April 6, 2009

Eliminating Securities Fraud Class Actions Under the Radar

Barbara Black, University of Cincinnati College of Law

Available at: https://works.bepress.com/barbara_black/1/
ELIMINATING SECURITIES FRAUD CLASS ACTIONS UNDER THE RADAR

Barbara Black*

At least since Basic, Inc. v. Levinson, the business community and many influential scholars have challenged the existence of the securities fraud class action on a variety of grounds. Recently, two proposals have been advanced to “fix” the problem of “abusive” securities fraud class actions. One proposal requires arbitration of all securities fraud actions; the other eliminates the corporate defendant in most actions. Proponents assert that shareholders should have the right to adopt these proposals through amendment of the company’s certificate of incorporation. Both these proposals have attracted more than academic interest. In reality, adoption of either proposal would substantially curtail, if not eliminate, the securities fraud class action.

Part I of this paper first reviews the two rationales – compensation and deterrence -- for the federal securities class action, sets forth the critics’ principal arguments as to why these goals are not achieved, and argues that the post-PSLRA securities fraud class action is reasonably effective in achieving both compensatory and deterrence goals. Part II then describes the two proposals. Part III explains why these proposals are impermissible under the anti-waiver clause, Section 29(a) of the Securities Exchange Act of 1934. Part IV explains why these proposals are also, under state law, illegal, unfair to shareholders that do not vote in favor of them, and unenforceable as to future stock purchasers. Part V concludes by calling for a national debate on the future of the securities fraud class action. The arguments for and against the securities fraud class action involve complexities and uncertainties that make “quick and dirty” solutions like these two proposals inappropriate.

The attacks on the securities fraud class action never end. At least since Basic, Inc. v. Levinson, the business community and many influential scholars have challenged

* Charles Hartsock Professor of Law and Director, Corporate Law Center. My thanks go to Edward Labaton, Donald C. Langevoort, Margaret V. Sachs, Michael Solomine, and Adam Steinman, who provided helpful comments on earlier drafts, and to Aaron Bernay, UC Law ‘10, and Daniel Wilberding, UC Law ’08, who provided useful research assistance.

1 485 U.S. 224 (1988). Indeed, the attacks on the class action generally, and the securities fraud class action specifically, go back to the 1966 amendments to F.R.C.P. 23 that expanded the scope of the federal class action; see, e.g., AMERICAN COLLEGE OF TRIAL LAWYERS, Report and Recommendations of the Special Committee on Rule 23 of the Federal Rules of Civil Procedure III (quoting a trial judge who referred to the class action device as “an engine of destruction” and a law professor who described it as “legalized blackmail”) (1972). For an early defense of rule 23, see Arthur R. Miller, Of Frankenstein
its continued existence on a variety of grounds. Even substantial congressional reform, in
the Private Securities Litigation Reform Act of 1995 (PSLRA),\(^2\) and again in the
Securities Litigation Uniform Standards Act of 1998 (SLUSA),\(^3\) to cure perceived abuses
did not satisfy its critics who assert that “the system is broken.”\(^4\) Recently, two proposals
have been advanced to “fix” the problem of “abusive” securities fraud class actions; in
reality, adoption of either proposal would substantially curtail, if not eliminate, the
securities fraud class action. One proposal requires arbitration of all securities fraud
actions (the “arbitration proposal”);\(^5\) the other eliminates the corporate defendant in most
actions (the “proposal to eliminate the corporate defendant”).\(^6\) Proponents assert that
shareholders should have the right to adopt these proposals through amendment of the
company’s certificate of incorporation.

Both these proposals have attracted more than academic interest. Prior to the
financial meltdown that currently commands the agency’s attention, it was rumored that
the Securities and Exchange Commission (SEC) was considering a change in its policy
that would permit companies to require arbitration of investors’ claims.\(^7\) More recently, a
shareholder of a public corporation submitted a preliminary proxy statement to the SEC

\(^{4}\) See, e.g., U.S. CHAMBER INSTITUTE FOR LEGAL REFORM, SECURITIES CLASS ACTION LITIGATION i (July 2008) (“Securities Class Action Litigation”).
\(^{5}\) See infra notes 85-92 and accompanying text.
\(^{7}\) Kara Scannell, SEC Explores A Wider Role for Arbitration – Agency May Consider Letting Firms Head Off Lawsuits by Investors, WALL ST. J. at A1 (Apr. 16, 2007). Although then Chairman Cox testified before Congress that no such policy was pending before the Commission, rumors persisted.
to solicit fellow shareholders for adoption of the proposal to eliminate the corporate defendant.  

Debate about the securities fraud class action is healthy. Radical change of an important investor protection mechanism, however, is such an important policy matter affecting our securities markets that the debate should take place in the national spotlight. Congress, the courts and the SEC are all important participants that should be in the forefront of this debate. The SEC is the “investor’s advocate,” charged with the responsibility to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. The Supreme Court and Congress have over the years engaged in an ongoing dialogue over the scope of the securities fraud class action. Recently the Court expressed the view that Congress is the dominant voice in this exchange in light of its recent extensive legislative involvement in this area; nevertheless, the Court maintains a significant role in interpreting and implementing Congressional policy. While the policymakers certainly should solicit and take into account investors’ views on the benefits and costs of securities fraud class actions,

---


9 See the description of the SEC at its website, http://www.sec.gov/about/whatwedo.shtml.

10 Id. In August 2007 a group of influential law professors called on the SEC to take a leadership role on these issues. Letter to SEC Chairman Christopher Cox from Professor Donald C. Langevoort et alia (Aug. 2, 2007). Chairman Cox announced the SEC would hold roundtable discussions, but it has not yet done so.


curtailment of the federal securities class action is not an issue of shareholder rights that should be decided through the e-proxies of individual corporations.\(^\text{13}\)

Part I of this paper first reviews the two rationales – compensation and deterrence -- for the federal securities class action, sets forth the critics’ principal arguments as to why these goals are not achieved, and argues that the post-PSLRA securities fraud class action is reasonably effective in achieving both compensatory and deterrence goals. Part II then describes the two “self-help” proposals\(^\text{14}\) to curtail securities fraud class actions. Part III explains why these proposals are impermissible under the anti-waiver clause, Section 29(a) of the Securities Exchange Act of 1934 (the Exchange Act).\(^\text{15}\) Part IV explains why these proposals are also, under state law, illegal, unfair to shareholders that do not vote in favor of them, and unenforceable as to future stock purchasers. Part V concludes by calling for a national debate on the future of the securities fraud class action. There is no easy answer to the future of the federal securities fraud class action. The arguments for and against it involve complexities and uncertainties that make “quick and dirty” solutions like these two proposals inappropriate.

I. The Debate over Securities Fraud Class Actions

In the typical secondary market securities fraud claim, the corporation introduces intentional misstatements into the market that artificially inflate the stock price, so that

\(^{13}\) Shareholder voting, particularly voting by retail investors, has dropped significantly at corporations that have adopted the notice and access model that dispenses with the requirement that corporations mail proxy statements to all investors. See Luis A. Aguilar, SEC Commissioner, Speech on Increasing Accountability and Transparency to Investors (Feb. 6, 2009), available at http://www.sec.gov/news/speech/2009/speech020609laa.htm.


\(^{15}\) 15 U.S.C. § 78cc(a).
purchasers of the stock during the period of the fraud pay an inflated price for the stock.\textsuperscript{16} The corporation’s fraud thus causes injury to purchasers when the corrective information reaches the market and the stock price drops.\textsuperscript{17} In the typical case, where the corporate defendant does not sell the securities during the period of the fraud, the corporation causes harm, but does not benefit directly from it, since the fraud does not increase the corporation’s assets (although corporations benefit in many real ways from their stock’s increased market value).

Because “[t]he overriding purpose of our Nation’s securities laws is to protect investors and to maintain confidence in the securities markets,”\textsuperscript{18} Congress, the Court and the SEC have long recognized that the securities fraud class action is “an indispensable tool”\textsuperscript{19} that allows defrauded investors to recover at least some portion of their losses. Moreover, because securities fraud undermines overall investor confidence in the securities market, Congress, the Court, and the SEC have also acknowledged the importance of the securities fraud class action as a necessary supplement to the SEC’s enforcement efforts.\textsuperscript{20} Thus, as described by Professor James Cox, the class action has a “quasi-public character.”\textsuperscript{21}

\textsuperscript{16} The situation where the corporation makes misstatements that depress the stock price and result in sellers during the period of the fraud receiving less than they otherwise would have, is far less common, although it was the fact pattern in \textit{Basic, Inc. v. Levinson}, 485 U.S. 224 (1987).

\textsuperscript{17} \textit{See} Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336 (2005).


\textsuperscript{20} \textit{Dura}, 544 U.S. at 345 (stating that private securities fraud actions serve to deter fraud); \textit{Basic}, 485 U.S. 224, 231 (1988) (stating that the Rule 10b-5 private claim constitutes an essential tool for enforcement of the 1934 Act); \textit{see also} J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964) (stating that private enforcement of proxy rules is a necessary supplement to SEC action). \textit{See Joint Explanatory Statement} at 31 (stating that private suits “help to deter wrongdoing”). \textit{See Labaton, Consequences,} 29 STETSON at 401 & n. 43
In order to facilitate securities fraud class actions, the Supreme Court, in Basic, Inc. v. Levinson,\textsuperscript{22} adopted the “fraud on the market” (FOTM) presumption of reliance in efficient markets so that plaintiffs did not have to establish their own reliance on the fraudulent statement; rather, in efficient markets “all information known to the public affects the price and thus affects every investor.”\textsuperscript{23} As a result of the Basic presumption, individual issues of reliance do not defeat class action certification so long as the securities are traded in an efficient market, and securities fraud class actions increased in number.\textsuperscript{24}

After Basic, the business community and many scholars charged that plaintiffs’ attorneys brought too many unmeritorious securities fraud class action suits in pursuit of quick settlements and substantial attorneys’ fees.\textsuperscript{25} In response, Congress enacted PSLRA in 1995.\textsuperscript{26} Business interests urged Congress to eliminate the FOTM presumption of reliance,\textsuperscript{27} without which securities fraud class actions would be difficult if not (setting forth testimony of SEC Chair Richard C. Breedon that private actions augment SEC enforcement resources and provide additional deterrence).

\textsuperscript{22} 485 U.S. 224 (1987).
\textsuperscript{23} Asher v. Baxter Int’l Inc., 377 F.3d 727, 731 (7th Cir. 2004). Belief in the efficiency of markets is also a core aspect of the SEC’s regulation of disclosure. Seasoned issuers, for example, can use Form S-3 to register securities and incorporate by reference information contained in Exchange Act filings, Item 12 (Incorporation of Certain Information by Reference), Form S-3, available at http://www.sec.gov/about/forms/forms-3.pdf.
\textsuperscript{24} Securities class actions have averaged between 47% and 48% of all class actions in recent years. See John C. Coffee, Jr., Reforming the Securities Class Action: An Essay on Deterrence and its Implication, 106 COLUM. L. REV. 1534, 1539-1540 (2006) (“Reforming the Securities Class Action”).
\textsuperscript{26} Supra note 2 and accompanying text.
impossible to maintain. The SEC opposed the elimination of the FOTM presumption, \(^{28}\) however, and Congress determined not to do so. Instead, PSLRA sought to weed out frivolous suits through a variety of procedural and other measures. \(^{29}\) Congress thus chose not to eliminate the securities fraud class action, but to cure it and thus confirmed its importance to the integrity of the U.S. capital markets. \(^{30}\) Consistent with the Congressional purpose, the Supreme Court identified PSLRA’s twin goals: “to curb frivolous lawyer-driven litigation while preserving investors’ ability to recover on meritorious claims.” \(^{31}\) In 1998, Congress reaffirmed the national importance of the reformed federal securities fraud class action and enacted SLUSA, which preempted most class actions filed under state common law and state securities statutes. \(^{32}\)

The business community’s campaign against the securities fraud class action has not abated since the enactment of PSLRA and SLUSA, even in the face of persistent widespread corporate fraud, including the Enron-era accounting frauds that led to the enactment of the Sarbanes-Oxley Act of 2002 (SOX) and the stock options backdating scandals of 2005-06. They make the same pre-PSLRA warnings that securities class actions present “a serious threat to the health of the U.S. economy” and the same pre-PSLRA arguments that “the culture of abusive class actions” is “driven by a multibillion-

\(^{28}\) Testimony of Chairman Arthur Levitt Concerning Litigation Reform Proposals Before the House Subcommittee on Telecommunications and Finance, Committee on Commerce, Feb. 10, 1995, available at http://www.sec.gov/news/testimony/testarchive/1995/spch025.txt (opposing proposal to eliminate the FOTM presumption both because it would be contrary to SEC’s disclosure regulation and because it would make it “virtually impossible” for investors to assert claims as part of a class action).

\(^{29}\) Among its procedural hurdles, PSLRA imposes heightened pleading requirements for scienter and a stay on discovery pending resolution of a defendant’s motion to dismiss. The statute also requires court appointment of a “lead plaintiff,” presumptively the largest shareholder willing to serve. For a brief description of the key provisions, see DONNA M. NAGY, RICHARD W. PAINTER & MARGARET V. SACHS, SECURITIES LITIGATION AND ENFORCEMENT CASES AND MATERIALS 9-10 (2d ed.)

\(^{30}\) Joint Explanatory Statement at 31, supra note 18.

\(^{31}\) Tellabs, 127 St. Ct. at 2509.

\(^{32}\) Supra note 3 and accompanying text.
dollar plaintiffs’ lawyer industry.” In addition, the business community asserts that the prevalence of private securities litigation places U.S. businesses at a competitive disadvantage and deters foreign businesses from entering the U.S. securities markets. Finally, according to its critics, there is no need for private litigation; the SEC and other regulators have the power not only to enforce the securities laws but also to recover compensation for investors. The business community’s concerns have a receptive audience in the Court; the majority opinion in *Stoneridge Investment Partners, LLC v. Scientific-America, Inc.* recited all of them as reasons to restrict the scope of liability in private Rule 10b-5 suits.

Many scholars also challenge the continued existence of the securities fraud class action on a related series of arguments grounded in finance theory that call into question both the class action’s compensatory and deterrence functions. They assert that the securities fraud class action does not perform well its compensatory function because investors do not receive very much compensation. Cases typically settle for a small percentage of investors’ losses and a significant portion of the settlement goes to payment of costs, including attorneys’ fees; accordingly, they believe that it is not worth the high

---

33 See, e.g., Securities Class Action Litigation i.


35 Securities Class Action Litigation iii. For description of the Fair Fund provision and a critique of the business community’s arguments, see Barbara Black, *Should the SEC Be A Collection Agency for Defrauded Investors?,* 63 BUS. LAW. 317, 325-327, 337-339 (2008) (“Should the SEC Be A Collection Agency?”).

36 128 S. Ct. at 772.

37 While the following discussion is abbreviated and does not attempt to explore all the nuances of these complex and interrelated arguments, I believe it fairly sets forth the positions of those who doubt the compensatory and deterrence rationales.

38 See Coffee, *Reforming the Securities Class Action,* 106 COLUM. L. REV. at 1545 (stating that “from a compensatory perspective, the conclusion seems inescapable that the securities class action performs
cost to produce such paltry returns to the investor. If this is serious concern, then increases in the amounts of settlements should be evidence of the success of the securities fraud class action rather than of its failure as critics view it.\textsuperscript{39} Moreover, this argument has general applicability to all class actions.\textsuperscript{40}

Other arguments discounting the compensation rationale focus specifically on the securities fraud class action. Unlike, for example, a defective product class action in which the corporation pays damages to users of the product for harm caused by the product, in a securities fraud class action the corporation pays damages to some of its current shareholders who purchased the stock at the inflated price. Thus, they argue, to the extent there is shareholder identity, paying plaintiffs for their damages is simply an expensive “pocket-shifting.”\textsuperscript{41} While this is true, the cost to the current shareholders may be less than the benefit to those same shareholders if a significant amount of the settlement is funded by insurance (which is usually the case)\textsuperscript{42} or by payments from individual defendants (which is usually not the case).\textsuperscript{43}

Finally, the critics argue that investors have a less costly method of protecting themselves against losses caused by securities fraud. If investors have a diversified

\textsuperscript{39} Securities Class Action Litigation ii (noting that, excluding billion dollar-plus settlements, the average 2007 settlement increased approximately 43\% from 2006). The average value of settlements fell in 2008, from $62.7 million to $31.2 million, Stephen Taub & Roy Harris, Class-action Values Plunging, but Not for Long, CFO.com (Mar. 11, 2009), available at http://www.cfo.com/printable/article/cfm/13277439.

\textsuperscript{40} Congress gave many examples of class action settlements that did not give class members meaningful compensation in the legislative history of the Class Action Fairness Act, see Sen. Rep. 109-14 (2005), reprinted in 4 U.S.C.C.A.N. 3, 15-20 (109\textsuperscript{th} Congr., 1\textsuperscript{st} Sess. 2005).

\textsuperscript{41} Coffee, Reforming the Securities Class Action, 106 COLUM. L. REV. at 1556.


\textsuperscript{43} Unfortunately, Stoneridge Inv. Partners, LLC v. Scientific-America, Inc., 128 S. Ct. 761 (2008), significantly reduces the likelihood that private plaintiffs can recover against third parties that knowingly participate in corporate fraud.
portfolio, over the long term, they will be on both sides of a securities fraud – buyers who have suffered a loss and sellers who reaped a benefit, because of a corporate fraud.\textsuperscript{44} Indeed, under this theory, a diversified investor will be overcompensated if it gets a recovery in a class action for its losses and does not have to account for its gains in other instances. The power of a diversified portfolio to net losses and gains over time has become an article of faith among academics, despite the fact there is little empirical evidence to support it.\textsuperscript{45} Under this view, taking money from the corporation, and ultimately its current shareholders, and giving it to another group of investors (some of whom may be one and the same), with the attendant “waste” of a significant portion being paid in attorneys’ fees and other costs, is unnecessary to compensate shareholders for their losses. Some scholars even argue that, just as contract law requires victims of contract breaches to take reasonable efforts to mitigate their losses, so too the securities laws should not protect unreasonable investors who fail to diversify.\textsuperscript{46} Indeed, some influential academics routinely dismiss compensation as a rationale for the securities fraud class action.\textsuperscript{47}


\textsuperscript{45} One empirical study, funded by the U.S. Chamber Institute for Legal Reform, found that large institutional investors generally break even from their investments in common stock impacted by fraud allegations and are often overcompensated as a result of litigation. Anjan V. Thakor, \textit{THE ECONOMIC REALITY OF SECURITIES CLASS ACTION LITIGATION} 20 (2005). Another study points out limitations in this study and finds that many diversified institutional investors suffer significant net losses from securities fraud over a ten-year period. Alicia Davis Evans, \textit{Are Investors’ Gains and Losses from Securities Fraud Equal Over Time? Some Preliminary Evidence}, available at: \url{http://ssrn.com/abstract=1121198} (2009).

\textsuperscript{46} See Richard A. Booth, \textit{The End of the Securities Fraud Class Action as We Know It}, 4 BERKELEY BUS. L.J. 1, 10 (2007).

Academic dismissal of the compensatory function contrasts sharply with the attitude of Congress and SEC, who have advanced compensation as a value in SEC enforcement actions since the inclusion in SOX of the Fair Fund provision that gives the SEC the authority to distribute civil penalties to fraud victims. With the exception of attorneys’ fees, the arguments against the compensation rationale apply equally to Fair Fund distributions, yet the amount of publicity that the agency generates for its distribution of Fair Funds reflects its judgment that compensation remains important to many investors. Should Congress and the SEC simply explain to investors that compensation is not a worthy goal of securities regulation?

Deterrence has been an equally important rationale for the securities fraud class action in recognition of the limited resources of the SEC and other regulators to enforce the securities laws. Indeed, the Court has more frequently identified deterrence than compensation as the rationale. Scholars debate how effectively securities fraud class actions deter corporate fraud. Some scholars worry about over-deterrence.

---

48 Black, Should the SEC Be A Collection Agency?, 63 BUS. LAW. at 341.

50 Cases cited in note 20.
52 See, e.g., Langevoort, Capping Damages, 38 ARIZ. L. REV. at 646 (describing OOP damages as “excessive and dysfunctional”), Alexander, Rethinking Damages, 48 STAN. L. REV. at 1496 (arguing that aggregate amount by which class members overpaid does not represent the true social cost of the violation).
Easterbrook and Professor Fischel were the first to articulate this concern. They build on the observation that, in every transaction where the stock price is inflated by fraud, there is a purchaser that suffered a loss and a corresponding seller who profited from the fraud. In the typical case, moreover, where the corporate defendant is not selling shares during the period of the fraud, the securities fraud does not increase the corporation’s assets, although corporations benefit in many real, if indirect, ways from an increased market capitalization. Thus, they argue, requiring the corporation to pay the total out-of-pocket (OOP) losses of the buyers makes the defendant pay for more harm that it caused; indeed, focusing solely on trading losses, the fraud has caused no damage. Significantly, Easterbrook and Fischel do not say that damages are zero; they recognize that there are other losses such as confidence in the trading markets.

Is it truly possible that fraud can be overdeterred? Rule 10b-5 claims require proof of scienter, and, since PSLRA, plaintiffs must “state with particularity facts giving rise to a strong inference that the defendant acted with [scienter]” to survive a motion to dismiss, and they must do so without the benefit of discovery. Indeed, Easterbrook and Fischel concluded that so long as liability was confined to truly egregious acts, OOP damages were acceptable. Later scholars doubt that liability is

---

54 Id. at 635. The assumption is that it would be both unfair and impracticable to require innocent sellers to disgorge their profits.
55 OOP losses is the standard measure of damages in securities fraud class actions. See Langevoort, Capping Damages, 39 ARIZ. L. REV. at 646.
57 Id. at 641.
60 Id. at (b)(3)(B). In addition, to plead scienter against a corporate defendant, plaintiff must raise a strong inference that someone whose intent can be imputed to the corporation acted with scienter. Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc., 531 F.3d 190 (2d Cir. 2008).
sufficiently limited\(^\text{62}\) and argue that less voluntary corporate disclosure, and other adverse effects, may be a consequence of securities fraud class actions.\(^\text{63}\)

I believe, however, that after PSLRA under-deterrence is a more serious concern than over-deterrence. PSLRA’s tightened pleading standards and bar on discovery prior to a motion to dismiss\(^\text{64}\) means that, combined with the short statute of limitations the Court legislated in *Lampf, Pleva, Lipkind, Prupius v. Gilbertson*\(^\text{65}\) and Congress only slightly expanded in SOX,\(^\text{66}\) plaintiffs’ attorneys may lack sufficient time to uncover sufficient evidence to persuade a court that fraud has occurred. Moreover, both supporters and detractors of the securities fraud class action agree that under the current system where the corporate defendant generally pays all of the settlement through insurance, and it is a rare case when individual defendants pay anything, there is insufficient deterrence for corporate managers and outside participants to refrain from committing securities fraud.\(^\text{67}\) Unfortunately, imposing personal liability on the perpetrators of the fraud, although it would enhance deterrence, is unlikely to become a common practice both for reasons of legal theory\(^\text{68}\) and expediency.\(^\text{69}\) Is the solution to

\(^{62}\) See, e.g., Langevoort, *Capping Damages*, 38 ARIZ. L. REV. at 644 (stating that scienter and materiality are too indeterminate), see also Alexander, *Rethinking Damages*, 48 STAN. L. REV. at 1489 (arguing that compensatory damages are not efficient deterrent because, among other reasons, there is too much uncertainty associated with the measure of damages).

\(^{63}\) See, e.g., Langevoort, *Capping Damages*, 38 ARIZ. L. REV. at 652-653.

\(^{64}\) See supra note 29 and accompanying text.


\(^{66}\) The limitations period is two years from discovery of fraud but not more than five years from the violation. 28 U.S. C. § 1658.

\(^{67}\) Coffee, *Reforming the Class Action*, 106 COLUM. L. REV. at 1566.


\(^{69}\) Coffee, *Reforming the Class Action*, 106 COLUM. L. REV. at 1566-1572 (describing the dynamics of settlement between plaintiffs’ counsel and the corporate defendant).
eliminate corporate liability? While some think yes,\textsuperscript{70} liability on non-corporate defendants should not be advocated as an alternative to corporate liability, but as a supplement.\textsuperscript{71} Otherwise, there is a great danger that no one will be held accountable for securities fraud.

In short, the securities fraud class action, while by no means perfect, is a reasonably effective system, particularly after the PSLRA reforms, that achieves both compensatory and deterrence goals.

Finally, some scholars also advance an argument based on fairness. They again emphasize that in most cases the securities fraud does not increase the corporation’s tangible assets. Accordingly, making the corporate defendant pay for harms from which it did not profit diminishes corporate assets and harms the current shareholders. (Again, advocates of this view tend to overstate the extent of the harm since most settlements are funded by insurance.) Shareholders who purchased shares before the class period\textsuperscript{72} thus bear the cost of the fraud perpetrated by the managers.\textsuperscript{73} As with some of the previous arguments, this argument against enterprise liability has broader applicability than the securities fraud class action.\textsuperscript{74}

\textsuperscript{70} As discussed infra notes 95-100 and accompanying text, this is the substance of Pritchard’s proposal; see also Fox, \textit{Mandatory Disclosure}, 109 COLUM. L. REV.

\textsuperscript{71} Coffee first says this, \textit{Reforming the Class Action}, 106 COLUM. L. REV. at 1566 (stating that “the radical reform of abolishing corporate liability for second market securities fraud seems an overly risky step” and then contradicts himself, 106 COLUM. L. REV. at 1582-1584 (proposing that the SEC exempt the non-trading corporate issuer from private liability for money damages under Rule 10b-5).

\textsuperscript{72} Coffee argues that these shareholders are likely to be retail investors pursuing a buy-and-hold strategy, including the company’s employees who invest through their 401(k) plans. Since they are less likely to have diversified portfolios, the losses occasioned by the fraud cause more harm to them. \textit{Reforming the Class Action}, 106 COLUM. L. REV. at 1559-1561.

\textsuperscript{73} See also Fox, \textit{Mandatory Disclosure}, 109 COLUM. L. REV. at \textsuperscript{ } (stating that current shareholders are victims of managers’ fraud). Some of the current shareholders may also be members of the plaintiff class, in which case this is, as discussed at notes 41-43 and accompanying text, “pocket-shifting.”

Professor Lawrence Mitchell traces the history of this concern for the “innocent shareholder” and demonstrates that it has been a “rallying cry …against corporate regulation.” He argues that the view of the “innocent shareholder” as a passive shareholder in need of protection is at odds with a model of shareholder activism that treats shareholders as important players in corporate governance reform. Professor Cox also points out that imposing on the shareholders the cost of managers’ misconduct is an accepted attribute of share ownership, as well as providing them with incentives to scrutinize the integrity of management in corporations in which they invest. Similarly, Professor Harvey Goldschmid argues that we want longterm shareholders to be concerned about the quality of management.

Professor John Coffee, in contrast, while he acknowledges that enterprise liability might enhance monitoring by the shareholders, believes that it “offends social norms” in this context. Tellingly, Professor Coffee apparently disagrees with himself on whether the corporation should continue to be a defendant. In the same article he asserts that “the radical reform of abolishing corporate liability for secondary market securities fraud seems an overly risky step” and then goes on to propose precisely that!

As the preceding discussion should make clear, the arguments for and against the federal securities fraud class action involve complexities and uncertainties that defy

76 There are, of course, arguments that, because of the “collective action” problem, shareholders are rationally apathetic.
77 Cox, Virtuous Class Actions, 39 ARIZ. L. REV. at 511.
80 Id. at 1566.
81 Id. at 1582-1584.
“quick and dirty” solutions. The future of the federal securities class action raises important policy questions that call for national debate. If, as many argue, compensation should not be recognized as a rationale for the securities fraud class action, what impact will that have on the confidence of the investor, so critical to the operation of an efficient and fair trading market?\(^8^2\) How do we square the dismissal of compensation as a rationale with the SEC’s recent authorization to distribute corporate penalties to compensate injured investors?\(^8^3\) If over-deterrence is a problem even after PSLRA, a less drastic solution may be to reduce the amount of liability.\(^8^4\) If the problem is insufficient deterrence on corporate managers, then the solution may be to impose more liability on managers in addition to the corporation. In assessing enterprise liability, how effective can shareholders be in monitoring the corporate managers against fraud, and how concerned should we be for passive shareholders?

We now turn to examine the two proposals that would allow shareholders to curtail or even eliminate the securities fraud class action.

II. The “Shareholders’ Rights” Proposals

A. The Arbitration Proposal. In late 2006–early 2007 three influential reports were issued addressing concerns about the declining prominence of the U.S. capital markets in the face of increasing competition from overseas markets.\(^8^5\) While the reports

---

\(^8^3\) See supra note 35.
\(^8^4\) Professor Langevoort previously called for caps on damages, *Capping Damages*, 39 Ariz. L. Rev. 639; Professor Alexander proposed a penalties-based approach, *Rethinking Damages*, 48 Stan. L. Rev. 1487.
identified many factors contributing to this perceived decline, each identified the costs of regulation and private enforcement of federal securities laws as significant anti-competitive factors. Two of them specifically recommended that corporations be permitted to amend their certificates of incorporation to require arbitration of securities fraud claims. They presented arbitration as an issue of shareholders’ rights: “shareholders should have the right to choose, particularly given the high cost to shareholders of litigation.” Further, “the [SEC] should not force shareholders to accept the costs that go with class action securities litigation, … where these shareholders choose to forego these rights.” It was widely reported that, in response to these proposals, the SEC planned to publish for public comment a proposal to permit arbitration. Then SEC-Chairman Christopher Cox denied that the agency was drafting such a proposal, and no such proposal was publicly released.

Neither report developed the substance or implementation of the recommendation in any depth. Their analysis of several critical issues is superficial. First, they express indifference as to whether plaintiffs could bring their federal securities claims as class action arbitrations or would be limited to individual arbitrations, although this indifference is likely disingenuous. Second, they assume that Section 29(a) of the Exchange Act presents no obstacle to shareholders’ waiving their right to bring their

---

87 Interim Report at 18; Bloomberg-Schumer Report at 103.
88 Interim Report at 109-110. For an exchange of views on the SEC’s refusal to allow acceleration of a registration statement because it contained a charter provision mandating arbitration of shareholder claims, see Carl Schneider, Arbitration in Corporate Governance Documents: An Idea the SEC Refuses to Accelerate, 8 INSIGHTS 21 (May 1990)) and Thomas L. Riesenber, Arbitration and Corporate Governance: A Reply to Carl Schneider, 8 INSIGHTS 2 (Aug. 1990).
89 See supra note 7.
90 See infra note 141 and accompanying text.
Finally, they assert that notice of the arbitration provision is sufficient to bind subsequent purchasers.  

**B. The Proposal to Eliminate the Corporate Defendant.** Although not the first to make the proposal, Professor Coffee received much attention when he floated the idea of eliminating the corporate defendant in secondary market securities fraud class actions. He advocated that the SEC use its statutory exemptive authority to accomplish this change. Recently, Professor Adam Pritchard advanced a proposal that, although he phrases it in more technical terms (“partial waiver of the FOTM presumption”), would effectively accomplish the same result. Because he does not believe that the SEC (or Congress or the Court) would take this action, Professor Pritchard proposes a self-help measure. Asserting that Basic’s recognition of the FOTM presumption is the problem, he argues that shareholders can “fix” the problem themselves through amending the certificate of incorporation to specify disgorgement as the measure of damages if plaintiffs invoke the FOTM presumption. In his view, disgorgement is the appropriate measure of damages in FOTM cases since deterrence is the principal justification for allowing securities fraud class actions. As a result, in the typical secondary market case, defendants would be limited to corporate managers who participated in the fraud and who received a direct financial gain from the fraud, as by selling their shares at the inflated price. Only investors that could establish their own reliance on the fraudulent

---

91 Interim Report at 110 (asserting there is “little chance” that securities law claims involving the corporate issuer would be held to be beyond arbitration).
92 Interim Report at 110-11 (notice in corporation’s SEC filings and on its website); Bloomberg-Schumer at 103 (notice provided by broker-dealers).
93 See supra note 79-81 and accompanying text.
94 Coffee, Reforming Class Actions, 106 COLUM. L. REV. at 1584.
96 Id. at 255.
97 Id. at 249
misstatements would be able to bring individual actions against the corporation and recover OOP damages; presumably only a few institutional investors would be able to establish reliance and would have a sufficiently large investment to make maintaining their own actions financially feasible. 98

Professor Pritchard provides a more extended analysis of the legal issues than do the proponents of the arbitration proposal. Like them, Professor Pritchard asserts that §29(a) of the Exchange Act does not prohibit shareholders from waiving the FOTM presumption 99 and that notice of the waiver is sufficient to bind subsequent purchasers. 100

Contrary to the assertions of the proponents of both proposals, I argue (in Part III) that § 29(a) of the Exchange Act makes both proposals impermissible under federal securities law. I make (in Part IV) three arguments based on state law. First, although the proponents of both proposals apparently did not recognize this, these certificate provisions are not permitted under state corporate law because they are “inconsistent” with law. Second, these proposals are unfair to current shareholders that do not vote in favor of the proposals. Third, these proposals are unenforceable as to subsequent stock purchasers.

III. Section 29(a) of the Exchange Act (the Anti-Waiver Clause)

This Part first addresses the legislative history and case law interpreting § 29(a) as background. It then addresses specific objections under § 29(a) relating to the arbitration proposal and the proposal to eliminate the corporate defendant and concludes that neither proposal is permissible.

98 Pritchard would allow institutional investors to recover OOP damages if they could prove actual reliance, id. at 250, even though, under his theory, they would be overcompensated if they have diversified portfolios. Id. at 224.
99 Id. at 252-254.
100 Id. at 252.
Section 29(a) of the Exchange Act states that “any condition, stipulation, or provision binding any person to waive compliance with any provision of this Act or of any rule or regulation thereunder …shall be void.” In 1934 Congress took this section verbatim from Section 14 of the Securities Act of 1933 (the Securities Act), which in turn was derived from Section 10(5) of Great Britain’s The Companies Act. The legislative history is scant, but this is not surprising. Congress drafted the provision broadly and plainly and must have thought it required no explanation. The investor protections afforded by the statute and its rules are so important that Congress would not permit parties to negotiate deals that weakened the statutory framework. While the Congressional purpose may have been at least partly protective, reflecting a concern that the more sophisticated party might persuade the less sophisticated party to give up his rights, Congress also must have been concerned about the national interest and the importance of federal regulation for the overall fairness and effectiveness of the securities market -- the fundamental purpose of the Exchange Act.

Wilko v. Swan, Shearson/American Express v. McMahon, and Rodriguez de Quijas v. Shearson/American Express are the only Supreme Court opinions that analyze the anti-waiver provisions in any depth. In these cases the Court considered

---

whether a provision in a customer’s brokerage agreement that required arbitration of all disputes was unenforceable with respect to federal securities claims because of the anti-waiver provision. In *Wilko* the Court held that “as the protective provisions of the Securities Act require the exercise of judicial direction to fairly assure their effectiveness, it seems to us that Congress must have intended § 14 to apply to waiver of judicial trial and review.” Over thirty years later, however, in *McMahon*, the Court changed its mind. In doing so, the Court’s statutory analysis focuses initially on the language and states that what the statute prohibits is waivers of the statute’s “substantive obligations,” which does not include the provision conferring exclusive jurisdiction over Exchange Act claims on the district courts. The Court, however, goes beyond this cramped reading and identifies the statute’s central purpose: “§ 29(a) is concerned with whether the agreement ‘weakens [customers’] ability to recover under the Exchange Act.’” The balance of the opinion and *Rodriguez* make clear that this is the judicial concern. After examining the current state of securities arbitration, the Court concludes that, contrary to the *Wilko*’s “mistrust of arbitration,” the process adequately vindicates customers’ rights, principally because of SEC oversight over the SRO arbitration forums.

In the 1990s several circuit courts had occasion to consider the applicability of § 29(a) to contracts to provide underwriting capital entered into between Lloyd’s of

---

108 346 U.S. at 437.
109 Since *McMahon* involved § 29(a), the technical overruling did not occur until *Rodriguez*, 490 U.S. 477 (1989).
110 482 U.S. at 228.
111 *Id.* at 230 (quoting from *Wilko*).
113 *Id.* at 233.
114 *Id.* at 238; *Rodriguez*, 490 U.S. at 483.
London and U.S. residents. According to the plaintiffs, Lloyd’s solicited U.S. investors to raise capital and concealed the underwriting risks and massive liabilities relating to asbestos litigation. The contracts specified English choice of law and an English forum for investors’ claims, and Lloyd’s insisted that execution of the contracts take place on British soil. While the choice-of-forum clause would likely pass muster under *McMahon* and *Scherk v. Alberto-Culver Co.*, the statute prohibits a clause mandating application of English law, because such a clause is a “provision binding any person to waive compliance with any provision of [the] Act.” The circuit courts, however, uniformly upheld both the choice of law and choice of forum clauses on the ground that these were international transactions among sophisticated investors. The opinions emphasized the importance of certainty and predictability in international transactions and respect for international law and worried that banning use of these clauses in international contracts would be an over-extension of U.S. securities laws -- policy concerns more properly left to Congress. Importantly, however, the courts recognized that the available English remedies must be “adequate substitutes” for federal securities laws. Thus, while these opinions carve out a questionable exception for international securities contracts among sophisticated investors, they do not detract from

---

115 Richards v. Lloyd’s of London, 135 F.3d 1289 (9th Cir. 1998) (en banc) (8-3); Lipcon v. Underwriters at Lloyds, London, 148 F.3d 1285 (11th Cir. 1998) (recognizing it is a “close question,” but following the “weight of circuit authority”); Roby v. Corp. of Lloyd’s, 996 F.2d 1353 (2d Cir. 1993); Bonny v. Society of Lloyd’s, 3 F.3d 156 (7th Cir. 1993).

116 See supra note 109-114 and accompanying text.


118 See the dissenting opinion in *Richards*, 135 F.3d at 1297.

119 *Lipcon* emphasized the narrowness of its holding by noting that international agreements were “sui generis,” 148 F.3d at 1293. Similarly, *Richards* emphasized the importance of certainty and predictability in international agreements, 135 F.3d at 1293.

120 *Lipcon*, 148 F.3d at 1294-95, *Richards*, 135 F.3d at 1293.

121 *Id.* at 1296, Stamm v. Barclays Bank of New York, 153 F.3d 30, 33 (2d Cir. 1998).
the *McMahon* principle that §29(a) forbids agreements that weaken investors’ protections under federal securities (or equivalent) laws.

Finally, it is well established that §29(a) does not permit provisions that weaken investors’ ability to recover under the federal securities laws, no matter what form they take: “no-reliance” clauses in stock purchase agreements,122 “no-action” clauses in indentures,123 clauses that provide for an alternative remedy,124 and clauses that specify indemnification as the sole remedy.125 The only situation where some courts have enforced no reliance clauses is in negotiated contracts among sophisticated investors or corporate insiders where the written agreement contains specific representations and the no reliance clause serves the purpose of barring representations not contained in the agreement.126 While the judiciary’s creation of a parole evidence rule exception to §29(a) is questionable, it is of limited scope.127

A. The Arbitration Proposal. Some commentators, like the proponents of this proposal, have mistakenly assumed that *McMahon*128 answers in the affirmative the question of whether §29(a) permits contracts requiring arbitration of federal securities

---

127 *Harsco*, 91 F.3d at 343 (recognizing that plaintiff’s remedies were weakened, but emphasizing that this was a detailed written agreement negotiated among sophisticated parties). *Harsco* was distinguished in MBI Acquisition Partners, L.P. v. Chronicle Publishing Co., 2001 WL 1478812 (W.D. Wisc. Sept. 6, 2001) (distinguishing *Harsco* because plaintiffs alleged that they attempted to confirm truth of agreement’s representations, but were “duped” by false answers).
128 See supra notes 109-114 and accompanying text.
fraud claims against the issuer. As an initial matter, section 2 of the Federal Arbitration Act (FAA) requires an agreement to arbitrate. In the customer/broker setting, there is privity of contract in the most traditional contract sense, because brokerage firms require customers to sign brokerage agreements that contain an arbitration clause. In contrast, there is no privity of contract between the issuer and the purchaser of its stock in the secondary market, and it is doubtful that a certificate of incorporation containing an arbitration provision is the required arbitration agreement for purposes of FAA § 2. We defer this discussion, however, to Part IV and assume there is a contract for purposes of the § 29(a) analysis.

Apart from the issue of privity, customer/broker claims are fundamentally different from purchaser/issuer claims. A customer’s dispute with his broker is a private dispute focusing on the individual broker’s alleged failure to live up to his duties owed to the individual customer, usually under state securities or common law, but occasionally under federal securities law as well. Moreover, the customer generally possesses much of the information necessary to present his claim, both in his account statements and in the broker’s statements (both written and oral) made to the customer. Whatever additional information the customer needs can be obtained from the broker through a

---

129 See John C. Coffee, Jr., Arbitration and Corporate Governance, 90 N.Y.L.J. 5 (col. 1) (May 31, 1990) (stating that the argument distinguishing McMahon and Rodriguez as limited to broker-dealer disputes “approaches the frivolous”).


131 For development of the issues discussed in this paragraph, see Barbara Black & Jill I. Gross, Making It Up As They Go Along: The Role of Law in Securities Arbitration, 23 CARDOZO L. REV. 991 (2002) (“Making It Up”).
relatively uncomplicated discovery process. In this setting, the traditional advantages of arbitration – lower cost, greater speed, informality, and confidentiality – may offer significant value to the participants. In contrast, securities fraud class actions allege a fraud on the marketplace, a matter of national significance that preempts state claims arising from the same set of facts. The purchaser is not likely to possess the necessary information to establish a securities fraud claim. Instead, there is need for a wide-ranging discovery process to balance the purchaser’s need for information with the issuer’s need for protection from an abusive “fishing expedition.”

Finally, the McMahon court upheld the arbitration agreement in the customer-broker setting principally because it had assurance that the customer’s rights would be adequately protected; customer-broker claims are generally arbitrated in SRO forums whose procedural rules must be approved by the SEC upon a finding that they are protective of investors. In contrast, purchaser/issuer claims would be arbitrated before one of the commercial arbitration forums where the SEC has no power or influence over the adequacy or fairness of its procedures.

In short, the traditional advantages of arbitration have little applicability to purchaser/issuer claims. To the contrary, there is a need for formality and transparency in order to meet the goals of the participants and the national interest. Adjudications, unlike arbitrations, fulfill functions of deterrence and development of legal standards and satisfy investors’ right to know the laws are being enforced.

---

132 See supra note 3 and accompanying text.
133 FINRA, for example, does not permit class arbitrations because they are incompatible with the virtue of arbitration as a relatively quick and inexpensive dispute resolution process. FINRA Customer Code Rule 12204(a).
proc edural advantages under PSLRA that Congress constructed for defendants, in order to achieve the twin goals “to curb frivolous lawyer-driven litigation while preserving investors’ ability to recover on meritorious claims,” are not readily transferable to the arbitration forum. Finally, arbitration cures none of the deficiencies in the class action about which its critics complain.

Do these significant distinctions between customer/broker and purchaser/issuer claims mean that the Court would not apply *McMahon* in the latter setting? Although securities fraud class arbitration is the antithesis of the fast, simple and inexpensive alternative to litigation that arbitration was originally intended to provide, it is unlikely that courts would preclude securities fraud class arbitrations because of the complexity of the claims. The Court, with its pro-arbitration policy and zeal to remove cases from the federal dockets, consistently rejects objections that federal statutory claims involving questions of national importance are not suitable for arbitration. Similarly, the arguments that Congress legislated specific judicial procedures for securities fraud actions or that *McMahon* should be limited to claims filed in an SRO forum are unlikely to persuade courts that the purchaser/issuer claims cannot be brought in arbitration. *If there is an agreement to arbitrate,* the Court’s approach is to enforce it; it is indifferent

---

135 *Tellabs*, 127 St. Ct. at 2509.
136 See supra note 134.
137 See JLM Industries, Inc. v. Stolt-Nielsen SA, 387 F.3d 163, 181(2d Cir. 2004) (rejecting argument that antitrust claims were beyond the capabilities of an arbitral panel). But see In re American Express Merchants Litig., 554 F.3d 300, 310 & n. 7 (2d Cir. 2009) (observing that the argument that class arbitrations are incompatible with the FAA was “intriguing”).
140 Just a reminder that we have not answered this question yet.
if the parties select the less-optimal forum. Accordingly, as to the broad question as to whether § 29(a) bars agreements to arbitrate federal securities claims against issuers, the answer may be no, not necessarily.

The analysis of the § 29(a) issue, however, does not end here. Despite the proponents’ professed agnosticism on the class arbitration issue, I suspect that defeating class actions is a primary motivating factor in the arbitration proposal. PSLRA’s legal procedures are so advantageous to defendants that it is bizarre that defendants would prefer arbitration where legal requirements may not be so strictly enforced unless their objective is to eliminate class proceedings. A waiver of class arbitration would be a significant advantage for corporate defendants because if investors could not aggregate their claims, few investors would suffer losses of sufficient magnitude to make arbitration cost-effective. The waiver of class arbitration, by seriously weakening investors’ ability to recover, would make the corporate defendant nearly impervious to fraud liability. Thus, the proponents’ professed indifference to this question appears disingenuous. If my suspicions are correct, the issue under § 29(a) can be more precisely framed as whether a contractual waiver of class arbitration would be enforceable.

Today many sellers of products and services include arbitration provisions that preclude class arbitrations, plaintiffs have challenged these bans on collective action under a number of theories, and “the wisdom and utility of these provisions have become the subject of intense debate.” Discover Bank v. Superior Court held that at least

141 Johnson & Brunet, Critiquing Arbitration, 36 SEC. REG. L.J. at (stating that the procedural protections against vexatious lawsuits would not apply in arbitration).
143 In re American Express Merchants’ Litig., 554 F.3d 300, 303 (2d Cir. 2009).
144 113 P.3d 1100 (Cal. 2005).
some waivers of class arbitration in consumer contracts were unconscionable under California law. The court emphasized, first, that the class action waiver was contained in an adhesive contract; specifically, the credit card company imposed the term on consumers “as an amendment to its cardholder agreement in the form of a ‘bill-stuffer’ that he would be deemed to accept if he did not close his account.”145 Second, the term was the equivalent of an exculpatory clause that was contrary to public policy,146 particularly given the “important role of class action remedies”147 in deterring and providing compensation for consumer fraud. Discover Bank, however, is an opinion with limited utility. On remand, the lower court did not, in fact, apply California law, but Delaware law, under which the class action waiver was legal. The California approach is a minority position; other courts have disagreed with its analysis.148 Finally, shortly after Discover Bank, the Court held, in Buckeye Cash Checking, Inc. v. Cardegna,149 that arbitrators, and not courts, decide whether an entire contract containing an arbitration clause is void as an illegal contract. While Discover Bank is distinguishable because the challenge there was to the arbitration clause itself,150 lower courts, following the Court’s pro-arbitration policy, may extend Buckeye’s holding.151

Green Tree Financial Corp. v. Randolph152 provides a basis for challenging class action waivers under the FAA. In that case, the Court stated that “it may well be that the

145 Id. at 1108.
146 Id.
147 Id. at 1106.
148 For a compilation of cases rejecting the unconscionability analysis, see Gilles, Opting Out, 104 U. MICH. L. REV. at 400 & n. 139.
151 See Awuah v. Coverall North America, Inc., 554 F.3d 7 (1st Cir. 2009) (expressing uncertainty, after Buckeye, as to whether judge or arbitrator decides the validity of an arbitration clause where the arbitration rules incorporated in the contract say the arbitrator decides the issue).
existence of large arbitration costs could preclude a litigant … from effectively vindicating her federal statutory rights in the arbitral forum.” Subsequent courts have acknowledged that excessive costs can make the arbitration remedy, in fact, illusory and prevent plaintiffs from vindicating their rights, so that arbitration is no longer “a valid alternative to traditional litigation.” In *In re American Express Merchants’ Litigation*, the Second Circuit held that, in the context of the particular dispute before the court, the class action waiver clause was unenforceable because it would effectively preclude individual plaintiffs from vindicating their statutory rights under federal antitrust law. Plaintiffs were able to prevail because of a financial consulting firm’s affidavit that estimated the cost of an expert study concerning the liability and damages relating to the antitrust tie-in claim and compared it with the potential recovery by an individual plaintiff. The economist concluded that “it would not be worthwhile” for a plaintiff to pursue an individual claim in light of these high costs and the small amount of individual damages. Accordingly, the court agreed with plaintiffs that the class action waiver “flatly ensures that no small merchant may challenge American Express’s tying arrangements under the federal antitrust laws,” a troubling outcome because “private suits provide a significant supplement to the limited resources available to the Department of Justice for enforcing the antitrust laws and deterring violations.”

---

153 *Id.* at 90.
155 554 F.3d 300 (2d Cir. 2009).
156 Because plaintiffs were willing to proceed with a class arbitration, the case does not address whether class arbitrations are ever incompatible with the FAA.
157 *Id.* at 317. Even the Clayton Act’s trebling of damages would not make individual claims financially feasible. *Id.* at 317-318.
158 *Id.* at 319.
159 *Id.*
In the context of securities fraud class arbitration, the Second Circuit’s analysis in *In Re American Express Merchants’ Litigation* is even more compelling because of § 29(a). The costs of proving a federal securities fraud claim in arbitration – including falsity, materiality, efficient market, scienter, causation and OOP damages160 -- would be so large as to make pursuing an individual claim infeasible except possibly for large investors that have suffered significant losses. Accordingly, unless the claims could be brought as class arbitrations, there is, as a practical matter, no remedy for investors with small holdings. A class action waiver in this context is the equivalent of a waiver of investor protections prohibited by § 29(a).

**B. The Proposal to Eliminate the Corporate Defendant.** Recall that Professor Pritchard’s proposal limits recovery to disgorgement if plaintiffs invoke the FOTM presumption of reliance in securities fraud class actions.161 His proposal is not only, as he labels it, a partial waiver of the FOTM presumption of reliance that limit plaintiffs’ recovery, but also operates to eliminate the corporate defendant in most instances. There can be no doubt that this waiver of reliance is impermissible under Section 29(a). As the earlier discussion explains, both the Securities and Exchange Acts, from their initial enactment, have forbidden private parties to adopt measures that weaken investors’ protections, especially their ability to recover damages, under the federal statutory framework.162 There is no ambiguity or uncertainty in the statutory language, and courts have consistently struck down no-reliance clauses in securities contracts163 as violative of § 29(a). Congress made the decision that the statutory protections are so important to

160 *Dura*, 544 U.S. at 341, sets forth the elements.
161 See supra note 96-97 and accompanying text.
162 See supra 101-127 and accompanying text.
163 See supra notes 122-125 and accompanying text.
individual investors and the marketplace as a whole that there is no place for “self-help” measures that curtail the statutory remedies.

Professor Pritchard offers two arguments as to why § 29(a) should not render his partial waiver of the FOTM presumption proposal unenforceable. Both are unconvincing. First, he argues that his proposal does not excuse compliance with the anti-fraud provision, but merely alters the remedy.\(^\text{164}\) This argument is disingenuous; the purpose and effect of his proposal are to eliminate, in most cases, the principal defendant in securities fraud class actions and the only defendant likely to be able to pay substantial damages. Moreover, even as to other defendants, his proposal limits recovery to disgorgement of gains, an amount that may, in many cases, be insufficient to make bringing these cases worthwhile. As discussed earlier, waivers of class actions should be impermissible under § 29(a) because the costs of bringing securities fraud actions make claims brought by small investors financially infeasible.\(^\text{165}\) Similarly, in instances where plaintiffs cannot establish that individual defendants directly benefited from their fraud, the likely recovery may not be large enough to make pursuing the remedy cost effective. As a result, the practical effect will be to excuse compliance with the antifraud provisions. Perpetrators of securities fraud should not have a free pass because, although they may have caused considerable losses to investors, they themselves did not receive much direct benefit from their fraud.

Second, Professor Pritchard argues that his proposal does not violate § 29(a) because the FOTM presumption of reliance is merely a “procedural device, created by the


\(^{165}\) See * supra* note 152-160 and accompanying text.
courts, not Congress.”\textsuperscript{166} The case law establishes that waivers of reliance present precisely the kind of danger that concerned Congress when it initially enacted the statute.\textsuperscript{167} Finally, Professor Pritchard’s dismissive treatment of the FOTM presumption ignores the fact that Congress itself recognized the FOTM presumption and its importance when it reformed the securities fraud class action in PSLRA.\textsuperscript{168}

This Part III demonstrates that both “self-help” proposals violate § 29(a) and thus are impermissible as a matter of federal securities law. Part IV explains why these proposals are also impermissible under state law.

IV. Legality, Fairness and Enforceability under State Law

A. Legality. Proponents of these proposals assume that state law permits inclusion of these provisions in a corporation’s certificate of incorporation. However, while modern corporation statutes allow great flexibility and private ordering, the discretion of corporate managers and shareholders to modify the corporation to include any provision that might serve their needs is not unlimited.\textsuperscript{169} A corporation’s certificate of incorporation may contain provisions that limit the stockholders’ powers only so long as they are “not inconsistent” with law.\textsuperscript{170} As stated by the Delaware Supreme Court, the “broad powers conferred by [the statute] do not authorize the stockholders to contract with each other or with the corporation to achieve a result forbidden by settled rules of public policy.”\textsuperscript{171} Thus, for example, courts have invalidated charter provisions that gave

\textsuperscript{166} Pritchard, Political Economy, 2007-2008 CATO S. CT. REV. at 253-54.
\textsuperscript{167} See supra note 122-125 and accompanying text.
\textsuperscript{168} See supra note 26-30 and accompanying text.
\textsuperscript{169} For example, would anyone seriously argue that a charter provision could prohibit a shareholder from owning stock in a competitor?
\textsuperscript{170} MBCA § 2.02(b)(2)(iii); see also Del. § 102(b)(1) (“not contrary to the laws of this State”). “All optional provisions must be lawful and cannot be contrary to public policy,” Fletcher CORPORATIONS § 150, p. 234.
\textsuperscript{171} Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 118 (Del. 1952).
the board of directors the power to deny a stockholder the right to examine books and records,\textsuperscript{172} that conferred lifetime appointments on directors and officers,\textsuperscript{173} and that permitted a majority of shares to ratify the issuance of stock options without consideration.\textsuperscript{174} The Delaware Supreme Court recognized the necessarily amorphous quality of this standard,\textsuperscript{175} but rather than attempt a definition of “public policy,” it explained that charter provisions could not “transgress a statutory enactment or a public policy settled by the common law or implicit in the General Corporation Law itself.”\textsuperscript{176} While none of the reported cases involves a clash between a federal statute and a charter provision,\textsuperscript{177} there is nothing in the Delaware opinions to suggest that considerations of public policy are limited to state law, as Professor Pritchard believes.\textsuperscript{178} Indeed, under preemption principles, charter provisions that violate the anti-waiver clause of the federal securities laws must be violative of public policy and impermissible under state law.

B. Fairness. Even if the charter provisions were legal under state law, there is a serious question of fairness about taking away rights from current shareholders that do not assent to the provision. If the managers and controlling shareholders include such a provision in the corporate charter prior to the company’s initial public offering, it is likely that all current shareholders have agreed to the provision.\textsuperscript{179} With respect to established

\textsuperscript{172}State ex rel. Cochran v. Penn-Beaver Oil Co., 143 A. 257 (Del. 1926)
\textsuperscript{174}Frankel v. Donovan, 120 A.2d 311 (Del. Ch. 1956).
\textsuperscript{175}93 A.2d at 118 (“the limits of ‘public policy’ are ill-defined and changing”).
\textsuperscript{176}Id. For a recent example following \textit{Sterling}, see Jones Apparel Group, Inc. v. Maxwell Shoe Co., 883 A.2d 837 (Del. Ch. 2004) (upholding a charter provision that established the record date for consent solicitations).
\textsuperscript{177}While \textit{Maxwell Shoe} states that a charter provision should be set aside only for transgressions of “a mandatory rule of our corporate code or common law,” 883 A.2d at 846, the analysis should be equally applicable to transgressions of a preemptive federal statute.
\textsuperscript{179}Coffee distinguishes between initial and midstream changes in corporate governance rules. \textit{No Exit?}, 53 BROOK. L. REV. at 924.
public corporations, however, proponents assume that both proposals can be adopted through amendment of the certificate of incorporate by majority vote. ¹⁸⁰ What about current shareholders that do not vote in favor of the amendment? Can their rights to bring federal securities class actions be substantially restricted without their assent? If they object to giving up their rights, are they relegated to selling their shares in the open market, perhaps at a reduced price reflecting the diminishment of their rights?¹⁸¹

It is true that modern corporate law, with its emphasis on flexibility and adaptability to change, allows substantial alteration, even elimination, of shareholder rights without their consent, as exemplified by the demise of the “vested rights” doctrine.¹⁸² However, the power of the shareholders holding a majority of the vote to alter corporate governance and stock ownership rules is not absolute. Thus, for example, majority shareholders will not be able to adopt a provision that eliminates the board of directors,¹⁸³ because minority shareholders cannot be deprived of the protections afforded by a board of directors with fiduciary responsibilities to the corporation.

Some legislatures recognize the harshness that results from the flexibility afforded by modern corporate law and grant appraisal rights to shareholders whose rights are

¹⁸⁰ It may be a majority of the outstanding shares, see DEL. CORP. CODE § 242(b)(1), or as few shares as a majority of a majority of shares, see MODEL BUS. CORP. ACT. § 10.03(e), depending on state law requirements.
¹⁸¹ Proponents will argue that it is more likely that share prices will go up, reflecting the savings achieved through limiting litigation. How the market will react is a matter of speculation, but at least for the first corporations that adopt one of these provisions we might expect a price decline reflecting market uncertainty because of the novelty.
¹⁸² See BARBARA BLACK, CORPORATE DIVIDENDS AND STOCK REPURCHASES § 5:4 ((reviewing demise of “vested rights” doctrine relating to defeasance of shareholders’ preferential rights).
¹⁸³ In Delaware a statutorily defined “close corporation” may provide for management by the shareholders if all the incorporators or shareholders agree to it and notice of the provision is conspicuously noted on the stock certificates. DEL. CORP. CODE § 351. MODEL BUS. CORP. ACT. § 7.32 is a similar provision; the agreement ceases to be effective when the corporation becomes public.
adversely affected by changes they vote against.\textsuperscript{184} In addition, courts may provide protection on fairness or fiduciary duty grounds,\textsuperscript{185} particularly where the alteration is not a “plain-vanilla” corporate governance provision, but goes to personal attributes of stock ownership.\textsuperscript{186}

The proponents have not satisfactorily addressed this fairness issue. One proponent of the arbitration proposal, at least, recognized that the rights of dissenting shareholders need to be addressed;\textsuperscript{187} another proponent of arbitration suggests an unworkable solution of prospective application.\textsuperscript{188} Professor Pritchard does not address the impact of the proposal to eliminate the corporate defendant on current shareholders. Fairness requires that, \textit{at a minimum}, current shareholders should have appraisal rights if they do not vote in favor of these two proposals.

\textbf{C. Enforceability.} Assuming that these charter provisions are legal and current shareholders that vote against the provision are treated fairly, is either provision enforceable as to subsequent stock owners? Proponents assert that notice on the corporate website and in its SEC filings is sufficient to bind future shareholders.\textsuperscript{189} This is, however, a questionable assertion under both contract and corporate law. The following discussion focuses first on the arbitration proposal and the requirement of an agreement under the Federal Arbitration Act (FAA). It then addresses the proposal to

\begin{footnotesize}
\textsuperscript{184} See, \textit{e.g.}, \textsc{New York Bus. Corp. Law} § 806(b)(6) (providing appraisal rights to shares adversely affected by certain charter amendments).
\textsuperscript{185} See, \textit{e.g.}, \textit{Dental v. Fidelity Sav. & Loan Ass’n}, 539 P.2d 649 (Ore. 1975) (recognizing that even with decline of vested rights, courts have not held that shareholders can lose all rights).
\textsuperscript{186} See \textit{Black v. Glass}, 438 So.2d 1359 (Ala. 1983) (striking down a bylaw that did not simply regulate the conduct of internal affairs, but instead allocated property rights among shareholders).
\textsuperscript{187} \textsuperscript{Bloomberg-Schumer Report at 103.}
\textsuperscript{188} Moscow, \textit{Arbitration Bylaws}, 20 INSIGHTS at 9.
\end{footnotesize}
eliminate the corporate defendant under corporate law. Finally, the issue of notice is specifically addressed.

The Arbitration Proposal. The Congressional purpose in enacting the FAA was to remove the anti-arbitration bias in federal courts. Accordingly, FAA § 2 states that arbitration agreements are enforceable to the same extent as other contracts. Over the years, the Court has transformed the FAA into an expression of “pro-arbitration” policy, but, even so, by definition, an arbitration agreement between the corporation and all its current and future shareholders is required. Is the corporate charter containing an arbitration provision a contract for purposes of FAA § 2?

Corporate law theory does repeatedly refer to the corporate charter as a contract among the corporation and its shareholders. Indeed, many corporate law scholars view the corporation as nothing more than a variety of contractual relationships between the various stakeholders. For these scholars, the question of whether the certificate of incorporation is a contract for purposes of FAA § 2 is easily answered in the affirmative. A corporate law metaphor, however, does not make the certificate of incorporation the equivalent of the commercial contract contemplated by the FAA, and the demise of the “vested rights” doctrine established that contract law principles are not grafted onto corporate law with full force and effect.

190 See Jean R. Sternlight, Panacea or Corporate Tool?: Debunking the Supreme Court’s Preference for Arbitration, 74 WASH. U. L.Q. 637, 660-662 (1996) (explaining how the Court created the myth of favoritism for arbitration) (“Panacea or Corporate Tool?”).
193 Shell, Arbitration and Corporate Governance, 67 N.C.L. REV. at 543 & n. 172 (citing sources).
194 “[The firm] is simply a legal fiction that encompasses a set of contractual relations.” STEPHEN BAINBRIDGE, CORPORATION LAW AND ECONOMICS § 1.5 at 26 (2002)
195 See Shell, Arbitration and Corporate Governance, 67 N.C. L. REV. at 543 & n. 170 (reviewing the legislative history).
196 See supra note 182 and accompanying text.
Arbitration of shareholders’ disputes in closely held corporations has long been generally accepted,197 but in those instances the arbitration clause is typically found in an actual agreement entered into by all the shareholders;198 it is rare to find the arbitration provision solely in the certificate of incorporation.199 To extend the concept of an agreement under FAA § 2 to include the certificate of incorporation of a corporation with a small number of shareholders, all of whom are actively engaged in the business, does not stretch the definition of a commercial contract very far, and it would not be objectionable if a court did so. In the context of public corporations, however, treating the certificate of incorporation as an actual contract among all current and future shareholders is pressing the metaphor too far.

Professor G. Richard Shell, in his careful examination of the legality of arbitration clauses in the context of shareholders’ derivative actions,200 thought a better analogy is found in cases where members of an association, such as a stock exchange,201 are bound by an arbitration clause in the association’s governing documents which serve as a constitution.202 However, as Shell acknowledges, consent to the terms contained in the association’s governing document is more naturally implied where the participants are members of a common trade or profession and the document sets forth norms that the members agree to abide by. In contrast, shareholders in publicly held corporations “share

---

198 Id. at 528 & n. 80.
199 Id. Shell found no case in which the arbitration clause was solely in the certificate of incorporation, nor have I found a case subsequently.
200 Shell, Arbitration and Corporate Governance, 67 N.C.L. REV. 528 (1989). It should be noted that the arguments in favor of arbitration in shareholders’ derivative actions are stronger than in securities fraud class actions, since in the former plaintiffs must be shareholders at the time of bringing the suit and the complaint is based on a breach of fiduciary duty owed to the corporation and its shareholders, while in the latter plaintiffs need only be purchasers or sellers during the period that the fraud tainted the stock price and the fraud is inflicted on the traders in the market. (Ralph Ferrara’s Treatise makes this point)
202 Shell, Arbitration and Corporate Governance, 67 N.C.L. REV at 546-547.
no common ground other than their investment preference." Accordingly, the presence of an arbitration provision in the certificate of incorporation alone does not constitute an “arbitration agreement” for purposes of FAA § 2.

The Proposal to Eliminate the Corporate Defendant. As discussed earlier, unlike contract law, which requires a party’s assent to be bound to the terms, modern corporate law promotes flexibility and adaptability by permitting most changes to corporate governance rules, and even changes in the attributes of stock ownership, by less than unanimous consent of the current shareholders. In addition, the changes are binding on subsequent purchasers; the cases routinely state that purchasers of stock take with notice of the contents of the certificate of incorporation. Although his discussion on this point is abbreviated, Professor Pritchard appears to rely on this principle.

The power of the current majority to bind all subsequent holders, however, has its limits; some alterations require the consent of, or at least notice to, subsequent shareholders to bind them. Courts are generally more likely to see the value of flexibility in alterations in corporate governance provisions and more protective of subsequent shareholders in alterations to personal attributes of stock ownership. Accordingly, corporate governance provisions affecting the allocation of powers among the corporation’s board of directors, officers and shareholders are the types of provisions

---

203 Id. at 547.
204 See supra note 169 and accompanying text.
206 See Pritchard, Political Economy, 2007-2008 CATO S. Ct. L. Rev. at 252 & n. 126 (citing In re Appraisal of Ford Holdings, Inc. Preferred Stock, 698 A.2d 973 (Del. Ch. 1977), where the court enforced a provision in the certificate of incorporation stipulating the fair value of preferred stock in an appraisal proceeding, even though there was no evidence that the current holders agreed to the provision or even knew of it).
207 We recognize that the distinction is a blurred one – e.g., dividend arrearages on preferred shares that fueled the “vested rights” debate. See supra note 182 and accompanying text.
where, in most instances, changes will bind future shareholders who do not have notice of the change. Bylaw amendments requiring a majority vote to elect directors in uncontested elections\textsuperscript{208} or limiting the term of any director who receives more votes against than for his election\textsuperscript{209} are popular recent examples of alterations of corporate governance rules that will bind all shareholders when adopted by the requisite percentage of shareholder votes. More generally, supermajority voting requirements for both board and shareholder action can be adopted by less than unanimous vote and are binding on all current and future shareholders.\textsuperscript{210}

However, the power of the shareholders holding a majority of the vote to bind subsequent holders to corporate governance rules is not unlimited. Some changes so fundamentally alter the corporate governance structure as to require special protections for subsequent shareholders. As discussed previously, an example is a provision that eliminates the board of directors and replaces it with management by the shareholders.\textsuperscript{211} This provision requires not only the unanimous approval of the current shareholders, but also conspicuous notice on the stock certificate to bind all future shareholders. In addition, only non-public corporations can adopt this radical change, in recognition of the fact that a corporation whose corporate governance structure lies so far outside the customary norm may mislead subsequent shareholders and a notice requirement is not sufficient warning.

\textsuperscript{208} \textit{Del. Corp. Code} § 216.
\textsuperscript{209} \textit{Model Bus. Corp. Act.} § 10.22
\textsuperscript{210} \textit{Del. Corp. Code} §§ 216 (Shareholder quorum and vote), 141(b) (Board quorum and vote); \textit{Model Bus. Corp. Act.} §§ 7.27 (shareholder quorum and vote), 8.24 (board quorum and vote).
\textsuperscript{211} \textit{See supra} note 183 and accompanying text.
Like corporate governance changes, many charter provisions relating to the terms of shares, including rights, qualifications, limitations and restrictions\textsuperscript{212} are binding on all current shareholders,\textsuperscript{213} and no notice is required to bind subsequent owners.\textsuperscript{214} Some alterations to attributes of stock ownership, however, are so contrary to the customary understanding of property rights that they cannot bind future shareholders unless they either agree or at least take the stock with notice. A restriction on transferability is the most common example.\textsuperscript{215} The power to transfer stock ownership is considered a traditional property right; while presumably the corporation statute could define stock ownership differently from other types of personal property and include prohibitions on transfer among the limitations and restrictions permitted in the certificate of incorporation’s statement of the stock terms, no state has chosen to do so. Thus, while the statutes do not limit restrictions on transferability to closely held corporations, it is unlikely that restrictions on transferability applicable to all shareholders would either be feasible or upheld by the courts once the corporation’s shareholder base reached a certain size.

Admittedly, the distinction between corporate governance rules and rules relating to attributes of stock ownership is blurred. Nevertheless, provisions that purport to restrict a current or former shareholder’s right to bring federal securities fraud class actions do not have much bearing on the allocation of power between shareholders and directors, except to the extent that current shareholders’ power to sue management may

\textsuperscript{212} \textsc{Del. Corp. Code} § 151(a), \textsc{Model Bus. Corp. Act.} § 6.01.
\textsuperscript{213} \textsc{Del. Corp. Code} § 242(b)(1), \textsc{Model Bus. Corp. Act.} § 10.03(e).
\textsuperscript{214} See, e.g., In re Appraisal of Preferred Shares, 698 A.2d 975 (Del. Ch. 1997) (preferred shares can stipulate the fair value of the shares for appraisal; while Chancellor Allen speaks of the preferred shareholders’ “contracting away” their rights, the plaintiffs purchased the shares on the secondary market.)
\textsuperscript{215} \textsc{Del. Corp. Code} § 202, \textsc{Model Bus. Corp. Act.} § 6.27. Moreover, the statutes require a legitimate corporate purpose for the restriction.
strengthen their position within the corporation. A provision that requires a majority vote to elect directors in uncontested elections does not have much in common with a provision that restricts the power of a former shareholder to sue the corporation and its managers for lying to the marketplace. Rather, the right to sue is more closely related to an attribute of stock ownership, particularly in securities fraud class actions, where (unlike shareholders’ derivative actions\(^{216}\)) standing is conferred not on shareholders, but on purchasers or sellers.

Indeed, proponents of both the arbitration proposal and the proposal to eliminate the corporate defendant acknowledge that fairness requires some kind of public notice,\(^{217}\) indicating that they do not believe that the analogy to contract law or the reliance on corporate law principles is compelling. Accordingly, we address now the question of notice.

**Notice.** Even though we have shown that there is serious doubt that the either proposal could be enforced under contract or corporate law principles, it is true that, in an era of standardized form contracts and internet transactions, modern commercial law has moved, in the name of efficiency, from an assent model to a notice model of contract formation.\(^{218}\) In the law governing commercial transactions, there are many decisions holding that where the purchaser of a product or service receives notice of the seller’s terms and has an opportunity to reject the product or service, a contract is created on the

---

\(^{216}\) Indeed, since a derivative claim involves the corporation’s right to sue, it may have already agreed to arbitrate certain disputes, which agreement may be binding on the shareholders. See Jerry A. Sanborn, *The Rise of “Shareholder Derivative Arbitration” in Public Corporations: In re Salomon Inc. Shareholders Derivative Litigation,* 31 WAKE FOREST L. REV. 337 (1996) (discussing a derivative suit involving alleged malfeasance committed by corporate employees of a securities firm, where defendants moved to compel arbitration pursuant with agreements with the New York Stock Exchange).

\(^{217}\) See supra notes 92, 100 and accompanying text.

\(^{218}\) See, e.g., Hill v. Gateway 2000, Inc., 105 F.3d 1147 (7th Cir. 1997).
seller’s terms. In addition, the trading markets bear some similarity to auctions, and the longstanding law regarding auctions establishes the principle that bids at an auction embody terms made by advertisement, posting or other publication, whether or not the bidder is aware of them. Accordingly, it may be that the ultimate issue as to the enforceability of both proposals is what kind of notice is required so that it is fair to bind subsequent stock purchasers.

It would be difficult to provide actual notice at the time of the sale. In an earlier era of corporate law, where shareholders typically received stock certificates, notice requirements were easily met; the provisions could be printed on the certificate, as is still the case with respect to closely held corporations. Purchasers do receive confirmations that could contain notice of the provisions, but requiring the broker-dealer to ascertain the existence of the terms and include the notice on the confirmation would impose a considerable burden on them. A generic statement on brokerage statements that some issuers may include such provisions should not be sufficient to constitute fair notice.

Proponents assert that, in lieu of actual notice at the time of sale, notice on the corporate website or in the corporation’s SEC filings (which, in many instances, the corporation no longer has to deliver to the shareholders) is sufficient to bind subsequent purchasers. Commercial law, however, does not support this assertion. Of critical importance in the commercial cases is that the purchaser, at a minimum, receives actual notice of the existence of the terms, either in a physical document or online, in

---

220 Rest. 2d Contracts § 28(2).
222 See supra notes 92, 100 and accompanying text.
sufficient time to renounce the transaction;\textsuperscript{223} “clarity and conspicuousness … are important in securing informed assent.”\textsuperscript{224} Thus, in \textit{Specht v. Netscape Communications Corp.},\textsuperscript{225} the Second Circuit said it would not enforce an arbitration clause where individuals could download a plug-in program from defendant’s website without first viewing defendant’s license agreement containing the arbitration agreement. Importantly, “inquiry notice” was not created even though plaintiffs would only have to scroll down to a screen located below the download button. Notice in the corporation’s SEC filings and its corporate website is not sufficient notice under \textit{Sprecht}, because the purchaser would have to engage in more of a search to determine the existence of the provision than the website visitors in \textit{Sprecht} had to do.

Proponents do have better support for their notice argument in the auction cases. Because of the special nature of auctions, the law imposes a greater responsibility on bidders to ascertain the terms of the sale, and they will be bound by publicized terms of which they should be aware,\textsuperscript{226} in recognition of the fact that auctions are “cost-saving device[s] in which face-to-face negotiations, except as to price, are not engaged in by the parties.”\textsuperscript{227} Thus, the court in \textit{Hessel v. Christie’s, Inc.}\textsuperscript{228} thought it likely that the bidder would be bound by the terms contained in the auction house’s catalog even if he did not receive it, because he should have inquired into the terms of the sale. In that case, the court noted that (1) the auction house’s customary practice was to post at its website, below the description of the items up for auction, the words “important notice;” when the

\textsuperscript{223} \textit{Specht v. Netscape Commun. Corp.}, 306 F.3d 17 (2d Cir. 2002).
\textsuperscript{224} \textit{Id.} at 29.
\textsuperscript{225} 306 F.3d 17 (2d Cir. 2002).
\textsuperscript{227} \textit{Travis v. Washington Horse Breeders Assoc.}, 759 P.2d 418, 422 (Wash. 1988).
\textsuperscript{228} 399 F. Supp.2d 506 (S.D.N.Y. 2005).
viewer clicked on those words, a notice appeared stating that the terms and conditions of the sale were set forth in the catalogue and that it was the viewer’s responsibility to inform himself of the terms; (2) the bidder had visited the website prior to the auction; and (3) the bidder was an experienced art purchaser who had purchased art many times before from the auction house. In short, courts assume that participants in auctions should know the rules of the game.

The proponents essentially argue that, like bidders at an auction, stock traders should know the rules of the game and be familiar with information posted on the corporation’s website and in its SEC filings. Unlike auctions, however, there is no expectation that purchasers review the corporate information before making stock purchases. For most investors, this is simply a waste of time; they should either rely on the market to price the stock or rely on the recommendation of their broker or investment adviser.229 Furthermore, unless and until adoption of these provisions becomes widespread, it would be unfair to charge even sophisticated traders with knowledge of these provisions.230

To summarize: Even if the arbitration proposal and the proposal to eliminate the corporate defendant were not impermissible under § 29(a), they are illegal, unfair and unenforceable under state law contract and corporate law principles.

CONCLUSION

Securities fraud class actions play an important role in compensating investors and deterring corporate fraud. When Congress reformed the securities class action in

---


230 See Register.com v. Verio, Inc., 356 F.3d 393 (2d Cir. 2004) (holding that daily user of website who conceded knew the terms of its use could be bound by them even though he never manifested his assent to the terms).
PSLRA and decided not to eliminate the FOTM presumption, it reaffirmed their importance. This is not to say that there is no place for further reform. The critics of the federal securities class action raise important policy questions that have serious consequences for the U.S. securities markets. The nation is beginning to consider what will possibly be the most significant regulatory reform to our financial markets since the 1930s. The SEC should exercise a leadership role in considering whether further reform to the securities fraud class actions is advisable and convene a broadly inclusive national discussion on this subject.\textsuperscript{231} There is no place for self-help measures advanced in the name of shareholders rights.

\textsuperscript{231} See supra note 10.