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Why Compulsory Arbitration Will Supercharge Securities Litigation

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"Don, the PSLRA is a law that changed my life," a doyenne of the plaintiff's securities bar told me. He was referring to the Private Securities Litigation Reform Act, passed in 1995. At that time, some saw this law as curtailing securities class actions - even a death knell. Ironically, it rejuvenated these cases. Recently, the SEC greenlighted arbitration clauses for securities litigation in IPOs. Those on the defense side may see this shift as a stake in the heart of securities class actions, their perceived Dracula, sucking the lifeblood out of victimized companies. In the extreme, however, this policy would supercharge securities cases. Those promoting these clauses are not Van Helsing, but instead standing in a pool of gasoline, matches in hand.

Veteran attorneys characterized securities litigation before 1996 as a race after a corporate disclosure by lawyers to find individuals who purchased a few shares of the stock and quickly hand-deliver a complaint to the relevant courthouse. This was not ambulance chasing; it was a contest to beat the ambulance to the scene. Additionally, companies had to provide discovery early on, a potentially expensive undertaking that encouraged settlement and could allow plaintiffs to engage in literal fishing expeditions to unearth materials with which to build cases around.

Congress expressly passed the PSLRA to curb frivolous suits. Although President Clinton - an ally of trial lawyers - vetoed the PSLRA, Congress overrode him, one of the only two occasions over his eight years in office. The law imposed a number of hurdles on plaintiffs, such as:

1) A bar on discovery until a complaint survives a motion to dismiss in court
2) In Exchange Act cases, plaintiffs must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind" to overcome such a motion to dismiss
3) A limitation on damages known as the "bounce back provision"
4) A requirement that all settlement terms, including the size of the settlement, be publicly revealed
5) A mandatory review at the conclusion of the case that could result in sanctions for any party or attorney who engaged in "abusive litigation."

Importantly, there was also a new process for selection of lead plaintiff: a sixty-day period after the filing of an initial complaint for a plaintiff to move for appointment. Congress required courts to presume the movant with "the largest financial interest in the relief sought by the class" as the most adequate, i.e., the movant with the largest loss in the relevant securities usually is appointed

These provisions (and others) in the PSLRA aimed at curbing litigation seemed draconian. How - outside of extreme circumstances - could a plaintiff provide facts about a defendant's state of mind without access to internal documents or questioning relevant witnesses under oath? Would courts sanction law firms each time a complaint failed to survive a motion to dismiss? The future seemed bleak for plaintiffs. And yet, in the years after the PSLRA, securities litigation in fact burgeoned. Each year, investors recover billions of dollars from securities class action settlements in the US. There are at least twenty plaintiff's law firms that specialize in securities litigation, many with highly successful track records.

How did the PLSRA create this unexpected result? Institutional investors soon realized that they routinely had larger losses than retail investors and that now they had sixty days to properly evaluate whether claims were meritorious before acting. It was no longer a race to the courthouse but now one for law firms to marshal the best facts and pick the strongest cases. Public knowledge of settlements allowed the public to see which settlements could provide significant recoveries to these institutions. As a result, their active participation and filing expanded dramatically. In turn, heightened institutional interest in these cases gave rise to new services such as portfolio monitoring and advanced claims filing processes. ISS SCAS, for example, began filing claims for investors in the years after the PSLRA. Meanwhile, courts took a more hands-off approach to reviewing whether failed cases constituted abusive litigation.

Fast forward to the current day. Companies making initial public offerings can now adopt provisions in their charters or bylaws requiring investors to bring any securities law claims in arbitration as opposed to court. Were a company to adopt such a provision, aggrieved investors would have to individually press their claims in arbitration against that company. A class action against it would be impossible. "[W]e must reform the litigation landscape for securities lawsuits to eliminate frivolous complaints, while maintaining an avenue for shareholders to continue to bring meritorious claims," SEC Chair Paul Atkins stated in an October 2025 speech.[1] Again, perceived frivolous litigation drives the SEC's sudden about-face, as it did Congress in passing the PSLRA.

It is unlikely that the option to arbitrate will end securities class actions as we know it. First, there are a number of legal obstacles. Delaware, still the chosen place of incorporation for the bulk of public companies, currently prohibits such clauses. And shareholders could argue that these clauses are not contracts and so cannot bind them with respect to secondary market transactions. Second, shareholders might not ratify such clauses or might enjoin boards from adopting such provisions.

Supposing, however, that all (or most large) US-listed companies adopted such provisions, securities litigation could emerge stronger. Under such a scenario, issuers would risk responding to multiple arbitrations, perhaps thousands, providing more opportunities for investors, opposed to the finality of a class action in court. Also, it is unclear whether the arbitration process would afford companies the current protections of the PSLRA (of course, a company could try to adopt these in the arbitration clauses). Any recoveries in arbitration would be confidential, but the PSLRA's requirement to publicly disclose settlement terms seemingly was intended to protect defendants. Also, attorneys' fees in class actions have to be approved by the court; plaintiffs proceeding individually can choose what they pay.

[1] October 9, 2025 speech in Newark, DE.

Investors also could take a page from the securities litigation playbook in the Netherlands, where one method to advance group securities claims is for investors to assign their claims to a foundation or other special purpose vehicle, known as a "Stichting." The foundation then litigates these claims. Litigation funding - especially in the securities litigation market - is rapidly growing abroad and increasingly backed by hedge funds or public listings. In a universe where securities class actions cease to exist, deep-pocketed litigation funders could buy the claims of many large investors in a large securities case and then fund arbitrations on behalf of consolidated bundles of claims, potentially even offering to take a contingent stake in the claims. These funders could also purchase insurance to cover any fee shifting (the loser pays the winner's legal costs) required by the arbitration clauses - there is a vibrant market for such insurance in the UK and elsewhere.[2]

While institutional investors have dominated the ranks of lead plaintiffs, especially in larger cases, most large institutions prefer the flexibility afforded by the class action framework to passively collect any relevant settlement recoveries with minimal internal effort. These investors only need to expend resources in pursuing active litigation in rare instances where their losses are extremely large. Thus, currently, they have minimal incentive to sell claims or take any action. But in the universe where securing any recovery will require effort, institutions will be motivated to contract with litigation funders or attempt to maximize recoveries in each case through active efforts. After all, the key rationale for opting out of a class action is that recoveries tend to be higher, because institutions are expending significant resources to do whatever is possible and choose their own course, including going to trial.

[2] Fee shifting works both ways too—a losing defendant might have to separately pay plaintiff's attorneys in addition to any damages imposed.

Settlements are often a fraction of class-wide damages because defendants do not want to risk losing at trial and be on the hook for beggaring sums. Plaintiffs may therefore respond in arbitrations by pushing for much higher percentages of their damages. The increased speed and informality of arbitration may also spur plaintiffs to push farther. So, defendants and their insurers might actually pay more rather than less, in a world where insurers will also have a much harder time obtaining information about settlements to properly price policies and set reserves. Indeed, this scenario would make the D&O insurance market much less efficient economically.

Issuers and defense attorneys should not necessarily be gleeful at the possibility of adopting arbitration clauses for securities claims. The PSRLA appeared to be a master stroke against securities class actions, affording only the most meritorious claims a means of succeeding. And yet, securities litigation blossomed. As arbitration becomes a potential forum for resolution of securities claims, it is important to remember that institutional investors that manage billions or even trillions of dollars are savvy, as is the plaintiff's bar. The only thing that is certain about the future is that no matter what the situation, those that adapt will succeed. As history shows with the PSLRA, no one can ignore the law of unintended consequences.