff, *Commercial Arbitration*, 61 COLUM. L. REV. 846, 861 (1961) (survey results indicating that 80% of arbitrators questioned believed they ought to follow the law in making their awards even though they felt free to make an award based primarily on the equities of the case); American Arbitration Association, Case Administration—Update, Press Release (July 25, 1986) (study showing that only 13% of awards were within 10% of half the amount claimed, thus demonstrating that arbitrators do not blindly "split the difference"); Stipanowich, *supra* note 341, at 485 (52% of attorneys questioned in ABA study believe that arbitrators do not issue unjustifiable compromise awards).

law has, in the past, been slow to accept innovative alternative means of resolving corporate governance disputes. In the end, however, the needs of shareholders have prevailed over the law's reluctance to change. Now that the door has been opened to arbitration of public shareholder disputes, courts should take a page from the book of close corporation law and permit corporations to experiment with this and other alternatives to court ordering.