Legal Backgrounder

Washington Legal Foundation

Advocate for freedom and justice®
2009 Massachusetts Ave., NW
Washington, D.C. 20036
202.588.0302

Vol. 18 No. 28 June 27, 2003

PROTECT INVESTORS FROM PLAINTIFFS' LAWYERS' STOCK MANIPULATION

by

Victor E. Schwartz and Peter D. Bernstein

Investors in publicly traded companies are protected by securities regulations against the selective disclosure of non-public information by those companies to securities analysts and institutional investors. Currently, no protections exist for potentially wild fluctuations in stock prices as a result of behind-the-scenes, undisclosed and unsolicited communications between personal injury lawyers and securities analysts. The information provided by lawyers to analysts often precedes the filing of a lawsuit against a company — regardless of the merits of the case. That private contact drives the price of the stock down. Investors witness the value of their stock disappear almost instantaneously, while securities issuers are powerless to respond in an appreciable and timely manner.

On the other hand, if and when plaintiffs' lawyers have strong cases on the merits, those facts become privy to a chosen few and not to the public at large. Lawsuits are powerful devices that affect the price of stock. One need look no further than the market fluctuations caused in the past by major litigation in asbestos, pharmaceuticals and tobacco. A sound public policy goal is to have the public in general make a fair evaluation of litigation. Regardless of the underlying merits of the litigation, stock prices should not be manipulated by innuendo or highly private limited communications between a chosen few.

These secret communications remain largely unregulated by the U.S. Securities and Exchange Commission ("SEC"). Left unchecked, these communications may significantly affect stock valuation and undermine investor confidence in a free and open market economy.

While virtually impossible to quantify how often this occurs, it is clear that intelligent and powerful plaintiffs' lawyers take full advantage of gaps in existing securities law. The *Wall Street Journal* recently ran an article describing how short-sellers of stock likely had prior knowledge of a multi-million class action against Eckerd Drug Stores. David Armstrong and Ann Zimmerman, *Suit Batters Penney Shares, But Serves Short-Sellers* Well, WALL ST. J., Jan. 8, 2003. J.C. Penney Co, the parent of Eckerd Drug, experienced a sharp drop in its stock price due to the filing of a lawsuit. This was a boon to short-sellers. The *Wall Street Journal* story details a connection between plaintiffs' lawyers against Eckerd Drug and short-sellers of the stock.

Plaintiffs' lawyers also may use secretly coordinated communications with selected securities analysts to drive down company stock as a means of forcing a quick settlement. This practice, while not illegal, can have

---

Victor E. Schwartz is a partner in the Washington, D.C. office of the law firm Shook, Hardy & Bacon LLP and chairs its Public Policy Group. **Peter D. Bernstein** is an associate in the firm's Business Litigation Group. The views of Mr. Schwartz and Mr. Bernstein are their own and do not necessarily reflect those of Shook, Hardy & Bacon LLP, any of its clients, or the Washington Legal Foundation.

a drastic effect on the value of a security and may cause serious financial harm to investors.

Deficiencies in Existing Securities Laws. Communications predating the filing of a class action between plaintiffs' lawyers and financial analysts are not illegal and they are not regulated in any significant way by the SEC. This is in sharp contrast to the principles and rules of full and fair disclosure governing corporate communications with securities market professionals (such as stock analysts or institutional holders of the issuer's securities who may trade on the basis of the information). The dialogue between plaintiffs' lawyers and securities analysts does not fall under the rubric of insider trading or misappropriation as regulated by existing laws. There would need to be trading on the part of the plaintiffs' lawyers under existing securities law in order to raise the ire of the SEC.

Under a classic theory, insider trading is the unlawful trading of securities by a person who possesses material, non-public information about the company. *Chiarella v. U.S.*, 445 U.S. 222 (1980). Simply put, any person who possesses knowledge of material, non-public information has a duty to shareholders to disclose that information or abstain from trading on the information. *Id.* at 230. Failure to disclose or abstain from trading is considered fraud under existing securities laws. Plaintiffs' lawyers are not insiders under this traditional theory.[1] Thus, the classic theory could not be used to stop their disclosures of potential litigation to analysts. Additionally, it is unclear whether information about a potential lawsuit falls into the category of "material, non-public information."

In 1997, the Supreme Court of the United States adopted the "misappropriation" theory in *U.S. v. O'Hagan*.[2] The theory stretches the fraud element to include frauds committed against persons other than purchasers or sellers of securities. The Court specifically found that O'Hagan, a corporate outsider, had deliberately misappropriated material, nonpublic information to trade for personal profit. The Court found O'Hagan deceived the source of the information[3] and simultaneously harmed the investing public. The misappropriation theory has been heavily criticized since its adoption and represents a significant deviation from the existing securities laws. Symposium, *Insider Trading Law, Policy, and Theory after O'Hagan*, 20 CARDO. L. REV. 7, 12 (1998) ("Ruth Bader Ginsburg, and the others who joined her in the majority, really gave no treatment to the fact that their decision was letting the courts manufacture a crime rather than having Congress legislate a crime."). It is unlikely that this theory can be applied to communications between plaintiffs' lawyers and analysts.

Under any theory of insider trading, it appears necessary to demonstrate that plaintiffs' lawyers traded in securities for personal gain as well as that they had utilized their communications with analysts as a settlement strategy. While Congress has historically and deliberately avoided defining insider trading for fear that any definition would have the potential of narrowing the actual application of the law, existing law may not catch simple stock manipulation where there has been no profit gained in trading by insiders. *Cf.* H.R. Rep. No. 100-910, at 11 (1998), reprinted in 1988 U.S.C.C.A.N. 603, 6048.

Aside from insider trading, stock manipulation is another securities area that fails to capture plaintiffs' lawyers' communications with securities analysts. Generally speaking, "[m]anipulation is intentional conduct designed to deceive investors by controlling or artificially affecting the market for a security." SEC Website (visited Feb. 6, 2003) < http://www.sec.gov/answers/tmanipul.htm>. One example of this practice was a guilty verdict delivered against a *Wall Street Journal* contributing investment advice columnist who profited from trading in advance of the release of information contained in future, unpublished columns. *Carpenter v. U.S.*, 484 U.S. 19 (1987) (The activities of the columnist were found to be a scheme to defraud the Wall Street

---

[1]The Supreme Court did hold that a tippee of an insider can be held liable under a classic theory where they fail to disclose or abstain from trading based on material, nonpublic information if he knew or should have known that the tip he received was a breach of the insider's fiduciary duty. *Dirks v. SEC*, 463 U.S. 646 (1983). In *Dirks*, the court looked at whether there was an expectation by the source as to whether the information would be kept in confidence. *Id.* at 665.

[2]521 U.S. 642 (1997). O'Hagan traded on knowledge that a client of his firm was about to embark on an acquisition of a publicly traded company. He did not work on the transaction.

[3]O'Hagan's conduct was found to be deceptive because he failed to disclose his personal trading to the client and his law firm.

Copyright © 2003 Washington Legal Foundation ISBN 1056 3059

Journal of its right to exclusive use of the information (i.e., kept confidential until publication)). The most common type of stock manipulation is the "pump and dump" whereby a person claims to have information demonstrating that the stock is undervalued and sells their shares at a profit when the price increases.[4] Communications between plaintiffs' lawyers and analysts differ from these cases because those individuals were found to have directly manipulated stock values for personal gain.

Accordingly, existing securities law is inadequate.

Public Policy Concerns. Permitting such covert communications is in sharp contrast to the principles and rules of full and fair disclosure already governing corporate communications with securities market professionals. Corporate insiders are bound by Regulation Fair Disclosure ("Regulation FD") when it concerns communication with outsiders. Fact Sheet, U.S. Securities and Exchange Commission, *Regulation Fair Disclosure and New Insider Trading Rules* (Aug. 10, 2000) (http://www.sec.gov/news/extra/seldsfct.htm).

To date, the SEC has shown little interest in the issue of secret plaintiffs' lawyer communications. This is likely due to the SEC's view that current securities laws are inadequate to deal with the problem. It may also be the result of the SEC's limited manpower that is faced with pressing investor protection issues, especially those relating to recent major corporate scandals.

Although the media has previously raised this problem[5], there has been no sustained support for regulatory and legislative changes to govern this type of behavior. Clearly, investors are economically harmed by the ability of some members of the plaintiffs' bar to diminish corporate market value and extort settlements. Unless some action is taken, there is little that can be done to put an end to this practice.

Possible Solutions. Following the Eckerd drug complaint, and in light of significant public policy concerns, the Washington Legal Foundation ("WLF") filed a petition with the SEC on March 23, 2003 requesting implementation of a rule to require pre-notification and disclosure of certain material and non-public communications between plaintiffs' lawyers and securities professionals. Among other things, the WLF proposal calls for the implementation of rules similar to Regulation Fair Disclosure with respect to the selective, private contacts between plaintiffs' lawyers and securities analysts.

Absent SEC regulatory action, another solution could be the passage of legislation that would amend current securities law to codify Regulation FD and ensure its application to plaintiffs' lawyers. Such a proposal would require plaintiffs' lawyers to conduct contacts with analysts in much the same way that fair disclosure of corporate communications is required.

Under any regulatory or legislative scenario, the disclosure burden would not be placed on analysts, for their role is a passive one in these scenarios. The natural focus of any legislative or regulatory proposal would be on plaintiffs' lawyers who engage in this manipulative activity; they initiate the contacts and disclose non-public information to securities analysts. This would mirror restrictions already in place for issuers of securities.

Among the issues that should be addressed in any type of proposal are: what would trigger the necessity of the disclosure, when the disclosure must be made,[6] what the disclosure should contain, and to whom and how the disclosure is made. Communications of this type should be made public so that a company's value cannot be manipulated to the detriment of the average investor based on a lack of objective knowledge in the investment community. A drawback is that a public disclosure could bring to light potential litigation against

---

[4]SEC Website, Three Settle SEC Charges In NEI Webworld Internet Stock Manipulation Case; Two Sentenced To Prison In Related Criminal Prosecution (Jan. 23, 2001) <http://www.sec.gov/litigation/litreleases/lr16867.htm>; SEC v. *Michael A. Furr*, Civ. No. CV-00-09456 DT (Manx) (C.D. Cal.) (Sept. 6, 2000) < http://www.sec.gov/litigation/litreleases/lr16686.htm>.

[5]David Segal, *Tag-Team Lawyers Make Businesses Blink; HMOs Latest to Grapple With Threat of Investor-Scaring Mega-Verdicts*, WASH. POST, Nov. 12, 1999, at A1; Milo Geyelin, *Lawyer Seeks Support for Settlement with HMOs*, WALL ST. J., Nov. 22, 1999, at B2; Jim Lafferty, Editorial, *Stock Market 'Tips' a Ploy to Force Companies to Settle Suits*, VENTURA CTY. STAR, Nov. 28, 1999, at B9.

[6]One thought is that any such proposal should incorporate a 48-72 hour waiting period so that a corporation would be put on alert and be given an opportunity to respond in a manner consistent with Regulation FD.

a company that might otherwise remain secret. Nevertheless, public light would help assure that potential or actual litigation is evaluated fairly, not just the self-serving plaintiffs' lawyer's assessment of the case.

First Amendment Issues. Any of the proposed legislative or rule changes will need to address First Amendment issues. A failure to address these issue will leave open the door for the plaintiffs' bar to challenge any restrictions on their contacts with securities analysts.

While any limitation placed on plaintiffs' lawyers might be argued as an infringement on the First Amendment rights of free speech and association, Regulation FD already places similar restrictions on individuals working for and with publicly traded corporation. In fact, the SEC has already established a proven track record in enforcing Regulation FD and to date it does not appear that there has been a First Amendment challenge.[7]

Like the communications restricted in Regulation FD, communications between plaintiffs' lawyers and securities analysts should receive no greater First Amendment protections than any other form of commercial speech. And in this instance, the plaintiffs' lawyers are not being restricted in what they can say. They only would be required to lift the veil of secrecy in limited situations. As we have shown, sound public policy supports such a move towards transparency.

The Supreme Court has developed a four-part analysis to review restrictions on commercial speech:

> At the outset, we must determine whether the expression is protected by the First Amendment. For commercial speech to come within that provision, it at least must concern lawful activity and not be misleading. Next, we ask whether the asserted governmental interest is substantial. If both inquiries yield positive answers, we must determine whether the regulation directly advances the governmental interest asserted, and whether it is not more extensive than is necessary to serve that interest.

Central Hudson Gas & Elec. v. Public Serv. Comm'n, 447 U.S. 557 (1980). Disclosure of contacts with securities analysts very strongly meets each of these requirements and falls within the scope the Supreme Court's interpretation of commercial speech.[8]

The filing of a lawsuit is clearly a lawful activity and there is no suggestion that the communications with the securities analysts are misleading. The government's interest in protecting investors has long been established. *See* SEC Website (visited June 3, 2003) < http://www.sec.gov/about/whatwedo.shtml> ("The primary mission of the U.S. Securities and Exchange Commission (SEC) is to protect investors and maintain the integrity of the securities markets."). Finally, the disclosure requirements do not exceed those already in place for corporate insiders under Regulation FD and certainly would protect investors from secret communications.

The government can regulate secret communications between plaintiffs' lawyers and securities analysts when it does so to advance the governmental interest, in a manner that is no more extensive than necessary.

Conclusion. Existing securities laws provide virtually no regulation of communications between plaintiffs' lawyers and securities analysts in advance of initiating litigation against a publicly-held corporation. The implementation of some form of regulation — similar to Regulation FD — or passage of legislation is necessary to level the playing field for plaintiffs' lawyers and publicly traded companies. Investors need to be protected from stock price manipulation by plaintiffs' lawyers. At the same time, when plaintiffs' lawyers have true, legitimate claims, the public at large needs to be aware of those facts, not just a chosen few.

---

[7]Peter Landers, *Schering-Plough, CEO Face SEC Case on Private Chats*, WALL ST. J., Mar. 13, 2003; Press Release, U.S. Securities and Exchange Commission, *SEC Brings First Regulation FD Enforcement Actions* (Nov. 25, 2002) (announcing actions against Raytheon Company (and CFO Franklyn A. Caine), Secure Computing Corporation (and CEO John McNulty, Siebel Systems, Inc. and Motorola, Inc.); Press Release, U.S. Securities and Exchange Commission, *SEC Files Settled Cease-and-Desist Order Against Siebel Systems, Inc. Finding that It Violated Regulation FD; Siebel Systems, Inc. Also Agrees to Pay a $250,000 Civil Penalty* (Nov. 25, 2002) (http://www.sec.gov/litigation/litreleases/lr17860.htm).

[8]The Supreme Court is currently undertaking a review of issues related to commercial speech that could affect this analysis. *Nike,Inc. et al. v. Kasky*, No. 02-575 (U.S., oral argument heard Apr. 23, 2003).

Copyright © 2003 Washington Legal Foundation ISBN 1056 3059