

# In a Bind: Mandatory Arbitration Clauses in the Corporate Derivative Context

Emily Farinacci\*

## I. INTRODUCTION

Arbitration has permeated the corporate governance landscape. Parties to contracts frequently choose to adhere to contractual language obligating them to resolve their disputes in front of a neutral arbitrator and outside of the courtroom.<sup>1</sup> An increasingly popular alternative dispute resolution mechanism, mandatory arbitration clauses are now springing up in more complex forms of contract: corporate bylaws and articles of incorporation.<sup>2</sup> These clauses bind a corporation's owners (its shareholders) to arbitration proceedings for resolution of their derivative claims against corporate management—one of the principal methods of upholding the corporate governance structure.<sup>3</sup> Because shareholders are being barred from the secure confines of Delaware jurisprudence as a result, mandatory arbitration clauses are causing a revolution in shareholder derivative suits, along with the fundamentals of Delaware corporate law.

The popularity of mandatory arbitration provisions is evidenced by the U.S. Supreme Court's endorsement of this alternative dispute mechanism within the corporate context. The recent 5–4 Supreme Court decision *AT&T*

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\* J.D. Candidate, The Ohio State University Moritz College of Law, 2013; B.S., B.A., Saint Louis University, 2009. The author would like to thank professors Paul Rose and Steven M. Davidoff for their interest and support in the topic; and her parents, John J. Farinacci and Joanne G. Farinacci for their never-ending support and guidance.

<sup>1</sup> The U.S. Supreme Court formally recognized the enforceability of class arbitration proceedings in *Stolt-Neilson S.A. v. AnimalFeeds Int'l Corp.*, 130 S. Ct. 1758, 1775 (2010), by recognizing that a party is compelled to class arbitration when “there is a contractual basis for concluding the party agreed to do so.” See also *Annual Review of Developments in Business and Corporate Litigation*, in 1 AMERICAN BAR ASSOCIATION COMMITTEE ON BUSINESS AND CORPORATE LITIGATION 232, 234–36 (2011).

<sup>2</sup> Christos Ravanides, *Arbitration Clauses in Public Company Charters: An Expansion of the ADR Elysian Fields or a Descent into Hades?*, 18 AM. REV. INT'L ARB. 371, 378 (2009) (“Arbitration is no longer a mere ‘legal possibility,’ but literally in the wings for public shareholders.”).

<sup>3</sup> Andrew J. Sockol, *A Natural Evolution: Compulsory Arbitration of Shareholder Derivative Suits in Publicly Traded Corporations*, 77 TUL. L. REV. 1095, 1096 (2003). “Mandatory” arbitration clauses refer to contractual provisions that deem arbitration the exclusive remedy for resolving disputes, as opposed to “voluntary” arbitration provisions which allow shareholders to elect litigation in court. Sen. Russell D. Feingold, *Mandatory Arbitration: What Process is Due?*, 39 HARV. J. ON LEGIS. 281, 283 (2002).

*Mobility v. Concepcion*<sup>4</sup> held that a California state law restricting the ability of corporations to use mandatory arbitration agreements for resolving consumer and employment contract disputes was preempted by the Federal Arbitration Act (FAA).<sup>5</sup> In *AT&T*, plaintiff-consumers argued that the contracts they entered into for cellular phone services, which contained a clause requiring arbitration of all customer class-action disputes, violated a California state rule barring all class-action waivers in adhesion contracts.<sup>6</sup> The Supreme Court disagreed, and declared the California law invalid under the FAA.<sup>7</sup> Stressing that “[t]he principal purpose of the FAA is to ensure that private arbitration agreements are enforced according to their terms,” the Court’s decision heightened the importance of the FAA within the context of corporate contracts.<sup>8</sup>

*AT&T Mobility* affects the rights of consumers and employees—parties who are most likely to bring suit in the form of a class action—and addresses mandatory arbitration clauses in the context of their increasingly frequent use within consumer and employment contracts. On the other hand, mandatory

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<sup>4</sup> *AT&T Mobility LLC v. Concepcion*, 131 S. Ct. 1740, 1756 (2011).

<sup>5</sup> Federal Arbitration Act, 9 U.S.C. §§ 1–16 (2006). *See also* Joseph C. Barsalona II, *Recent Development: AT&T Mobility LLC v. Concepcion et ux.*, 27 OHIO ST. J. ON DISP. RESOL. 273, 273 (2012) (noting the Supreme Court’s reluctance to deviate from the FAA’s dual objectives to enforce private contracts and facilitate streamlined dispute resolution processes).

<sup>6</sup> *AT&T Mobility*, 1315 S. Ct. at 1744–45. The cell phone contract’s arbitration clause required all consumer claims to be brought “in the parties’ individual capacity, and not as a plaintiff or class member in any purported class or representative proceeding.” *Id.* at 1744 (internal citation omitted).

<sup>7</sup> *Id.* at 1750. The Court’s ruling in *AT&T* reflects its previously noted stance regarding the applicability of the FAA to state law in *Southland Corp. v. Keating*, 465 U.S. 1, 16 (1984). In *Southland*, the Court formally recognized a “national policy favoring arbitration” and ruled that the federal statutory law of the FAA preempts any state law that frustrates the FAA’s objectives by requiring a judicial forum to resolve claims. *Id.* at 10.

<sup>8</sup> *AT&T Mobility*, 1315 S. Ct. at 1748. (internal citation omitted). *See also* CompuCredit Corp. v. Greenwood, 132 S. Ct. 665 (2012) (finding an arbitration provision within a consumer’s credit card agreement enforceable under the FAA, even though the Credit Repair Organizations Act is silent on the issue). Some speculate that the holding of *AT&T* will have a spillover effect onto a corporation’s relationship with its shareholders, particularly in the securities class action context. Jennifer B. Poppe & Alithea Z. Sullivan, *Could the Supreme Court’s Enforcement of Arbitration in Concepcion Reverberate in the Securities Litigation Sphere?*, 8 SEC. LITIG. REP., no. 8, Sept. 2011, at 1; Vinson & Elkins, *Securities Litigation Insights*, at 4 (2011), available at <http://www.velaw.com/uploadedFiles/VEsite/Resources/SecuritiesLitigationInsightsAugust2011.pdf>.

arbitration clauses within corporate bylaws for use in resolving shareholder derivative suits have not been so readily adopted.<sup>9</sup> Issues of internal corporate governance involving disputes between shareholders, public corporations, and management are traditionally seen as more appropriately handled by state courts rather than private decision-makers.<sup>10</sup> However, “sporadic academic duels over the relationship between arbitration and public corporate governance have set the stage for a legal battle now inevitable.”<sup>11</sup>

Several independent indicators point to increased popularity of mandatory arbitration clauses in corporate bylaws. A greater number of companies trading on U.S. stock markets are inserting arbitration clauses into their bylaws.<sup>12</sup> Empirical studies taken from the years 1996 to 2007 indicate a steady increase in the number of companies registered in the United States who opted for arbitration (from eighteen in 1996 to forty-one in 2006).<sup>13</sup> The SEC, which has explicit authority to regulate mandatory arbitration provisions under Dodd-Frank, has tentatively adopted a more welcome attitude toward arbitration of disputes within the securities law realm.<sup>14</sup> Finally, modern judicial rulings favoring arbitration agreements in the corporate setting have become increasingly prevalent.<sup>15</sup>

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<sup>9</sup> See, e.g., *In re Salomon Inc. S’holders’ Derivative Litig.*, 1994 U.S. Dist. LEXIS 13874 at \*41–42 (S.D.N.Y. Sept. 28, 1994) (finding that an enforceable arbitration agreement existed in a public corporation regardless of the absence of shareholder ratification). The New York Stock Exchange reacted to the *Salomon* decision by forbidding arbitration of derivative claims. See NASD Code of Arbitration Procedure for Customer Disputes, § 12205 FINRA (2008), available at [http://www.finra.org/web/groups/rules\\_regs/documents/rule\\_filing/p018365.pdf](http://www.finra.org/web/groups/rules_regs/documents/rule_filing/p018365.pdf).

<sup>10</sup> Ravanides, *supra* note 2, at 374.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.* at 378.

<sup>13</sup> *Id.* at 393.

<sup>14</sup> See, e.g., Kara Scannell, *SEC Explores Opening Door to Arbitration*, WALL ST. J., April 16, 2007, at A1, available at [http://www.law.harvard.edu/programs/corp\\_gov/MediaMentions/04-16-07\\_WSJ.pdf](http://www.law.harvard.edu/programs/corp_gov/MediaMentions/04-16-07_WSJ.pdf). On May 3, 2012, the SEC approved of a raise in the limit for damages awarded in FINRA simplified arbitration proceedings from \$25,000 to \$50,000, which will presumably lead to an increase in number of claims administered by FINRA’s arbitration program. SEC, 34-66913, at 10 (2012), reprinted in 2012 SEC LEXIS 1415.

<sup>15</sup> See, e.g., Maureen Weston, *Universes Colliding: The Constitutional Implications of Arbitral Class Actions*, 47 WM. & MARY L. REV. 1711, 1715 (2006) (citing *Southland*, *supra* note 7) (“[T]he United States Supreme Court has, since the 1980s, consistently recognized a ‘national policy favoring arbitration’ and relied on the Federal Arbitration Act (FAA) to uphold enforcement of these contracts.”). See also John C. Coffee, Jr., *No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of*

This note addresses the following scenario: Large public corporation A has included a provision in its charter<sup>16</sup> mandating that all shareholders are limited to arbitration proceedings in lieu of litigation to carry out suits brought on behalf of the corporation. There are both benefits and drawbacks to such a provision, which affect the rights of shareholder owners, corporate directors, and the corporation. The following discussion focuses less on the enforceability of arbitration clauses and more on the effect such clauses would have assuming they are enforceable by courts. Because the majority of public corporations are incorporated in Delaware, this note frequently discusses the implications of mandatory arbitration provisions within the context of Delaware corporate law.<sup>17</sup>

Due to the momentum that mandatory arbitration provisions have gained over the past decade, it is likely the Delaware courts, corporations, and their shareholders will notice a change in the face of the derivative suit. Delaware corporate law historically reflects a fundamental struggle between corporations and their shareholders: Delaware law strives to enable directors to exercise their unfettered business judgment in making management decisions, while simultaneously incentivizing those directors to stay within the bounds of their fiduciary duties of loyalty and care owed to the corporation's shareholders. The shareholder derivative suit provides a mechanism to keep a corporation's directors in check.<sup>18</sup> But the mechanism is not perfect. This note proposes that arbitration may provide an answer to some of the problems that have arisen with derivative suits, and may even provide unforeseen advantages to Delaware law.

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*Remedies*, 53 BROOK. L. REV. 919, 919 (1988) (suggesting that, “[a]loof and insular as corporate law often seems, it cannot remain uninfluenced for very long by developments in the mainstream of American civil law.”). Coffee notes two landmark cases in particular, *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987) and *Perry v. Thomas*, 482 U.S. 483 (1987), which he predicted “will encourage the proponents of alternative methods of dispute resolution to propose charter amendments under which all internal corporate disputes should be resolved through arbitration.” *Id.* at 954.

<sup>16</sup> Throughout this note the terms “charter,” “articles of incorporation,” and “bylaws” are used interchangeably to refer to a corporation’s founding documents where an arbitration provision binding shareholders would be found.

<sup>17</sup> Sara Lewis, *Transforming the “Anywhere but Chancery” Problem Into the “Nowhere but Chancery” Solution*, 14 STAN. J.L. BUS. & FIN. 199, 200 (2009) (noting that approximately 60% of all publicly traded U.S. corporations are incorporated in Delaware).

<sup>18</sup> Susanna M. Kim, *Conflicting Ideologies of Group Litigation: Who May Challenge Settlements in Class Actions and Derivative Suits?*, 66 TENN. L. REV. 81, 135 (1998).

Part II of this note will briefly review the current status of mandatory arbitration agreements within Delaware courts today, as well as illuminate lingering concerns with such arbitration clauses through a case study of a recently announced initial public offering (IPO). Part III provides an overview of mandatory arbitration clauses, their direct effects on shareholders, and their major benefits and drawbacks noted throughout the legal community. This section proposes that the benefits arguably outweigh the drawbacks for corporations and their constituencies as a whole. Part IV analyzes the constitutional implications of binding arbitration clauses on shareholders' rights to sue on behalf of the corporation. Some argue that forcing shareholders into arbitration takes away their fundamental right to have their claims heard in a courtroom setting.<sup>19</sup> Lastly, Part V addresses the current status of the Federal Arbitration Act and foreshadows two major obstacles this pro-arbitration legislation may face in the near future. This section also provides an overview of the enforceability of mandatory arbitration clauses under § 2 of the FAA and why any issues with enforceability may be discarded in light of recent developments of forum selection clauses and the enabling rights afforded to corporate directors under § 102(b)(1) of the Delaware General Corporation Law (DGCL).

## II. THE BUZZ IN DELAWARE: TRENDS IN USE OF ARBITRATION AGREEMENTS

In 2000, at a presentation discussing the role of corporate litigation in the twenty-first century at the University of Virginia School of Law, former President of the Delaware State Bar Association William Prickett challenged his audience to imagine how the face of litigation would change with modern times: "We should devote some of our creative energy to considering how we can accelerate and make available the processes of the court to resolving the important corporate issues without going through the nineteenth century system of litigation."<sup>20</sup>

Also presenting was E. Norman Veasey, former Chief Justice of the Delaware Supreme Court, who highlighted the fact that the demand requirement in the corporate derivative suit has been widely criticized and the law has been reshaping itself as a result.<sup>21</sup> Speculating into the future,

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<sup>19</sup> Ravanides, *supra* note 2, at 377.

<sup>20</sup> E. Norman Veasey & Michael P. Dooley, *The Role of Corporate Litigation in the Twenty-First Century*, 25 DEL. J. CORP. L. 131, 156 (2000).

<sup>21</sup> *Id.* at 138. *See also id.* at 154 (suggesting that the derivative action is "dead" in Delaware because "one is forced to spend a year-and-a-half or so diddling around with the preliminary issue of demand.").

Justice Veasey declared, “We’ll see more court-appointed experts in certain areas. There’ll be more alternate dispute resolution. There has to be. Courts cannot handle it without it.”<sup>22</sup> More than a decade after Prickett and Veasey made their predictions, a noticeable trend toward using arbitration to resolve shareholder derivative claims has arisen in Delaware and elsewhere.

### A. Delaware’s Enabling Law

Until recently, perhaps the most telling indication that arbitration agreements within corporate bylaws would become increasingly prevalent was within the Delaware judiciary itself. Following enabling legislation passed in 2009 by the Delaware General Assembly, the Court of Chancery adopted rules governing arbitration in 2010.<sup>23</sup> The relevant statutes are 10 Del. C. §§ 349 and 351, along with the accompanying Court of Chancery Rules 96–98 (Arbitration Rules).<sup>24</sup> The passing of this legislation indicated the Chancery Court’s approval of arbitration within the corporate context, and furthermore may indicate that arbitration will become an increasingly common way of resolving shareholder disputes.<sup>25</sup>

Section 349 of the Delaware Code, acting as an enabling statute, provides that “[t]he Court of Chancery shall have the power to arbitrate business disputes when the parties request a member of the Court of Chancery, or such other person as may be authorized under rules of the Court, to arbitrate a dispute . . . .”<sup>26</sup> The Code also states that arbitration proceedings will be held confidential and outside of the public record unless the outcome of arbitration is appealed.<sup>27</sup> Any appealed arbitration cases go directly to the Delaware Supreme Court.<sup>28</sup>

As outlined in Rules 96–98, Chancery Court arbitration provides several advantages to parties seeking to resolve disputes outside of the traditional courtroom setting. First, matters submitted to arbitration are usually resolved

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<sup>22</sup> *Id.* at 140 (citing Mediation Rule 174).

<sup>23</sup> DEL. CH. CT. R. 96–98 (2010), available at [http://courts.delaware.gov/rules/Chancery96-97-98\\_020110.pdf](http://courts.delaware.gov/rules/Chancery96-97-98_020110.pdf).

<sup>24</sup> *Id.* (these rules give the Court of Chancery the power to arbitrate disputes at the request of both parties).

<sup>25</sup> Lewis Lazarus, *Court of Chancery Arbitration Likely to Become More Prevalent*, MORRIS JAMES, LLP (Sept. 28, 2011, 11:46 AM), <http://www.morrisjames.com/pp/article-58.pdf>.

<sup>26</sup> DEL. CODE ANN. tit. 10, § 349(a) (West 2006).

<sup>27</sup> DEL. CODE ANN. tit. 10, § 349(b) (West 2006).

<sup>28</sup> Lazarus, *supra* note 25 (unless parties stipulate to a non-appealable arbitration award under DEL. CODE ANN. tit. 10, § 351).

quickly; arbitration hearings are normally scheduled within ninety days of the filing of a petition, unless otherwise provided by the parties.<sup>29</sup> Disputes are resolved by decision-makers with the knowledge and experience of chancellors, as “arbitrator” is defined as “a judge or master sitting permanently in the court.”<sup>30</sup> All Chancery Court arbitration proceedings are confidential—even the filing of a petition for arbitration will not be included on the court’s docket system.<sup>31</sup> Finally, not all cases are eligible to be submitted to arbitrators; the amount in controversy must exceed \$1 million if monetary damages are sought, the case must involve a dispute involving at least one party who is a Delaware entity, and both parties must have agreed to arbitration proceedings.<sup>32</sup> These benefits of efficiency, confidentiality, and expertise may lead to increased utilization of Chancery Court arbitration to resolve complex business disputes. Moreover, if shareholders are deemed to have “agreed to arbitration proceedings” by adhering to the corporation’s bylaws, Chancery Court arbitration could potentially apply to shareholder derivative suits.

Despite the potential of Delaware Chancery Court arbitration to launch corporate arbitration proceedings into the forefront of Delaware jurisprudence, a ruling on August 30, 2012 by a district court judge struck down the arbitration provision on the grounds that the secrecy of these arbitration proceedings violated the First Amendment, which recognizes a qualified right of access to all civil and criminal trials.<sup>33</sup> United States District Court Judge Mary McLaughlin ruled that a Chancery Court arbitration proceeding is “essentially a civil trial,” and that despite the efficiencies arbitration presents, “the judiciary as a whole is strengthened by the public knowledge that its courthouses are open and judicial officers are not adjudicating in secret.”<sup>34</sup> Only six cases have been arbitrated to date

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<sup>29</sup> DEL. CH. CT. R. 97(e).

<sup>30</sup> DEL. CH. CT. R. 96(d)(2).

<sup>31</sup> DEL. CH. CT. R. 97(a)(4) (but if the controversy is appealed to the Supreme Court, the record shall be filed by the parties).

<sup>32</sup> Lazarus, *supra* note 25, at 1.

<sup>33</sup> Steven M. Davidoff, *The Life and Death of Delaware’s Arbitration Experiment*, N.Y. TIMES DEALB%K (Aug. 31, 2012, 11:58 AM), <http://dealbook.nytimes.com/2012/08/31/the-life-and-death-of-delawares-arbitration-experiment/>.

<sup>34</sup> Del. Coalition v. Strine, No. 1:11-1015, 2012 U.S. Dist. LEXIS 123980 at \*27, 31 (D. Del. Aug. 30, 2012).

under the Delaware arbitration rules, and five of them have no public record.<sup>35</sup>

The impact of the district court's ruling could deal a substantial blow to the increasing use of arbitration in the corporate context—at least within Delaware. However, the ultimate legality of Delaware's arbitration proceedings is yet to be determined; the *Delaware Coalition* case was appealed to the Third Circuit on October 4, 2012. Both parties in the lawsuit have received backing from *amicus curiae* briefs. Notably, the U.S. Chamber of Commerce, the Business Roundtable, and the corporate law section of the Delaware State Bar Association<sup>36</sup> filed briefs supporting Delaware's current arbitration statute.<sup>37</sup>

Furthermore, Judge McLaughlin's district court opinion swung on the fact that Delaware Chancery Court justices were the ones presiding over the arbitration proceedings, as opposed to court-annexed arbitrations conducted by third parties.<sup>38</sup> Thus, she leaves open the possibility of a revised Chancery Court arbitration provision mandating the use of outside third parties to conduct arbitration proceedings, which would presumably achieve the same principles of efficiency such rules originally presented.

### B. *The Carlyle Group IPO*

A recent example of the contentions surrounding the growing use of the mandatory arbitration clause is the forthcoming IPO of private equity group the Carlyle Group (Carlyle). The Carlyle Group is creating buzz around the corporate legal community for creating an IPO that is particularly unfriendly toward its shareholders. The news once again raises discussions surrounding the implementation of mandatory arbitration to resolve shareholder disputes. Carlyle's proposed IPO filing contained a provision requiring all shareholder

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<sup>35</sup> Rita K. Farrell, *Judge Rules Against Arbitration by a Delaware Court*, N.Y. TIMES, Aug. 31, 2012, at B2.

<sup>36</sup> *Id.*

<sup>37</sup> Pamela Park, *Litigation Watch: Delaware Chancery Court Arbitrations Come Under Fire*, THOMPSON REUTERS (Jan. 24, 2013), <http://currents.westlawbusiness.com/Article.aspx?id=d2f78fe7-65c7-4cb1-aeee-d07cdefc5385&cid=&src=&sp=>. See also Brief for The Chamber of Commerce of the United States of America and the Business Roundtable as *Amici Curiae Supporting Defendants-Appellants*, Delaware Coalition for Open Government, Inc., v. The Hon. Leo E. Strine, Jr., et. al., 2012 WL 3744718, available at <http://www.chamberlitigation.com/sites/default/files/cases/files/2012/NCLC%20amicus%20brief%20--%20Delaware%20Coalition%20for%20Open%20Government,%20Inc.%20v.%20The%20Hon.%20Leo%20E.%20Strine,%20Jr.,%20et%20al.,%20%28Third%20Circuit%29.pdf>.

<sup>38</sup> *Del. Coalition*, 2012 U.S. Dist. LEXIS 123980, at \*27.

disputes—involving both state law and federal securities law claims—to be submitted to private, confidential arbitration.<sup>39</sup> Foreshadowing further developments in this area, Steven M. Davidoff, law professor at The Ohio State University, states, “Carlyle is being super-aggressive here because it knows that, to the extent the arbitration provision covers federal securities law, its legality is uncertain.”<sup>40</sup>

In fact, Carlyle announced within a matter of days of releasing the structure of its IPO that it planned to withdraw the proposed arbitration provision due to increased pressure from investors and regulators.<sup>41</sup> Responding to accusations that Carlyle was using the arbitration provision as a means to dilute shareholder power, Carlyle’s spokesperson told reporters that “[Carlyle] first offered the provision because we believed that arbitrating claims would be more efficient, cost effective and beneficial to our unitholders.”<sup>42</sup> The recent contentions surrounding the Carlyle Group’s IPO reflects a rare cautionary approach to arbitration clauses in the wake of the FAA. The SEC in its ruling noted the unique status of arbitration provisions within the securities context and their potential drawback of weakening investor protections.<sup>43</sup> Because federal securities law is primarily aimed at deterring fraud and exposing misleading disclosures to the investor

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<sup>39</sup> Steven M. Davidoff, *Carlyle Readies an Unfriendly I.P.O. for Shareholders*, N.Y. TIMES DEALB%K (Jan. 18, 2012, 3:19 PM), <http://dealbook.nytimes.com/2012/01/18/carlyle-readies-an-unfriendly-i-p-o-for-shareholders/>.

<sup>40</sup> *Id.*

<sup>41</sup> Kevin Roose, *Carlyle Drops Arbitration Clause From I.P.O. Plans*, N.Y. TIMES DEALB%K (Feb. 3, 2012, 2:06 PM), <http://dealbook.nytimes.com/2012/02/03/carlyle-drops-arbitration-clause-from-i-p-o-plans/>. In response to Carlyle’s proposed mandatory arbitration clause, three democratic congressmen drafted a letter to then-sitting SEC chairwoman Mary L. Shapiro asking the SEC to block the IPO if the clause is not removed. *Id.* See also Letter from Cong. Comm. to Mary L. Schapiro, Chairman, SEC (Feb. 3, 2012), available at <http://www.citizen.org/documents/Letter-to-SEC-Arbitration-of-Shareholder-Claims.pdf>. Carlyle also faced uncertainty from the SEC, which has been hesitant in the past with corporate IPOs that include similar arbitration provisions. Roose, *supra*. However, the contention surrounding Carlyle’s particular arbitration provision may be attributable to the fact that the provision provided for *private* mandatory arbitration proceedings to resolve shareholder disputes, which would be set within boundaries established by Carlyle. This may be more extreme than arbitration proceedings which take place within the Delaware courts and heard by neutral, qualified arbitrators. Davidoff, *supra* note 33.

<sup>42</sup> Roose, *supra* note 41.

<sup>43</sup> Lawrence A. Cunningham, *So much for your day in court*, BALTIMORESUN, Mar. 21, 2012, [www.baltimoresun.com/news/opinion/oped/bs-ed-arbitration-20120321,0,970456.story](http://www.baltimoresun.com/news/opinion/oped/bs-ed-arbitration-20120321,0,970456.story).

community, confidential arbitration hearings arguably cannot offer the same exposure and subsequent deterring effect as a public trial.<sup>44</sup>

Whether courts will agree with the SEC's opinion on Carlyle and carve out an exception to its increasingly *favor arbitrationis* stance is yet to be determined. Lawrence A. Cunningham, Professor at George Washington Law School, is doubtful that the U.S. Supreme Court will change its tune.<sup>45</sup> He further predicts that more companies, now intrigued by Carlyle's strategy, will be adopting mandatory arbitration clauses into their charters in the near future.<sup>46</sup>

### C. Finding a Middle Ground

Despite indications that Delaware corporations prefer to use arbitration proceedings to resolve shareholder derivative complaints, several grumblings of disapproval from a variety of scholars remain. Many suggest that cases which involve subject matter that is particularly ground-breaking or noteworthy within Delaware corporate law should not be reduced to principles of arbitration because case precedent is continuously relied upon

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<sup>44</sup> *Id.*

<sup>45</sup> *Id.* (speculating that the Supreme Court could "portray a corporate charter as a contract binding on even those who opposed it and rebuke the [C]ommission's public policy concerns to channel all disputes over corporate securities into closed-door arbitration hearings."). See also Carter Dougherty, *Consumers May See New Limits on Mandatory Arbitration*, BLOOMBERGBUSINESSWEEK (May 21, 2012), available at <http://www.businessweek.com/news/2012-05-21/consumers-may-see-new-limits-on-mandatory-arbitration> (commenting that despite the SEC's reaction to Carlyle's mandatory arbitration clause, "the SEC could be vulnerable to a court challenge on forcing shareholders to arbitrate. The SEC relies on longstanding practice, not a specific regulation or law, to stamp out arbitration clauses for shareholders.").

<sup>46</sup> Cunningham, *supra* note 43. The Carlyle Group, however, faced lukewarm investor interest prior to its IPO. This was reportedly partially a result of Carlyle's practice of putting shareholder rights second to other private equity asset management firms. Steven M. Davidoff, *In Private Equity IPO, a Shareholder Fear of Losing Favor*, N.Y. TIMES DEALBOOK (Mar. 13, 2012, 6:46 PM), <http://dealbook.nytimes.com/2012/03/13/in-private-equity-i-p-o-a-shareholder-fear-of-losing-favor/>. Unlike other publicly traded companies which make their fiduciary duties to shareholders a first priority, managers of publicly traded private equity firms have a tendency to favor themselves and their fund investors over its shareholders. *Id.* The Carlyle Group went public on May 3, 2012 at \$22 per share, which was below the \$23–\$25 range originally proposed in its filing with the SEC. Dan Primak, *Carlyle Group Prices Low IPO*, FORTUNE.CNN.COM (Mar. 2, 2012, 5:56 PM), <http://finance.fortune.cnn.com/2012/05/02/carlyle-group-prices-low-ipo/>.

throughout the legal community.<sup>47</sup> Some cases may be simply too important to be kept confidential.<sup>48</sup> This concern reflects the larger question of how the foundational principles of corporate law will evolve with increasingly frequent arbitration proceedings.<sup>49</sup>

To mitigate these concerns, the Delaware courts may wish to “cap” their use of arbitration to smaller derivative claims involving collateral issues and instead force more significant derivative claims to be litigated.<sup>50</sup> However, this suggestion raises serious issues with the enforceability of mandatory arbitration clauses. If courts were to filter out “critical” derivative suits from ones with lesser impact, uncertainty would be created with each arbitration clause that corporations place in their bylaws. Instead, Delaware courts must consider the overall benefits and drawbacks of using arbitration agreements in corporate bylaws, and possibly look to other areas of the law to understand why such alternative dispute mechanisms are gaining in popularity. Upon doing so, perhaps the concerns surrounding mandatory arbitration clauses can be balanced against offsetting benefits to Delaware courts, corporations, and shareholders alike.

### III. OVERVIEW: BENEFITS AND DRAWBACKS OF USING ARBITRATION IN THE CONTEXT OF SHAREHOLDER SUITS

Shareholder derivative suits represent the cornerstone of shareholders’ rights to monitor the conduct and behavior of the corporation’s managers.<sup>51</sup> Derivative suits play a particularly important role in public corporations (as opposed to closely held corporations),<sup>52</sup> where control is separated from

<sup>47</sup> See, e.g., Veasey & Dooley, *supra* note 20, at 155.

<sup>48</sup> *Id.*

<sup>49</sup> Scholars that caution against arbitration insist that “the only way the Delaware corporate law is going to develop is through litigation. If the Delaware corporate law does not continue to grow, it will stultify and will no longer be the preeminent forum for the resolution of these very important corporate issues.” *Id.*

<sup>50</sup> *Id.*

<sup>51</sup> See, e.g., *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 548 (1949).

<sup>52</sup> This note addresses shareholder derivative suits in the context of public corporations, as opposed to closely held corporations. One of the early obstacles to arbitration of shareholder derivative suits within close corporations was the prospect of violations of public policy, raising the question of whether shareholder claims may be arbitrated at all. G. Richard Shell, *Arbitration and Corporate Governance*, 67 N.C.L. REV. 517, 531 (1989). Many close corporations once avoided arbitration by arguing that a corporation was not a party to the shareholder arbitration agreement. *Id.* However, courts have since held that a close corporation binds itself into an arbitration agreement by signing the agreement itself. *Id.* at 532. Courts tend to consider close corporations and

ownership of corporate assets.<sup>53</sup> Because managers in large public corporations do not necessarily have an ownership stake in the company they are managing, shareholders face possible agency costs in the form of mismanagement or misappropriation of corporate assets.<sup>54</sup>

The derivative suit, in addition to the shareholders' right to vote, provides a disincentive for corporate managers to act against the best interest of the corporation and its constituents while providing a mechanism for the shareholder's voice to be heard. In a derivative suit, shareholders of a corporation sue the corporate directors and officers on behalf of the corporation itself for a wrongdoing that has harmed the corporation—usually in the form of a breach of fiduciary duty.<sup>55</sup> All awards resulting from the derivative suit are given to corporate funds, as opposed to the shareholders as individuals who stand to personally gain from monetary awards.<sup>56</sup>

### A. A Critique of *The Derivative Action*

Despite its prominent place in Delaware corporate law, derivative suits have become heavily criticized due to shareholders frequently abusing their right to sue.<sup>57</sup> This especially holds true in class action complaints stemming from a corporation's decision to partake in change-in-control transactions of some sort.<sup>58</sup> It is often the case that, after management announces a merger or acquisition stemming from a drop in stock price, shareholder-plaintiffs' attorneys immediately file multiple identical lawsuits against management for breach of fiduciary duties, and will quickly settle with corporations for large sums of money before going to trial.<sup>59</sup> This recurring pattern of filing a

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their shareholders "one party" for purposes of arbitration, thus allowing arbitration proceedings to occur. *Id.* Arbitration is now an accepted means of resolving shareholder disputes in close corporations. *Id.* at 533.

<sup>53</sup> *Id.* at 535.

<sup>54</sup> *Id.*

<sup>55</sup> Glenn G. Morris, *Shareholder Derivative Suits: Louisiana Law*, 56 LA. L. REV. 583, 584 (1996).

<sup>56</sup> *Id.* at 589–90.

<sup>57</sup> Shell, *supra* note 52, at 540.

<sup>58</sup> Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 134–35 (2004) (“Derivative lawsuits and federal securities class actions are portrayed as slackers in debates over how best to control the managerial agency costs created by the separation of ownership and control in the modern corporation . . . [E]arly hopes that these suits would effectively monitor managerial misconduct have been replaced with concerns about the size of the litigation agency costs of such representative litigation.”).

<sup>59</sup> *Id.* at 138.

shareholder complaint and quickly settling for large sums of money has earned many plaintiffs' attorneys the name "pilgrims."<sup>60</sup> As a result, the fundamental reason for derivative suits—to guarantee a check on managerial behavior—has been eroding in the face of complaint frivolity.<sup>61</sup>

The drawbacks exemplified in "pilgrim plaintiffs" cases stemming from board decisions to merge with or acquire another entity have had a spill-over effect on Delaware corporations' recurring criticisms toward derivative litigation. Corporate directors frequently complain that litigated derivative suits result from plaintiffs' attorneys' misdirected motives for suing "on behalf of a corporation"; many attorneys sue merely to glean attorneys' fees, rather than suing because of the merits of the derivative claim.<sup>62</sup> In addition, litigation can be costly and time consuming for corporations, and corporate directors are easily distracted from their normal duties within the corporation as a result.<sup>63</sup> This holds especially true for derivative litigation as opposed to other forms of litigation; plaintiff shareholders wishing to bring a derivative claim must surpass a variety of requirements (the most prominent being the demand requirement) before bringing suit.<sup>64</sup> If plaintiffs cannot satisfy the demand requirement, there is a risk that their claim may not be heard at all.<sup>65</sup>

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<sup>60</sup> *In re Revlon, Inc. S'holders Litig.*, 990 A.2d 940, 945 (Del. Ch. 2010) (noting that lawsuits brought by "frequent filers" tend to settle more quickly than other plaintiffs' attorneys). The Delaware Chancery Court further commented in *Revlon* that "[t]raditional plaintiffs' law firms who bring class and derivative lawsuits on behalf of stockholders without meaningful economic stakes can best be viewed as entrepreneurial litigators who manage a portfolio of cases to maximize their returns through attorneys' fees." *Id.* at 959.

<sup>61</sup> As a result of increasingly frequent derivative complaints, many courts are now requiring plaintiffs to post bonds to insure that they will be able to pay defendant's attorneys' fees and other expenses in the event that such suits will be dismissed as frivolous. Thompson & Thomas, *supra* note 58, at 136.

<sup>62</sup> Sockol, *supra* note 3, at 1096.

<sup>63</sup> *Id.* at 1097.

<sup>64</sup> *Id.* The preconditions that must be satisfied before bringing a derivative suit are outlined in FED. R. CIV. P. 23.1 and MODEL BUS. CORP. ACT ANN. §§ 7.40–47 (1999), which include the demand requirement, the contemporaneous ownership requirement, and special pleading rules. See Bryan Stanfield, *For Better or For Worse?: Marriage of the Texas and Model Business Corporation Acts' Derivative Action Statutes and What it Means for Corporations*, 35 TEX. TECH L. REV. 347, 350–52 (2004).

<sup>65</sup> Indeed, some suggest that arbitration panels would lead to a greater likelihood of derivative suits reaching the merits of the action by avoiding stifling special litigation committees of corporations quickly rejecting shareholder demand. Coffee, *supra* note 15, at 958. As arbitration provides a more flexible proceeding, Coffee suggests shareholders may gain a "greater access to external monitoring" through arbitration. *Id.*

Finally, derivative suits are repeatedly criticized for failing to result in any substantial benefit to the corporation and its shareholders.<sup>66</sup>

### B. *The Benefits of Arbitration*

The possibility of arbitrating shareholder complaints presents corporations with an outlet against these recurring drawbacks of derivative suits. Professor of Legal Studies at the University of Pennsylvania G. Richard Shell outlines four general ways arbitration benefits the corporation and reduces overall transaction costs.<sup>67</sup> Arbitration of shareholder suits potentially: (1) helps to build an atmosphere of trust and goodwill among shareholders and directors, as opposed to contentious litigation, (2) provides the parties to the arbitration with a wider variety of resources, information, and ideas to help solve contractual impasses, (3) reduces tension among the parties by providing neutral “division services,” and (4) provides quick and efficient resolution of shareholder disputes.<sup>68</sup> Due to lower discovery costs, arbitration can prove less costly for corporations than a judicial proceeding.<sup>69</sup> Attorneys’ fees would also likely be significantly lower if arbitration is utilized, which in turn allows the corporation itself to glean a greater portion of the net pecuniary award resulting from the outcome of the arbitration.<sup>70</sup>

In addition to the benefit of cost savings, shareholders may also be more attracted to a neutral arbitration panel to hear their derivative complaint. This holds especially true if they are facing the influence of a corporation’s special litigation committee, which may decide for various reasons that it is in the best interest of the corporation to not proceed with a derivative suit.<sup>71</sup> Mandatory arbitration clauses grant the corporation, and its shareholders by way of adopting the corporation’s bylaws, the ability to choose who hears and resolves their dispute.<sup>72</sup> Finally, a group of independent arbitrators could

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<sup>66</sup> Sockol, *supra* note 3, at 1116.

<sup>67</sup> Shell, *supra* note 52, at 568–69.

<sup>68</sup> *Id.* See also H. R. REP. NO. 96, 68th Cong., 1st Sess., at 2 (1924) (“[T]he costliness and delays of litigation . . . can be largely eliminated by agreements for arbitration.”).

<sup>69</sup> Sockol, *supra* note 3, at 1114. See also Ravanides, *supra* note 2, at 374.

<sup>70</sup> Sockol, *supra* note 3, at 1099.

<sup>71</sup> Shell, *supra* note 52, at 573 (Likewise, “[i]f 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.”).

<sup>72</sup> Paul B. Marrow, *Determining if Mandatory Arbitration is “Fair”:* *Asymmetrically Held Information and the Role of Mandatory Arbitration in Modulating Uninsurable Contract Risks*, 54 N.Y.L. SCH. L. REV. 187, 192 (2010).

potentially guarantee expertise in arbitrating derivative suits and provide precedent comparable to that which is now relied on within the Delaware judiciary.<sup>73</sup> This final proposition has great potential for truth if the trend in corporate law of defaulting corporate complaints to an arbitration setting continues into the future.

### *C. The Drawbacks of Mandatory Arbitration*

Although gaining in popularity, mandatory arbitration clauses within corporate bylaws are not a perfect solution to the abuses of shareholder litigation. They, too, have faced a variety of criticisms within the legal community.<sup>74</sup> For instance, there is concern that uneven bargaining power between a corporation and its shareholders may lead to corporations showing the upper hand in electing arbitrators, and therefore unfairly influencing the arbitration process.<sup>75</sup> Furthermore, because arbitration outcomes need not be based upon rules of law, “[f]iduciary norms may . . . be subordinated to general equitable principles in arbitration.”<sup>76</sup> This may lead not only to an inconsistent application of current legal rules, but also a diminished deterrent effect of binding fiduciary duties upon corporate directors.<sup>77</sup> Many believe that arbitrating shareholder suits will endanger shareholder rights by denying access to the courts and halt developments of legal doctrine in the area of corporate governance.<sup>78</sup> Complex arbitration proceedings can take just as long and prove just as costly as litigation proceedings.<sup>79</sup> Finally, many public corporations choose to incorporate in Delaware solely to have access to the expertise provided; arbitrators arguably cannot provide the same expertise that years of judicial precedent have set in place.<sup>80</sup>

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<sup>73</sup> Sockol, *supra* note 3, at 1115.

<sup>74</sup> Jeffrey A. Sanborn, *The Rise of “Shareholder Derivative Arbitration” in Public Corporations: In re Salomon Inc. Shareholders’ Derivative Litigation*, 31 WAKE FOREST L. REV. 337, 338 (1996) (noting criticisms by legal commentators and state legislatures).

<sup>75</sup> Shell, *supra* note 52, at 549–50.

<sup>76</sup> *Id.* at 561.

<sup>77</sup> *Id.*

<sup>78</sup> *Id.* at 573.

<sup>79</sup> *Id.* at 572.

<sup>80</sup> Sockol, *supra* note 3, at 1111.

*D. A Net Benefit to Corporations and Shareholders Alike*

The benefits to be gained from using arbitration arguably outweigh the previously-listed drawbacks—possibly explaining the trend toward increased arbitration clauses within corporate bylaws. Furthermore, many of the potential drawbacks surrounding the use of such clauses can be minimized. For instance, although some believe that arbitrating derivative complaints in a private, extrajudicial setting will remove incentives for directors to abide by their fiduciary duties of loyalty and care to the corporation, other market forces counteract this concern; the election of an initially strong board of directors, regular audits by independent accounting firms, and the listing requirements by self-regulatory organizations like the New York Stock Exchange (NYSE) all act to counter the possibility of managerial wrongdoing.<sup>81</sup> Also, the prediction that mandatory arbitration will encroach upon Delaware common law precedent has been downcast as unlikely; arbitration proceedings are solely meant to *complement* court-held derivative litigation, and the Legislature and Bar Association deemed the possibility of “crowding out” the regular docket with arbitrated claims very unlikely.<sup>82</sup>

Shareholders are not completely left without an alternative when mandatory arbitration clauses are found in corporate bylaws. In the event that shareholders are not satisfied with the outcome of arbitration proceedings or both parties fail to come to a mutually acceptable settlement, shareholders have additional resources at their disposal to resolve their claims; for instance, shareholders may approach the board of directors directly to discuss proposed reforms, prepare a stockholder resolution for an upcoming annual meeting, or launch a proxy fight to elect new directors.<sup>83</sup> Shareholders also have the ability to bring expedited vacatur and modification of the arbitration settlement under FAA §§ 10–11.<sup>84</sup>

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<sup>81</sup> Thompson & Thomas, *supra* note 58, at 142. See also STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 404 (2002) (noting that if derivative litigation were eliminated entirely, “[d]irectors would remain subject to various forms of market discipline, including . . . markets for corporate control and employment, proxy contests, and shareholder litigation where the challenged misconduct gives rise to a direct cause of action.”).

<sup>82</sup> *Delaware Business Court Arbitration Program Provides Fast Resolution Path for Fortune 500 Company Disputes*, JAMS DISPUTE RESOLUTION ALERT, 1–3 (2011), available at [www.mediationworld.net/uploads/201211815121.pdf](http://www.mediationworld.net/uploads/201211815121.pdf).

<sup>83</sup> *Norfolk Cnty. Ret. Sys. v. Jos. A. Bank Clothiers, Inc.*, 2009 Del. Ch. LEXIS 20 at \*30 (Del. Ch. Feb. 12, 2009) (internal citation omitted).

<sup>84</sup> 9 U.S.C. §§ 10–11 (2006) (allowing modification of awards on the grounds of corruption, fraud, undue means, or miscalculation, misconduct, misbehavior, or evident partiality by the arbitrator). See also *Hall St. Assocs., L.L.C. v. Mattel, Inc.*, 552 U.S.

Arbitrating shareholder complaints presents a board of directors with the opportunity to focus on their roles within the corporation and work toward maximization of corporate profit and shareholder value—without having to worry about litigating against shareholder complaints in the courtroom. A major criticism of derivative suits, despite their ability to deter malfeasance of corporate directors, is their potential to stifle profit-enhancing creativity among management. As corporate managers are constantly acting under the threat of being sued for breach of fiduciary duties,<sup>85</sup> they may be hesitant to take risks and avoid experimentation that leads to corporate profitability.<sup>86</sup> As a result, the net benefit of these mandatory arbitration clauses will be felt not only by directors in terms of diminished distractions from their corporate duties and the Delaware courts, which will hear smaller numbers of frivolous shareholder complaints, but also by the shareholders themselves. By providing directors the opportunity to focus their efforts on the corporate mission with minimal distractions, the likelihood of maximizing shareholder value increases.

#### IV. CONSTITUTIONAL IMPLICATIONS: DOES MANDATORY ARBITRATION DENY SHAREHOLDERS THEIR CONSTITUTIONAL RIGHT TO SUE ON BEHALF OF THE CORPORATION?

With increasing popularity of arbitration clauses in corporate charters comes increased concern by constituents—including shareholders, consumers, and employees—that their constitutional right to sue is being curtailed. The proposed Arbitration Fairness Act of 2011<sup>87</sup> attempts to address this concern by allowing those constituents to decide for themselves whether their claim should be arbitrated or litigated.<sup>88</sup> The legislation has raised questions regarding the constitutional implications mandatory arbitration clauses have on shareholders' rights to sue. Much debate has

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576, 586 (2008). Courts also have the ability to declare the arbitration clauses themselves invalid under the FAA's saving statute, which allows courts to invalidate agreements "upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2 (2006).

<sup>85</sup> Notwithstanding any § 102(b)(7) provisions exculpating directors from actions of gross negligence.

<sup>86</sup> Thomas P. Kinny, *Stockholder Derivative Suits: Demand and Futility Where the Board Fails to Stop Wrongdoers*, 78 MARQ. L. REV. 172, 174–75 (1994).

<sup>87</sup> H.R. 1020, 111th Cong. § 2(b) (2009).

<sup>88</sup> See, e.g., <http://www.fairarbitrationnow.org/> (last visited Jan. 12, 2013).

surrounded the question of whether it is fundamentally fair to force shareholders into arbitration proceedings.<sup>89</sup>

### A. *Judicial Findings of Constitutionality*

The Southern District of New York case *In re Salomon Shareholders' Derivative Litigation*<sup>90</sup> exemplifies a trend among courts across jurisdictions holding that mandatory arbitration clauses align with shareholders' constitutional rights. The court in *Salomon* granted the defendant corporation's motion to compel arbitration with plaintiff shareholders, citing the FAA as well as the rules of the NYSE for authority.<sup>91</sup> The court declared that shareholder rights were not curtailed by honoring an arbitration agreement because, in a derivative suit, "the corporation [is] suing in its own right."<sup>92</sup> Decided in 1994, this case formally recognized a substantive right to arbitration for shareholders, and slowly set the tone for greater acceptance of arbitration within shareholder derivative suits.<sup>93</sup>

A case that preceded *Salomon* was *Ross v. Bernhard*, where the U.S. Supreme Court recognized that the corporation itself, not the shareholder initiating the derivative suit, is the necessary party to a derivative action.<sup>94</sup> The Court in *Ross* deemphasized shareholders' rights within a derivative context by reminding the judicial community that the fundamental purpose behind a derivative suit is to vindicate the claims of *the corporation*: "[T]he shareholders, 'standing in the shoes of the corporation[,] have no rights greater than those of the corporation, nor can those they choose to sue be deprived of defenses they could assert against the corporation's claims."<sup>95</sup> Thus, as long as the corporation agreed to arbitrate its claims, the arbitration

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<sup>89</sup> Ravanides, *supra* note 2, at 377.

<sup>90</sup> *In re Salomon*, *supra* note 9, at \*2.

<sup>91</sup> *Id.* at \*41–42. Article XI, § 1 of the NYSE Constitution, which governs arbitration of disputes between members of the NYSE, provides, "Any controversy between parties who are members . . . shall at the instance of any such party be submitted for arbitration in accordance with the provisions of this Constitution and [NYSE rules]." *Id.* at \*7–8.

<sup>92</sup> *In re Salomon*, *supra* note 9, at \*14.

<sup>93</sup> Sockol, *supra* note 3, at 1114. *See also* Ravanides, *supra* note 2, at 424.

<sup>94</sup> *Ross v. Bernhard*, 396 U.S. 531, 539 (1970) ("The heart of the action is the corporate claim."). *See also* BAINBRIDGE, *supra* note 81, at 385 (noting that state courts vary widely in recognizing a constitutional right to trial by jury in derivative suits).

<sup>95</sup> *In re Salomon*, *supra* note 9, at \*13 (citing *Ross v. Bernhard*, 396 U.S. 531, 534 (1970)).

agreement must be upheld and shareholders' rights to sue are not unconstitutionally violated.<sup>96</sup>

### B. *The Other Side of the Coin: The Shareholder's Perspective*

Despite the positive trend among courts, a competing public policy argument has been repeated by plaintiffs for decades: shareholders themselves do not sign the agreement to arbitrate; thus, there is no way to ensure by a neutral arbitrator that corporate abuses are continuously monitored and corporate management is acting in the best interests of the corporation.<sup>97</sup> Indeed, the shareholder derivative suit, "born of stockholder helplessness, was long the chief regulator of corporate management and has afforded no small incentive to avoid at least the grosser forms of betrayal of stockholders' interests."<sup>98</sup>

Moreover, there is a question of whether mandatory arbitration clauses overstep a party's right to a jury trial—thus eliminating, or at least diminishing, the deterrent effects corporate actions have when held in the judicial setting.<sup>99</sup> The question of whether binding arbitration clauses violate a party's Seventh Amendment right to a jury trial has been addressed in several contexts,<sup>100</sup> but arbitration agreements can particularly curtail the constitutional rights of those parties to a class action.<sup>101</sup> Many derivative suits are technically a form of class actions,<sup>102</sup> so the same questions of constitutional rights to trial by jury apply.

### C. *Answering Constitutional Concerns*

Whether constitutional rights of shareholders are violated within a derivative context is somewhat of a different question than whether they are violated in a traditional lawsuit. The U.S. Supreme Court formally acknowledged the right of a corporation to have its claim heard by a jury in

<sup>96</sup> *Id.* at \*15.

<sup>97</sup> *Cf.* *Fox v. Merrill Lynch & Co.*, 453 F. Supp. 561, 564 (S.D.N.Y. 1978) (noting that "[a] valid arbitration provision must be in writing, but a party may be bound by that provision without having signed an exemplar.").

<sup>98</sup> *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 548 (1949).

<sup>99</sup> *In re Salomon*, *supra* note 9, at \*21–22. *See also* Feingold, *supra* note 3, at 288.

<sup>100</sup> Jean R. Sternlight, *Mandatory Binding Arbitration and the Demise of the Seventh Amendment Right to a Jury Trial*, 16 OHIO ST. J. ON DISP. RESOL. 669, 680 (2001).

<sup>101</sup> *See, e.g.*, Jean R. Sternlight, *As Mandatory Binding Arbitration Meets the Class Action, Will the Class Action Survive?*, 42 WM. & MARY L. REV. 1, 5 (2000).

<sup>102</sup> *See, e.g.*, Morris, *supra* note 55, at 591. *See also* Sanborn, *supra* note 74, at 363.

*Ross v. Bernhard*.<sup>103</sup> However, shareholders do not always forego their right to a jury trial by relying on arbitration to resolve the dispute. Many times the alternative is to have their derivative claim heard by a judge without a jury.<sup>104</sup> In fact, most states have rejected the *Ross v. Bernhard* approach and hold that there is no right to a trial by jury in shareholder derivative suits, as there is generally no right to a jury trial in courts of equity.<sup>105</sup> In Delaware, the frontrunner of state corporate law, all derivative suits are filed in the Court of Chancery, which sits without a jury.<sup>106</sup> Furthermore, derivative suits are often settled (or dismissed because of lack of demand futility) before a case gets to trial.<sup>107</sup> Thus, the constitutional right of shareholders to have the corporation's claim heard before a court may, for practical reasons, not be of great significance.

The district court in *Salomon* answered these policy concerns by leaving it up to Congress to change: “[I]f the parties’ agreement to arbitrate covers statutory claims, the claim is non-arbitrable only where ‘Congress itself has evinced an intention to preclude a waiver of judicial remedies for the statutory rights at issue.’”<sup>108</sup> Congress can always exclude particular classes of disputes from the scope of the FAA by declaring them non-arbitrable.<sup>109</sup> There are currently no statutes prohibiting arbitration of matters involving public companies and their shareholders; thus, no statutory conflict exists between arbitration of a derivative suit and the underlying purpose of the

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<sup>103</sup> *Ross v. Bernhard*, 396 U.S. 531, 542 (1970); *but cf. id.* at 546 (Stewart, J., dissenting) (stating that “historically the [derivative] suit has in practice always been treated as a single cause tried exclusively in equity . . . [T]here is therefore no constitutional right to a jury trial even where there might have been one had the corporation itself brought the suit.”).

<sup>104</sup> See 19 AM. JUR. 2D *Corporations* § 2373 (1986) (“In the absence of statutory provisions to the contrary . . . in [a derivative] suit in state court, the stockholders are not entitled, as a matter of right to a trial by jury.”).

<sup>105</sup> Ann M. Scarlett, *Shareholders in the Jury Box: A Populist Check Against Corporate Mismanagement*, 78 U. CIN. L. REV. 127, 147 (2009).

<sup>106</sup> *Id.* at 147–48.

<sup>107</sup> See Kelli A. Alces, *Enforcing Corporate Fiduciary Duties in Bankruptcy*, 56 U. KAN. L. REV. 83, 116 (2007) (“There are strong incentives for a derivative suit to settle before a trial on the merits.”); Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs’ Attorney’s Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 44 (1991) (“Most class action and derivative litigation is settled prior to judgment.”).

<sup>108</sup> *In re Salomon*, *supra* note 9, at \*23 (citing *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth*, 473 U.S. 614, 628 (1985)).

<sup>109</sup> Ravanides, *supra* note 2, at 429.

FAA favoring arbitration.<sup>110</sup> Furthermore, the argument that common law precedent, especially within the realm of corporate law, cannot be replaced by arbitration rulings lacks foundation absent contrary legislative intent: “As the FAA’s federal pro-arbitration policy preempts contrary state policies, absent a federal statute reflecting clear congressional intent to refute the arbitrability of intra-corporate controversies, arbitration agreements could not be set aside on state policy grounds.”<sup>111</sup>

The debate over the constitutional rights of plaintiffs in a derivative suit continues to be a topic of contention in the wake of increasing arbitration proceedings.<sup>112</sup> Delaware Courts at least provide shareholder plaintiffs with the opportunity to have their claims heard in front of a neutral arbitrator within the four walls of the court, albeit not necessarily inside a courtroom in front of a jury.<sup>113</sup> Many argue that the “secret proceedings” held in the Delaware Chancery Court promote efficiency while keeping the arbitration fair to both parties.<sup>114</sup> If the Delaware courts ceased to offer arbitration proceedings, corporations would arguably look elsewhere to hold private arbitration discussions—potentially increasing the risk that the results of the dispute will be unfair to one party, stray from the ideals of Delaware corporate law, and further encroach upon shareholders’ constitutional rights.<sup>115</sup>

Although there are concerns over the possibility that mandatory arbitration violates shareholders’ constitutional right to access the judiciary,

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<sup>110</sup> *Id.* (“[T]he question in the case of intra-corporate arbitration would be whether policies underpinning other statutory schemes clash with and prevail over the FAA’s favor arbitrationis.”).

<sup>111</sup> *Id.* at 431.

<sup>112</sup> See, e.g., Randall Chase, *Judge Hears Arguments Over Secret Arbitration in Business-oriented Delaware Court*, COURIER-POST, Feb. 9, 2012, available at <http://www.courierpostonline.com/article/20120209/NEWS05/202090344/Judge-hears-arguments-over-secret-arbitration-business-oriented-Delaware-court> (reporting a movement by the Delaware Coalition for Open Government against the Delaware Chancery Court’s rule enabling arbitration, which claims that the law is an unconstitutional violation of shareholders’ access to the courts).

<sup>113</sup> See *Delaware Business Court Arbitration*, *supra* note 82, at 3.

<sup>114</sup> *Id.* Corporations who choose to have the arbitration held within the Chancery Court face a \$12,000 filing fee and a daily fee of \$6,000 for each day a judge is involved in the arbitration. *Id.* Chancellor Strine himself commented that such arbitration offering is “designed to ensure Delaware remained an attractive place for business entities to form.” *Id.*

<sup>115</sup> *Id.*

not all judicial tribunals are subject to public access.<sup>116</sup> Resolving claims by arbitration cannot be said to so drastically curtail shareholders' rights as to be deemed unconstitutional.

#### V. SECTION 2 OF THE FAA AND RECENT CONTROVERSIES: POLICY IMPLICATIONS

The source of arbitration law governing the enforceability of clauses mandating the arbitration of shareholder derivative complaints is the FAA, not state arbitration law.<sup>117</sup> The FAA, enacted in 1925, was created in order to quell former judicial hostility toward arbitration agreements.<sup>118</sup> The most relevant section of the Act, § 2, states that “[a] written provision in . . . a 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, save upon such grounds as exist at law or in equity for the revocation of any contract.”<sup>119</sup> Because a corporation's bylaws and articles of incorporation serve as a contractual agreement binding the corporation, its directors, and its shareholders,<sup>120</sup> § 2 of the FAA would likely deem a contractual provision mandating arbitration of shareholder derivative suits valid and enforceable.<sup>121</sup>

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<sup>116</sup> See *Delaware Business Court Arbitration*, *supra* note 82, at 3. For instance, public access to courts is historically limited in familial disputes such as child custody or marital relations.

<sup>117</sup> Shell, *supra* note 52, at 543.

<sup>118</sup> AT&T, *supra* note 4, at 1745. See also *In re Salomon*, *supra* note 9, at \*9; 14 Penn Plaza LLC v. Pyett, 556 U.S. 247, 266 (2009) (upholding the enforcement of arbitration clauses within collective bargaining agreements under the ideals of the FAA); Dean Witter Reynolds Inc. v. Byrd, 470 U.S. 213, 221 (1985) (noting that the FAA “requires that we rigorously enforce agreements to arbitrate”); Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24 (1983) (“[Q]uestions of arbitrability must be addressed with a healthy regard for the federal policy favoring arbitration”).

<sup>119</sup> 9 U.S.C. § 2 (2006).

<sup>120</sup> See, e.g., *Kidsco Inc. v. Dinsmore*, 674 A.2d 483, 492 (Del. Ch. 1995) (stating that corporate bylaws are a contract between the corporation and its shareholders) (citing *Centaur Partners IV v. Nat'l Intergroup, Inc.*, 582 A.2d 923, 926 (Del. 1990)).

<sup>121</sup> This note assumes that corporate bylaws requiring arbitration are valid and enforceable. Such enforceability questions are resolved by a court determining (1) whether there is an agreement to arbitrate under the state's contract law principals, and (2) whether that agreement is otherwise enforceable under defenses of law and equity such as unconscionability or duress. See *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth*, 473 U.S. 614, 626–28 (1985) (noting arbitrability questions are normally resolved by courts in favor of arbitration). Although the final clause of § 2 acts as a savings clause to deem unenforceable arbitration clauses “upon such grounds as exist at

## A. *Obstacles to the Legitimacy of the FAA*

Although the FAA has gained legitimacy within Delaware courts and among corporate law in general, it still faces challenges within the derivative context. This section outlines those challenges and discusses whether they present a substantial threat to the presence of corporate mandatory arbitration provisions.

### 1. *Conflicting Policy of the Arbitration Fairness Act*

A recent proposal by Congress which threatens the enforceability of the FAA is the Arbitration Fairness Act (AFA), originally proposed by the legislature in 2007 and reintroduced after the U.S. Supreme Court's decision in *AT&T Mobility v. Concepcion*.<sup>122</sup> As noted above,<sup>123</sup> the U.S. Supreme Court in *AT&T* required that courts give arbitration agreements as much deference as other contracts and enforce them according to their terms, with the exception of unconscionable contracts, or contracts resulting from fraud or duress.<sup>124</sup> In *AT&T*, the Court rejected the idea that arbitration agreements among consumer contracts are void against public policy, thus establishing the legitimacy of the FAA scheme with respect to consumer suits and their use by corporations in general.<sup>125</sup> But Congress, concerned that the Court's *AT&T* decision denies consumers and workers the right to have their claims heard in court,<sup>126</sup> reacted by reintroducing the AFA—legislation which bars

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law or in equity for the revocation of any contract," the Supreme Court made clear in *AT&T Mobility LLC v. Concepcion* that the scope of the savings clause which acts to invalidate arbitration clauses should be limited to grounds of fraud, duress, or unconscionability, not "from the fact that an agreement to arbitrate is at issue." Barsalona, *supra* note 5, at 276 (quoting *AT&T*, 131 S. Ct. at 1746).

<sup>122</sup> Sarah Rudolph Cole, *On Babies and Bathwater: The Arbitration Fairness Act and the Supreme Court's Recent Arbitration Jurisprudence*, 48 HOUS. L. REV. 457, 493 n.157 (2011).

<sup>123</sup> See *supra* Part I.

<sup>124</sup> *AT&T Mobility*, *supra* note 4, at 1745–46. See also *Mastrobuono v. Shearson Lehman Hutton*, 514 U.S. 52, 53–54 (1995) ("[T]he central purpose of the Federal Arbitration Act [is] to ensure that private agreements to arbitrate are enforced according to their terms.").

<sup>125</sup> *AT&T Mobility*, *supra* note 4, at 1747 (ruling that "[r]equiring the availability of classwide arbitration interferes with fundamental attributes of arbitration and thus creates a scheme inconsistent with the FAA.").

<sup>126</sup> Kimberly Atkins, *Legal Affairs: Lawmakers Again Try to Ban Forced Arbitration Clauses*, LEGALNEWS.COM (May 20, 2011), <http://www.legalnews.com/detroit/950169>.

pre-dispute mandatory arbitration clauses within contracts in order to protect parties to contracts of unequal bargaining power.<sup>127</sup>

The proposed AFA declares invalid pre-dispute arbitration agreements affecting employment, consumer or franchise disputes, or a dispute arising under “any statute intended to protect civil rights.”<sup>128</sup> The legislation further proposes that the validity and enforceability of such arbitration agreements be determined by the court, not an arbitrator, regardless of whether or not a party challenges the arbitration agreement specifically.<sup>129</sup>

This latter provision—impressing upon courts to determine whether or not an entire arbitration agreement is valid—goes directly against common law precedent. The Supreme Court in 1967 originally ruled that a court can hear claims regarding the validity of the arbitration clause, but not the validity of the *entire* contract (e.g., the company charter) which is to be determined by the arbitrator.<sup>130</sup> The policy behind this decision is that a court should not have to address the validity of an arbitration provision if the document in which it is contained is deemed unenforceable by arbitration.<sup>131</sup> In 2010, the Court changed this rule to further favor the arbitrator’s discretionary authority by stating that courts cannot decide challenges to the validity of an arbitration agreement *containing a provision delegating power to an arbitrator* to resolve threshold issues of validity of the agreement.<sup>132</sup>

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<sup>127</sup> Arbitration Fairness Act of 2007, S. 1782, 110th Cong. (2007); *see also* Arbitration Fairness Act of 2009, H.R. 1020, 111th Cong. (2009). The AFA in part provides, “[m]any corporations add to their arbitration clauses unfair provisions that deliberately tilt the systems against individuals, including provisions that strip individuals of substantive statutory rights, ban class actions, and force people to arbitrate their claims hundreds of miles from their homes.” *Id.*

<sup>128</sup> Arbitration Fairness Act of 2009, *supra* note 127. *See also* Jill I. Gross, *The End of Mandatory Securities Arbitration?*, 30 PACE L. REV. 1174, 1176 (2010) (noting that these categories are defined broadly in order to ensure maximum invalidation of mandatory arbitration provisions).

<sup>129</sup> Arbitration Fairness Act of 2009, *supra* note 127.

<sup>130</sup> *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 403–04 (1967) (“[I]f the claim is fraud in the inducement of the arbitration clause itself—an issue which goes to the ‘making’ of the agreement to arbitrate—the federal court may proceed to adjudicate it. But the statutory language does not permit the federal court to consider claims of fraud in the inducement of the contract generally.”).

<sup>131</sup> *Id.*

<sup>132</sup> *See Rent-A-Center, West, Inc. v. Jackson*, 130 S. Ct. 2772, 2780 (2010) (emphasis added) (dictating that the arbitrator has the power to decide challenges to enforceability of arbitration agreements—not the court—unless the challenge is directed to the delegation clause itself). *See also Annual Review, supra* note 1, at 232.

Rather, only an objection made to the delegation provision itself is reviewable by a court.<sup>133</sup>

The future of the AFA is unknown. Although its origins lie in congressional disapproval of arbitration agreements within consumer contracts, if passed, it may have a spill-over effect on such arbitration provisions used by corporations in different contexts, such as the shareholder derivative context. Either way, the proposed bill is raising awareness of congressional disapproval of the FAA as it currently stands.

## 2. *Uncertain Status of Securities Arbitration*

Another challenge to the FAA is the fluctuating status of securities arbitration. “Securities arbitration” refers to the arbitration of disputes between investors and their individual brokers and other disputes between securities industry parties.<sup>134</sup> Although arbitration has been the primary mechanism for resolving securities disputes for over twenty years,<sup>135</sup> these disputes are now arbitrated within the dispute resolution forum of the Financial Industry Regulatory Authority (FINRA).<sup>136</sup> FINRA, a non-governmental regulatory organization for U.S. securities brokers and dealers formed in 2007 by the National Association of Securities Dealers (NASD) and the NYSE, houses the largest dispute resolution forum in the securities industry.<sup>137</sup> Arbitration is normally mandatory in securities disputes, and

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<sup>133</sup> *Rent-A-Center*, 130 S. Ct. at 2780. In *Rent-A-Center*, the Court was asked to enforce the delegation provision of an arbitration agreement binding an employer from suing his employer in court. *Id.* at 2775. The Court enforced the delegation provision under § 2 of the FAA but deemed such a provision severable from the entire arbitration agreement, the validity of which was to be determined by an arbitrator as a whole. *Id.* at 2779.

<sup>134</sup> Gross, *supra* note 128, at 1177.

<sup>135</sup> *Id.* at 1179.

<sup>136</sup> A FINRA member is defined as an entity “who is registered or has applied for registration under the Rules of FINRA” or “[a] sole proprietor, partner, officer, director, or branch manager of a member, or other natural person occupying a similar status or performing similar functions, or a natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by a member, whether or not any such person is registered or exempt from registration with FINRA.” N. Kane Bennett, *Navigating FINRA’s Mandatory Arbitration Requirement—An Overview*, CONNECTICUT BUSINESS LITIGATION BLOG (Mar. 14, 2011), <http://www.connecticutbusinesslitigation.com/2011/03/articles/commercial-litigation/navigating-finras-mandatory-arbitration-requirement-an-overview/> (citing FINRA Manual Rule 13100(r)).

<sup>137</sup> News Release, Financial Industry Regulatory Authority, NASD and NYSE Member Regulation Combine to Form the Financial Industry Regulatory Authority—

allows only “limited grounds on which a court may hear a party’s appeal on an award.”<sup>138</sup>

Despite its successes, FINRA arbitration has recently received criticisms that may, if deemed legitimate, spill over onto the legitimacy of the FAA. Similar to other mandatory arbitration agreements such as the one at issue in the *AT&T* case, FINRA’s private arbitration process has felt backlash from consumer groups who are raising concerns that their right to sue in court has been unconstitutionally curtailed.<sup>139</sup> Individual investors also have a general negative perception of securities arbitration.<sup>140</sup> There is a possibility that securities disputes would be covered by the AFA provision exempting arbitration from all “consumer disputes.”<sup>141</sup> Thus, if the AFA is passed into law, securities arbitration could be lost. Finally, the 2010 Dodd-Frank reforms added to the uncertainty of the future of securities arbitration by granting the SEC the authority to prohibit pre-dispute arbitration agreements in securities contracts.<sup>142</sup>

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FINRA (July 30, 2007), available at <http://www.finra.org/Newsroom/NewsReleases/2007/P036329>; Michael Smallberg, *SEC Withholds Records on Oversight of Self-Regulatory Group*, PROJECT ON GOVERNMENT OVERSIGHT BLOG (June 16, 2011, 4:52 PM), <http://pogoblog.typepad.com/pogo/2011/06/sec-withholds-records-on-oversight-of-self-regulatory-group.html>. FINRA recently announced the launch of a pilot program designed to ease arbitration requirements for large cases based on claims of at least \$10 million. The program reportedly “enables parties to customize the administrative process to better suit special needs of a larger case and allows them to bypass certain FINRA arbitration rules.” News Release, Financial Industry Regulatory Authority, *FINRA Launches Pilot Program for Large Arbitration Cases* (July 2, 2012), <http://www.finra.org/Newsroom/NewsReleases/2012/P127254>.

<sup>138</sup> FINRA, *Arbitration: Decisions & Awards*, <http://www.finra.org/ArbitrationAndMediation/Arbitration/Process/DecisionAwards/index.htm> (also referring to the FAA). In recent news, the Second Circuit affirmed a district court’s approval of a \$20.5 million FINRA arbitration award against hedge fund broker Goldman Sachs Execution & Clearing L.P. Rejecting Goldman’s argument that the arbitration award should be vacated because the award was “in manifest disregard of the law,” the court commented that “review under the manifest disregard standard . . . is highly deferential to the arbitrators, and relief on such a claim is therefore rare.” *Goldman Sachs Execution & Clearing, L.P. v. Official Unsecured Creditors’ Comm. of Bayou Group, LLC*, 491 Fed. App’x 201, 203 (2d Cir. July 3, 2012) (internal quotation marks omitted).

<sup>139</sup> Smallberg, *supra* note 137.

<sup>140</sup> Gross, *supra* note 128, at 1185.

<sup>141</sup> *Id.* at 1178–79.

<sup>142</sup> *Id.* After the Dodd-Frank amendments, Section 15 the Securities Exchange Act of 1934, 15 U.S.C. § 78o, now provides, “The Commission, by rule, may prohibit, or impose conditions or limitations on the use of, agreements that require customers . . . to

Many argue that such criticisms of and threats to securities arbitration are unfounded, as there are many benefits to investors stemming from FINRA's arbitration program.<sup>143</sup> Securities arbitration presents advantages to investors similar to those offered to shareholders in derivative suit arbitration proceedings. In fact, the climate in the SEC is reportedly changing. Traditionally opposed to arbitration clauses on the grounds that they threaten to dilute shareholders' and consumers' rights, the SEC has slowly become receptive to arbitration provisions within corporate documents.<sup>144</sup> Moreover, the U.S. Supreme Court has displayed its approval of arbitrating disputes in the securities context. In 1989, the Court formally overruled its decision in *Wilko v. Swan*,<sup>145</sup> a case which voided arbitration of securities claims under the Securities Act of 1933.<sup>146</sup> In doing so, the Court commented that "resort

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arbitrate any future dispute between them arising under the Federal securities laws, the rules and regulations thereunder, or the rules of a self-regulatory organization if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors." Dodd-Frank Wall Street Reform and Consumer Protection Act, H. R. 4173, 111th Cong. § 921 (2010), *available at* <http://www.sec.gov/about/offices/owb/dodd-frank-sec-922.pdf>.

<sup>143</sup> See, e.g., Gross, *supra* note 128, at 1186–90 (noting that FINRA arbitration proceedings are overseen by the SEC to ensure fairness, facilitate access to forums for investors, promote transparency, and contain procedural safeguards to all parties involved). Because of the procedural safeguards provided by an administrative agency toward arbitration proceedings, Gross argues that securities arbitration should not be reduced to the same concerns surrounding mandatory arbitration provisions in consumer contracts. *Id.* at 1194. The same argument could be made regarding the procedural safeguards offered by Chancery Court arbitration proceedings, as discussed above. See *supra* Part II.

<sup>144</sup> Ravanides, *supra* note 2, at 408 ("With the SEC re-considering its *de facto* veto of public arbitration, the legal argument in favor of the arbitrability of intra-corporate controversies is almost invincible . . . . There is no reason why this national policy would not justify the enforcement of arbitration provisions embedded in a public company's governing documents, when arbitration is the prevalent dispute resolution mode in the securities industry."). See also Steven A. Ramirez, *Arbitration and Reform in Private Securities Litigation: Dealing With the Meritorious as Well as the Frivolous*, 40 WM. & MARY L. REV. 1055, 1127–28 (1999) (predicting the SEC's encouragement of arbitration clauses within registration statements). *But cf.* Stephen Bainbridge, *Is Carlyle Even Less Shareholder Friendly Than the Green Bay Packers? Is That a Bad Thing?* PROFESSORBAINBRIDGE.COM (Jan. 19, 2012, 3:49 PM), <http://www.professorbainbridge.com/professorbainbridge.com/2012/01/is-carlyle-even-less-shareholder-friendly-than-the-green-bay-packers-is-that-a-bad-thing.html> (noting the SEC's "longstanding policy" of refusing to approve IPO registration statements containing mandatory arbitration provisions).

<sup>145</sup> *Wilko v. Swan*, 346 U.S. 427 (1953).

<sup>146</sup> *Rodriguez de Quijas v. Shearson/Am. Express, Inc.*, 490 U.S. 477 (1989).

to arbitration does not inherently undermine any of petitioners' substantive rights under the Securities Act."<sup>147</sup>

If arbitration of securities disputes continues to grow, and the SEC refrains from exercising its veto right over arbitration clauses, the threat stemming from the AFA and other consumer groups will possibly be mitigated. Two years after the implementation of Dodd-Frank reforms, the SEC has shown no sign of using its newfound power to curtail the enforceability of mandatory pre-dispute arbitration agreements in the securities context.<sup>148</sup> Regardless, the status of such pre-dispute arbitration agreements will unquestionably have an effect on the success of the FAA and, in turn, similar clauses found within corporate bylaws affecting shareholders.

### B. *Enforceability of Mandatory Arbitration Clauses*

Despite threats to both the legitimacy of the FAA and the subsequent enforceability of the mandatory arbitration provisions corporations implement into their bylaws, there remain several fundamental arguments toward enforceability. Firstly, there is a strong argument that arbitration provisions should be deemed enforceable based on pure principles of contract law.<sup>149</sup> As previously noted,<sup>150</sup> corporate bylaws are a contract that all shareholders adhere to upon the purchase of corporate stock.<sup>151</sup> It is

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<sup>147</sup> *Id.* at 486.

<sup>148</sup> Jay Eng, *Two Years & Still Waiting for the SEC to Address the Enforceability of Mandatory Pre-Dispute Arbitration Agreements in Customer-Broker Disputes Under Section 921 of Dodd-Frank*, SECURITIES CLASS ACTION & ARBITRATION LAW (July 16, 2012), <http://securitiesattorneys.us/finra-arbitration/two-years-still-waiting-for-the-sec-to-address-the-enforceability-of-mandatory-pre-dispute-arbitration-agreements-in-customer-broker-disputes-under-section-921-of-dodd-frank/>. To date, eighteen comments on the Title IX provisions of Dodd-Frank have been submitted and published by the SEC. *Pre-Dispute Arbitration: Title IX and the Dodd-Frank Wall Street Reform and Consumer Protection Act*, SEC.GOV (Apr. 2, 2012), <http://www.sec.gov/comments/df-title-ix/pre-dispute-arbitration/pre-dispute-arbitration.shtml>.

<sup>149</sup> In order to enforce arbitration agreements within the corporate context, the corporation must establish that the proceedings "have a contractual basis and that shareholders are not deprived of the protections of litigation without contest, which ultimately comes down to a question of notice." Dana Freyer & Robert Saylor, *Commercial Disputes*, in ALTERNATIVE DISPUTE RESOLUTION: THE LITIGATOR'S HANDBOOK 147, 166 (Nancy F. Atlas, et al. eds., 2000).

<sup>150</sup> See *supra* Part III.

<sup>151</sup> Shell, *supra* note 52, at 544; see also *Centaur Partners, IV v. Nat'l Intergroup, Inc.*, 582 A.2d 923, 928 (Del. 1990) (ruling that corporate charters and bylaws are

implicitly assumed that all parties to a contract have read and agreed to the terms of the contract before signing it.<sup>152</sup> The same principle holds true for a corporation's bylaws outlining the rights of its shareholder owners, as long as such provisions are placed within a charter at the time of a company's initial public offering.<sup>153</sup>

Another argument for enforceability flows from DGCL § 102(b)(7), which allows corporations to adopt charter provisions limiting director and officer liability.<sup>154</sup> Stephen M. Bainbridge, professor at UCLA School of Law, suggests that because corporate law allows for corporations to freely amend a set of default rules outlining the duties of corporate officers and the corporate form in general, "there seems little reason not to expand the liability limitation statutes to allow corporations to opt out of derivative litigation."<sup>155</sup> Indeed, Professor Bainbridge's argument touches on the underlying attraction of enabling Delaware law. If derivative suits are largely viewed by corporations as stifling upon corporate management, Delaware

contracts to be governed by general rules of contract interpretation). *But cf.* Poppe & Sullivan, *supra* note 8, at 7 (suggesting that the FAA arguably may not apply to a company's charter or bylaws because they are not a "contract" in the traditional sense, as defined under state contract law). Indeed, possible grounds for objecting to the FAA's applicability to corporate charters are the statute's specification of a "written provision" as a contract. Federal Arbitration Act, *supra* note 5, at § 2. Some argue that corporate bylaws are distinct from contracts made and signed between two commercial actors. Lawrence A. Cunningham, *Rhetoric Versus Reality in Arbitration Jurisprudence: How the Supreme Court Flaunts and Flunks Contracts*, 75 LAW & CONTEMP. PROBS. 129, 129 (2012). However, with its pro-arbitration stance the Supreme Court has "redefined the meaning of contracting" to encompass contracts formed and approved by shareholder referendum. Cunningham, *supra* note 43.

<sup>152</sup> *Westendorf v. Gateway 2000, Inc.*, 2000 Del. Ch. LEXIS 54 at \*14 (Mar. 16, 2000) ("One who knowingly accepts the benefits intended as the consideration, coming to him or her under a contract voluntarily made by another in his or her behalf, becomes bound by reason of such acceptance to perform his or her part of the contract.") (quoting 17B C.J.S. § 631 (1999)) (enforcing an arbitration clause within a consumer purchase agreement).

<sup>153</sup> *Parfi Holding AB v. Mirror Image Internet, Inc.*, 817 A.2d 149, 2002 Del. LEXIS 679 at \*155–56 (Nov. 4, 2002) ("When parties to an agreement decide that they will submit their claims to arbitration, Delaware courts strive to honor the reasonable expectations of the parties and ordinarily resolve any doubt as to arbitrability in favor of arbitration.") (reversing lower court's enforcement of arbitration clause within corporate bylaw because it was outside the scope of the duties and obligations under the shareholder agreement).

<sup>154</sup> DEL. CODE ANN. tit. 8, § 102(b)(7) (2006); BAINBRIDGE, *supra* note 81, at 404.

<sup>155</sup> BAINBRIDGE, *supra* note 81, at 404 ("If eliminating derivative litigation seems too extreme, why not allow firms to opt out of the derivative suit process by charter amendment?").

should serve as the example to other jurisdictions by allowing corporations to include in their bylaws mandatory arbitration provisions for reasons of efficiency. The underlying principle of § 102(b)(7) applies: just as the fear of being sued for gross negligence and violating the duty of care can stifle potential profit-maximizing risk-taking by boards of directors, constant litigation of shareholder derivative suits can do the same. If corporations are allowed to limit director liability under § 102(b)(7), they should be able to limit the forum in which shareholder disputes are resolved.

### 1. *Forum Selection Clauses and DGCL § 102(b)(1)*

Furthermore, many argue that mandatory arbitration provisions should receive the same attitude of deference by Delaware courts as have been given exclusive jurisdiction provisions within corporate bylaws. An exclusive jurisdiction provision (also known as a forum selection provision) allows corporations to select in advance the jurisdiction in which shareholder disputes will be held (normally in the state of incorporation).<sup>156</sup> Such a clause normally provides:

*Unless the Corporation consents in writing to the selection of an alternative forum, the Court of Chancery of the State of Delaware shall be the sole and exclusive forum for (i) any derivative action or proceeding brought on behalf of the Corporation, (ii) any action asserting a claim of breach of a fiduciary duty owed by any director, officer or other employee of the Corporation to the Corporation or the Corporation's stockholders, (iii) any action asserting a claim arising pursuant to any provision of the Delaware General Corporation Law, or (iv) any action asserting a claim governed by the internal affairs doctrine. Any person or entity purchasing or otherwise acquiring any interest in shares of capital stock of the Corporation shall be deemed to have notice of and consented to the provisions of this Article.*<sup>157</sup>

Such provisions are implemented by corporations to address the problem of multijurisdictional shareholder litigation by channeling all suits into one

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<sup>156</sup> Steven M. Davidoff, *A Litigation Plan That Would Favor Delaware*, N.Y. TIMES DEALBOOK (Oct. 26, 2010, 9:30 AM), <http://dealbook.nytimes.com/2010/10/26/a-litigation-plan-that-would-favor-delaware/>.

<sup>157</sup> Broc Romanek, *Coordinated Attack on Exclusive Forum Bylaw Provisions*, THECORPORATECOUNSEL.NET (Feb. 9, 2012), <http://www.thecorporatecounsel.net/Blog/2012/02/coordinated-attack-on-exclusive-forum.html> (emphasis added).

jurisdiction—usually Delaware.<sup>158</sup> Forum selection clauses can be phrased in one of two ways: either mandatory or elective.<sup>159</sup> A mandatory forum selection provision requires that all shareholder litigation will occur in the jurisdiction of incorporation or a specific state, e.g. Delaware.<sup>160</sup> An elective forum selection provision gives the corporation the *option* to elect that all shareholder litigation will take place in the jurisdiction of incorporation.<sup>161</sup>

Forum selection provisions within corporate charters have been upheld by the Delaware Courts as being within the directors' authority outlined under DGCL § 102(b)(1).<sup>162</sup> In its 2010 decision *In re Revlon, Inc. Shareholders Litigation*, the Delaware Chancery Court held that forum selection clauses are enforceable.<sup>163</sup> Professor Stephen M. Bainbridge notes, “[T]here’s no immediately obvious policy reason why the same result would not apply to mandatory arbitration provisions.”<sup>164</sup>

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<sup>158</sup> Alison Frankel, *El Paso Case Shapes Up as Latest M&A Shareholder Venue Fight*, THOMSON REUTERS (Oct. 21, 2011), [http://newsandinsight.thomsonreuters.com/Legal/News/2011/10\\_-\\_October/El\\_Paso\\_case\\_shapes\\_up\\_as\\_latest\\_M\\_A\\_shareholder\\_venue\\_fight/](http://newsandinsight.thomsonreuters.com/Legal/News/2011/10_-_October/El_Paso_case_shapes_up_as_latest_M_A_shareholder_venue_fight/).

<sup>159</sup> Davidoff, *supra* note 156. Davidoff suggests that corporations would be wise to put such provisions to a shareholder vote, in order to address any objections based on the grounds of corporate governance. If shareholders vote to adopt these provisions, there is a greater likelihood they would pass through judicial scrutiny. Davidoff, *supra* note 156. Arguably, this flexibility to choose between mandatory and elective language of a forum selection clause could also be applied to arbitration clauses; an elective arbitration clause could give the corporation the *option* of bringing a derivative claim in a judicial forum or submit it to arbitration. Furthermore, like forum selection clauses, a corporation always has the choice to submit mandatory or elective arbitration clauses to a shareholder vote in a charter amendment, although the likelihood of approval is less certain in the derivative context.

<sup>160</sup> *Id.*

<sup>161</sup> *Id.*

<sup>162</sup> DEL. CODE ANN. tit. 8, § 102(b)(1) (2006) (allowing certificates of incorporation to contain “[a]ny provision for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders, or any class of the stockholders . . . if such provisions are not contrary to the laws of this State.”).

<sup>163</sup> *In re Revlon*, 990 A.2d at 960. Since the *Revlon* opinion was adopted, twenty-three companies have adopted similar forum selection clauses in their charters. Davidoff, *supra* note 156.

<sup>164</sup> Bainbridge, *supra* note 144. Professor Steven M. Davidoff further notes that, given the Chancery Court’s recent endorsement of forum selection clauses in *Revlon* and the fact that such clauses arguably satisfy DGCL § 109’s requirement that corporate bylaw provisions relate to “the business of the corporation . . . and its rights or powers or the rights or powers of its shareholders, directors, officers and employees,” the Delaware

Most notably, the *Revlon* court stated in dicta that arbitration clauses within corporate bylaws are similarly encompassed within directors' discretionary § 102(b)(1) powers, and thus would prove similarly enforceable as forum selection provisions.<sup>165</sup> Such provisions can have the beneficial effects of self-selecting merited shareholder suits for resolution, and also deterring "shirking" by frequent filers seeking to reap the profits of attorneys' fees from a derivative suit.<sup>166</sup> As highlighted by the Chancery Court, and as outlined above,<sup>167</sup> mandatory arbitration provisions are recognized as enforceable by courts in a variety of business entity contexts, particularly within the LLC organization.<sup>168</sup> Thus, it may be only a matter of time until enforceability of those provisions is recognized for large publicly traded corporations.

Of course, forum selection clauses have not been welcomed by corporate constituencies with completely open arms. Forum selection provisions have recently met resistance in a series of suits challenging forum selection clauses requiring shareholder suits to be filed within the Delaware Court of

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Legislature may consider amending its corporate law rules to explicitly allow forum selection clauses. Davidoff, *supra* note 156.

<sup>165</sup> *In re Revlon, Inc.*, 990 A.2d at 960 (stating that "if boards of directors and stockholders believe that a particular forum would provide an efficient and value-promoting locus for dispute resolution, then corporations are free to respond with charter provisions selecting an exclusive forum for intra-entity disputes."); see also *id.* at n.8, where Vice Chancellor Laster further predicted that "[t]he issues implicated by an exclusive forum selection provision must await resolution in an appropriate case."

<sup>166</sup> *In re Revlon, Inc.*, 990 A.2d at 961 (noting that such forum selection provisions will have the long-term beneficial effect of enhancing the legitimacy of Delaware corporate law). See also Joseph A. Grundfest, *Choice of Forum Provisions in Intra-Corporate Litigation: Mandatory and Elective Approaches*, The 2010 Pileggi Lecture, Oct. 6, 2010, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1690561](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1690561) ("It is important to distinguish profit maximizing conduct by plaintiff counsel from welfare maximizing behavior in shareholders' best interests. The two concepts are not identical.").

<sup>167</sup> See *supra* Part III.A.

<sup>168</sup> See, e.g., *Elf Atochem N. Am. Inc. v. Jaffari*, 727 A.2d 286, 287 (Del. 1999) (validating an LLC's contractual provision requiring that all disputes be resolved by arbitration or court proceedings in California); *Douzinis v. Am. Bureau of Shipping, Inc.*, 888 A.2d 1146, 1149 (Del. Ch. 2006) (declaring an arbitration clause within an LLC charter enforceable pursuant to DEL. CODE ANN. tit. 6, § 18-1101(c)(2)). Noting Delaware's favorable attitude toward enforceability of arbitration provisions, the Chancery Court in *Douzinis* reiterated that "a broad arbitration provision in an LLC Agreement could encompass breach of fiduciary duties claims raised by a member." *Id.*

Chancery.<sup>169</sup> Shareholders are alleging that these provisions violate their due process rights because they were not subject to mutual consent by the shareholders.<sup>170</sup> The law firms suing on behalf of the shareholders reportedly find merit in contesting these provisions due to recurring patterns of corporations attempting to limit shareholder rights.<sup>171</sup> By filing these suits, firms are not arguing that Delaware is an inappropriate venue; rather, they seek a final ruling on whether the practice of using corporate bylaws to specify a forum for shareholder suits is contrary to Delaware law in the first place.<sup>172</sup>

The enforceability of forum selection clauses is yet to be determined, but due to the pending litigation on the topic, the wait will probably not be long. Given the trend of corporations adopting these provisions, the arguments toward their enforceability, and the preference to keep corporate law within the province of the Delaware judiciary,<sup>173</sup> these clauses will likely be deemed enforceable. Moreover, if mandatory arbitration provisions fall within the purview of forum selection clauses, any decisions made regarding the validity of the latter could potentially affect the validity of the former.<sup>174</sup>

## VI. CONCLUSION

Corporate management's frustration toward shareholder derivative suits has finally come to fruition. Mandatory arbitration clauses seek to eliminate

<sup>169</sup> Francis Pileggi, *Multiple New Suits Challenge Exclusive Forum Selection Bylaws in Delaware Court of Chancery*, DELAWARE CORPORATE & COMMERCIAL LITIGATION BLOG (Feb. 7, 2012), <http://www.delawarelitigation.com/2012/02/articles/chancery-court-updates/multiple-new-suits-challenge-exclusive-forum-selection-bylaws-in-delaware-court-of-chancery/>.

<sup>170</sup> *Id.*

<sup>171</sup> Alison Frankel, *Shareholder Lawyers Sue Over Delaware Forum-selection Bylaws*, THOMSON REUTERS (Feb. 8, 2012), [http://newsandinsight.thomsonreuters.com/Legal/News/2012/02\\_-\\_February/Shareholder\\_lawyers\\_sue\\_over\\_Delaware\\_forum-selection\\_bylaws/](http://newsandinsight.thomsonreuters.com/Legal/News/2012/02_-_February/Shareholder_lawyers_sue_over_Delaware_forum-selection_bylaws/).

<sup>172</sup> *Id.*

<sup>173</sup> See, e.g., Frankel, *supra* note 158 (“Delaware judges typically frown upon any litigation maneuver that compromises Delaware’s authority as the ultimate arbiter of commercial disputes.”).

<sup>174</sup> For instance, in the forum selection clause previously noted, see *supra* Part V, the phrase “[u]nless the Corporation consents in writing to the selection of an alternative forum” could also apply to an arbitration tribunal. If such a forum selection clause is deemed by the judiciary to be enforceable, a clause which submits shareholder suits to arbitration proceedings may likely be treated the same.

the recurring drawbacks that meritless strike suits have on corporate management and the Delaware judiciary. Although such provisions have not gone without critique, their increasing popularity foreshadows a changing tide in forum selection for the traditional shareholder complaint. If corporations are successful in implementing arbitration provisions within their bylaws, either upon incorporation or by shareholder-approved charter amendment,<sup>175</sup> arbitration tribunals are sure to become increasingly popular in Delaware.

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<sup>175</sup> DEL. CODE ANN. tit. 8, § 242(b) (entitling shareholders to vote on proposed amendments to a corporate charter). *See also* Shell, *supra* note 52, at 550 (“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.”).