Legal Backgrounder

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202.588.0302

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EMPOWER SHAREHOLDERS, NOT COURTS AND LAWYERS, TO DETER CORPORATE WRONGDOING

by

Professor Patrick M. Garry

A Criticism of Shareholder Class Actions. Courts have described shareholder class action lawsuits as "legalized blackmail."[1] Such lawsuits are brought on behalf of shareholders alleging that their corporation misrepresented the profitability of its business, causing the shareholders to buy stock at an inflated price, only to see that price later plummet when the "truth" of the corporation's business was revealed.[2] While the suits often result in minimal payments to the class members, plaintiffs' lawyers receive millions of dollars in fees.

Shareholder class actions contain an inherent irrationality. The plaintiffs, who hold stock in the defendant corporation, essentially end up suing themselves, since any monetary gain received in a settlement amounts to a corresponding loss in the value of plaintiffs' investment in the defendant corporation. Moreover, because any settlement is accompanied by an extremely high transaction cost in the form of lawyers' fees, the lawsuit can actually yield a net negative return to the class members.

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[1]*In re Gen. Motors Corp. Pick-Up Truck Fuel Tank Products Liability Litig.*, 55 F.3d 768, 784-85 (3d Cir.), *cert. denied*, 516 U.S. 824 (1995); *Castano v. Am. Tobacco Co.*, 84 F.3d 734, 746 (5th Cir. 1996).

[2]A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 928 (1999). These suits are commonly brought under Rule 10b-5 of the Securities Exchange Act.

Patrick M. Garry is a visiting professor at the South Dakota School of Law. He is co-author of *The Irrationality of Shareholder Class Action Lawsuits: A Proposal for Reform,* 49 S.D. LAW REV. ___ (2004).

Evidence suggests that shareholder litigation results more from the movement of a company's stock price than from the actual commission of fraud by the corporation.[3] According to the pattern that has emerged, a significant drop in the stock price of a targeted corporation prompts plaintiffs' attorneys to file a shareholder class action alleging fraud against that corporation. In fact, many shareholder lawsuits are brought within days of such a decline in stock price.[4]

Comparing the performance of the stock market over the years 1991-2002 with the number of shareholder class action lawsuits filed during that period, an inverse relationship becomes evident: when the market falls, lawsuit filings rise. But if shareholder suits commence in response to evidence of actual fraud, one would expect them to occur independent of overall stock market movements. In addition, the most frequent class action defendants in 2000 and 2001 were companies whose stocks suffered the biggest declines — technology companies. However, there is no reason to believe that technology companies are more prone to making fraudulent statements than companies in any other line of business.

Another indication that shareholder class actions are not based on merit is that they have failed to result in significant corporate reform aimed at preventing future fraud.[5] Corporate officers are named as defendants in over 80 percent of the complaints, yet those individuals are rarely sanctioned. As a study recounted in the author's recent law review article reveals, 73 percent of the individuals named in shareholder lawsuits as perpetrators of fraud were still employed by the corporation a year later.[6]

In an effort to limit the filing of frivolous lawsuits, Congress in 1995 passed a securities litigation reform law[7]; but that reforms has had little success. Following passage of the law, the number of lawsuits actually increased, which was exactly the opposite of what Congress intended. When the market dropped in 2001, for instance, securities litigation hit an all-time high, increasing 355 percent from the number of class action filings in 1996.[8]

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[3]Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions,* 47 STAN L. REV. 497, 528 (1991).

[4]*See* Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?* 2003 U. ILL. L. REV. 913, 920 (2002); James Bohn & Steven Choi, *Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions,* 144 U. PA. L. REV. 903, 916 (1991)

[5]Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?* 7 J.L. ECON. & ORG. 55, 63-64 (1991). Romano also found that in eight percent of the cases, the only relief was lawyers' fees. *Id.* at 61.

[6]*The Irrationality of Shareholder Class Action Lawsuits: A Proposal for Reform*, 49 S.D. LAW REV. ___ (2004). Of the 27 percent no longer employed, it is impossible to tell how many resigned voluntarily or how many were fired for reasons related to the allegations in the complaint.

[7]Private Securities Litigation Reform Act, Pub. L. No. 104-67, 109 Stat. 737.

[8]Elaine Buckberg, Todd S. Foster, Ronald I. Miller & Adam Werner, *Recent Trends in Securities Class Action Litigation: Will Enron and Sarbanes-Oxley Change the Tides?* NERA Economic Consulting 2 (2003).

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A Reform Proposal. The current regime of shareholder class action lawsuits benefits only the lawyers, and does not deter fraudulent behavior. What is needed is a new system — one that takes advantage of the unique role of shareholders vis-à-vis the defendant corporation. Other types of class actions involve plaintiffs who have no legal or economic connection to defendants. But in shareholder litigation, the plaintiffs are the owners of the defendant corporation, and hence in a unique position to remedy past misdeeds of the corporation and deter future wrongdoing. Shareholders, for instance, can take immediate action in response to suspected fraud; they do not have to wait for a lawsuit.

To end lawyer control over shareholder litigation, plaintiffs' counsel should have to notify shareholders of the prospective defendant that a complaint is about to be filed. The shareholders would then have a specific amount of time to investigate the case and reach a resolution. If the shareholders fail to take any action or come to any resolution in the allotted time, plaintiffs' counsel could proceed with the lawsuit.

Direct shareholder involvement in investigating fraud would be more efficient and more responsive to the best interests of the corporation than would lawyer-driven litigation.[9] This investigation could be done pursuant to a detailed set of procedures previously agreed upon by the corporation — procedures perhaps adopted from a model code drafted specifically for shareholder fraud inquiries. Those companies adopting such procedures could be identified on the various stock exchanges, so that potential investors would know prior to investing whether a company had pledged itself to the anti-fraud code. Presumably, investors would prefer to invest in companies that had made a special commitment to deter financial misrepresentations.

Deterrence could be accomplished through shareholder-initiated sanctions against the individuals responsible for any fraud. This scheme of individual-focused sanctions would achieve the highest level of deterrence, since unlike the current system it would strike precisely at the source of the fraud.[10] Nothing can deter like the threat of losing one's job; additionally, such a firing would attract a kind of publicity that securities class actions rarely attain, thus achieving an even greater degree of deterrence. Shareholders could also be counted on to be firm but not onerous with the sanctioned officers, since those shareholders would obviously not want to discourage prospective officers from working for the corporation.

The reform proposal outlined here focuses not only on deterrence, but on achieving vital reforms in the corporate governance structure. Every opportunity should be given to let the

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[9]Plaintiff class members, in particular non-named plaintiff class members, have little power to participate in or even to be informed of the conduct of shareholder class action litigation.

[10]Under the securities class action scheme, corporations have refrained from sanctioning wrongdoers. Although shareholders would want to impose sanctions on the responsible individuals, the board of directors has generally been reluctant to do so, in part because of the hesitancy to admit any corporate liability in the ongoing class action.

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corporate governance system play out before being preempted by litigation. In almost no other type of class action does there exist the kind of built-in alternative to litigation that exists with shareholders acting through the corporate governance system and within the venue of the shareholder meeting.

The value of this reform proposal is that it offers shareholders the chance to determine what remedy affords the most deterrence and most effectively contributes to their best interests as investors. Shareholders should not be automatically dragged into a lawsuit started by a plaintiffs' attorney and in which they have virtually no supervisory role. Thus, shareholder class actions should go forward following notice to the shareholders only if: 1) the shareholders fail to act; 2) plaintiffs' lawyers present to the court evidence that the shareholders did not find or consider; 3) there is evidence of collusion between the shareholders and the alleged wrongdoers; or 4) there is evidence that the corporation profited from the fraud.

Conclusion. Shareholder class action lawsuits serve little social value. They neither compensate the victims of fraud, nor deter the perpetrators. But even more than failing to confer a social benefit, they actually undermine the interests of the class members they seek to serve. Moreover, class actions do so despite the existence of an alternative forum which could far better meet the goals and issues underlying shareholder fraud suits, and despite the fact that the commencement of class action litigation effectively denies the availability of that alternative forum.

Most class action lawsuits involve plaintiffs who share no common connection other than the lawsuit. However, shareholders have a ready-made venue through which to resolve the kinds of issues that are presented in securities class actions. This venue, the shareholder meeting and voting process, gives shareholders a greater chance to actively redress the harms inflicted by corporate fraud and deter its future perpetration. The role and power of shareholders provides a more effective way of reforming corporate mismanagement than does the role and power of class action plaintiffs. Consequently, the nation's securities laws should try to allot as much leeway to shareholder investigation and sanctioning of corporate fraud as possible.

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