Carlyle leaves out mandatory arbitration clause in IPO

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The Carlyle group today announced that it was withdrawing the mandatory arbitration clause that was included in its registration statement filed with the Securities and Exchange Commission ("SEC"), in response to pressure from shareholder rights activists, potential investors and the SEC. Carlyle, which is preparing to conduct an IPO this year, had earlier included in its filing, a provision mandating that all shareholder disputes be settled only through arbitration, and further that all arbitration be brought in an individual capacity. The clause which would have prohibited Carlyle's shareholders from filing class-action law suits had attracted intense criticism for its lack of respect towards investors' rights.

Historically, the SEC has disfavored mandatory shareholder arbitration provisions. In 1990, when Franklin First Financial Corp that was planning its IPO sought to include an arbitration provision in its charter and bylaws, the SEC firmly objected to its inclusion. The SEC was of the view that it would be contrary to the public interest to require investors who want to participate in the nation's equity markets to waive access to a judicial forum for vindication of federal or state law rights. In reaching this position, the SEC relied on anti-waiver provisions contained in federal securities law.

Carlyle's mandatory arbitration proposal appeared to have the backing of a series of Supreme Court judgments that had emphasized the liberal federal policy favoring arbitration agreements in the US. The US Supreme Court has repeatedly

pointed out that arbitration agreements pursuant to the Federal Arbitration Act ("FAA") were the favored route to settle disputes between companies and their customers and employees. Whether this notion extended to US securities markets could have been tested had Carlyle stuck to its mandatory arbitration provision.

Courts in the US rigorously enforce agreements to arbitrate. That is the case even when the claims at issue are federal statutory claims, unless the FAA's mandate has been "overridden by a contrary congressional command." It is the position of the SEC that the anti-waiver provisions of federal securities law constitute such a command.

However, the Supreme Court in several cases has addressed general anti-waiver clauses in federal statutes. In each case, the Court has required arbitration pursuant to the FAA. In its latest interpretation of the FAA on January 10 this year, the Supreme Court was categorical that general anti-waiver provisions in the Credit Repair Organizations Act ("CROA") are not a barrier to the enforcement of an arbitration provision pursuant to the FAA *(CompuCredit Corp. v. Greenwood).* In the words of the Court: "Because the CROA is silent on whether claims under the Act can proceed in an arbitrable forum, the FAA requires the arbitration agreement to be enforced according to its terms."

The general anti-waiver provisions of the federal securities law are no different from the one interpreted by the Court in CompuCredit. Section 29(a) of the Securities Exchange Act provides: "Any condition, stipulation or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder…shall be void." In the past, the Supreme Court has held that these anti-waiver clauses do not apply to procedural provisions, such as contractual agreements requiring arbitration. In *Shearson/American Express, Inc. v. McMahon* and *Rodriguez de Quijas v. Shearson/American Express*, the US Supreme Court overturned long-standing precedent by holding that arbitration provisions contained in brokerage customers' agreements were enforceable with respect to federal securities claims. The Court in *McMahon* held that: "By its terms, Section 29(a) of the Securities Exchange Act prohibits waiver of the substantive obligations imposed by the Exchange Act."

Likewise, Carlyle could have argued that the proposal to bind shareholders to mandatory arbitration does not purport to waive any substantive obligations imposed by federal securities law; instead, it is procedural in nature and stipulates

an alternative forum for the enforcement of substantive rights created by federal securities law.

The *McMahon* and *Rodriguez* decisions were rendered in the context of customer/broker claims. No doubt, there are significant differences between customer/broker and purchaser/issuer claims. However, Professor Barbara Black in her paper on the issue, *Eliminating Securities Fraud Class Actions Under the Radar,* points out that these differences would not be sufficient in persuading the court to distinguish earlier precedents in *McMahon* and *Rodriguez,* and hold that the purchaser/issuer claims can not be brought into arbitration, assuming that the requisite consent is present.

Carlyle had also wished to prohibit class-action arbitration. Fascinatingly, the US Supreme Court last year in *AT&T Mobility LLC v. Concepcion,* upheld an arbitration provision in a consumer contract that disallowed class-wide procedures because the FAA preempted California precedent striking down class arbitration waivers as unconsciable. Justice Scalia was emphatic that in class arbitration, the traditional advantages of arbitration- informality, low cost, and speed- are lost because of the need of procedures to deal with class certification issues and protection of absent class members. Although the decision considers class action waivers in the context of consumer arbitration contracts, the majority's opinion does not suggest any intent to limit its holding to consumer agreements. Accordingly, the decisions in *AT&T Mobility, CompuCredit, McMahon* and *Rodriguez* strongly support Carlyle's initial decision to include a mandatory arbitration provision.

Another thing that would have worked in Carlye's favor is that Carlyle is a limited partnership rather than a corporation. Because of the partnership structure, common unit holders are more limited than common stockholders. Limited partnerships have fewer fiduciary duties than corporations. But what if Carlyle were a corporation? It can be argued that the Supreme Court's long standing endorsement of a broad arbitration policy and its earlier precedents would support Carlyle's initial position. Indeed, the Supreme Court was quite definite in *CompuCredit:* "we have repeatedly recognized that contractually required arbitration of claims satisfies the statutory prescription of civil liability in court."

The Supreme Court has never ruled whether public corporations can extend the broad arbitration mandate to prohibit future class-actions. That could have changed had Carlyle met opposition from the SEC and responded by suing the

agency.

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