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Governance

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Arbitration and Corporate Governance: Publicly Held Companies

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ARBITRATION AND CORPORATE GOVERNANCE: PUBLICLY HELD COMPANIES

I. Public Corporations' Use of Arbitration in Matters Relating to Corporate Governance: U.S. Experience

1. Executive employment agreements; see GAF Corp. v. Werner, 66 N.Y.2d 97, 495 N.Y.S.2d 312 (1985) (executive can compel arbitration of shareholder derivative claim of breach of employment agreement).
2. Valuation and appraisal of shares of minority shareholders dissenting from mergers.
3. Permissive indemnification of directors.

II. In Spite of Wide Use of Arbitration for Disputes Involving Private Corporations, There are Barriers to Its Use by Public Corporations.

A. *Legal/theoretical*

1. Is there a contractual obligation binding on all concerned?
2. What notice is required in the case of individual shareholders?
3. Are there unconscionability issues?

B. *Public policy*

1. Some see a particular value in judicial enforcement of standards.
2. Shareholders in a public corporation can sell their shares and exit easily as an alternative to enforcing legal rights, unlike the situation with private corporations.

C. *Practical Constraints*

1. Some question the adequacy of arbitration for complex cases.
2. Arbitration may offer insufficient incentives for plaintiffs' lawyers to pursue claims.

III. U.S. Precedents for Arbitration of Shareholder Derivative Claims

- Diana v. Merrill Lynch, Pierce, Fenner & Smith, Inc., Fed. Sec. L. Rep. (CCH) 96,194 (S.D.N.Y. Oct. 5, 1977) (derivative claim referred to NYSE, which declined jurisdiction)
- Salomon Inc. Shareholders' Derivative Litigation, Fed. Sec. L. Rep. (CCH) 98,454; 1994 WL533595 (S.D.N.Y. Sept. 30, 1994) ("Salomon I") (same; clear articulation of reasoning that shareholders asserting derivative claim "stand in the shoes" of corporation, so only it and the officers charged need be parties to agreement to arbitrate); see also In re Salomon

Shareholders Derivative Litigation, 68 F.3d 554 (2d Cir. 1995) (“Salomon II”) (court refused to appoint arbitrator after NYSE declined jurisdiction).

- Under the Salomon court’s reasoning, no special provisions in a corporate charter or by-laws are necessary to require arbitration of derivative claims; they would, however, be likely to add legitimacy.
- However, NYSE Rule 600 now prohibits arbitration of shareholder derivative claims in that forum.
- Frederick v. First Union Securities Inc., 122 Cal. Rptr. 2d 774 (Cal. Ct. App. 2002) (Salomon I rationale still good after Salomon II; clause provided for NYSE or NASD arbitration; court submitted case to NASD because “the record provid[ed] no indication that the NASD will refuse to arbitrate this derivative action.”).

Commentary

- John C. Coffee, Jr., No Exit? Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies, 53 Brooklyn L. Rev. 919 (1988).
- G. Richard Shell, Arbitration and Corporate Governance, 67 North Carolina L. Rev. 517 (1989).
- Jeffrey A. Sanborn, The Rise of “Shareholder Derivative Arbitration” in Public Corporations; In re Salomon Inc. Shareholders’ Derivative Litigation, 31 Wake Forrest L. Rev. 337 (1996).

IV. Will Other Arbitration Law Developments Make Arbitration of Shareholder Claims More Likely in the Future?

Claims by individuals against corporate enterprises arising from what typically are contracts of adhesion (consumer sales transactions and employment contracts) present some similar issues, and these have been or soon may be largely resolved.

1. Assurance of procedural fairness and affordable cost

a) AAA Protocols, developed by diverse industry participants (available on the Internet at www.adr.org)

i) Due Process Protocol for Employment Disputes (1995)

ii) Consumer Due Process Protocol (1998)

iii) Health Care Due Process Protocol (1998)

b) U.S. judicial decisions continue to reject individual companies' mandatory arbitration plans in whole or in part when they are found unfair.

2. Class action arbitration

a) Can arbitrators exercise powers and employ remedies available in judicial proceedings?

b) How should arbitrators interact with a court when the court refers particular issues for arbitration?

c) Green Tree Financial Corp.v. Bazzle, 2003 WL 21433403 (U.S.), decided June 23, 2003 (by 5-4 vote, U.S. Supreme Court holds arbitrator should decide whether contract permits class-wide arbitration of claims against commercial lender, which South Carolina law allows).

V. Stock Exchange and Similar Experience

In the U.S., stock exchange arbitrations typically are limited to customer-broker disputes; "industry" disputes, usually employer-employee disputes involving exchange member firms; and disputes between exchange member firms.

1. Arbitration statistics (NYSE):

a. Cases Filed	2000	2001	2002
Customer Disputes ^a	328	541	1009
Industry Disputes ^b	204	226	285
Member (other) disputes ^c	21	13	21
Total:	553	780	1315
b. Cases Closed			
Decisions	148	146	299
Settled (including mediation)	423	281	395
Other:	33	35	23
Total:	604	462	717

^a Claims by or against customers of a member firm

^b Disputes between member firms and employees or non-members

^c Disputes between members

2) Panel composition has been the subject of Government scrutiny and regulation, to assure no domination by industry “insiders.”

3) As noted above, the NYSE refuses to arbitrate class and derivative claims.

B. The City Disputes Panel was organized in 1994 under principal sponsorship of the Corporation of the City of London to resolve disputes among financial services industry participants; but it was premised on voluntary submissions by industry members and has not been successful.

C. Some issues presented by the Sao Paulo Stock Exchange “Market Arbitration Panel” plan:

1. Composition of the panel
2. Maximum number of arbitrators (5)
3. Grouping of similar claims
4. Extension to officers and directors
5. Who is in charge of the initial settlement hearing?
6. “Review” of draft award by exchange executives
7. Under what circumstances would a company extend effects of an award to other shareholders?
8. Publication of awards