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COMMENTARY: *THE SOCIAL MEANING OF SHAREHOLDER SUITS*[*]

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In 1972 Abe Pomerantz settled a shareholder derivative action brought on behalf of a mutual fund for $1 million. The court awarded the firm the $250,000 fee that Abe had requested. The mutual fund had some five million shares outstanding.

Critics of the shareholder suit could have reported the next day, "Shareholders Get Pennies on the Dollar, Lawyers Get Windfall Fee." That case was *Rosenfeld v. Black*,[1] and the decision Abe won in the Second Circuit Court of Appeals was a landmark. As Judge Murray Gurfein said in approving the settlement and the fee in the district court, Pomerantz and his partner Bill Hawdely made the law.

And, indeed, they did. *Rosenfeld* set a standard of conduct which reverberated throughout the mutual fund industry. The case held that an advisor to a mutual fund occupied a fiduciary relationship to it and could not sell that position for a profit. The profit in that situation amounted to pennies per share. But the point here is that the case set a standard of conduct for an entire industry.

The same could be said of many of the other notable victories of Abe and his partners: *Perlman v. Feldmann*,[2] *Moses v. Burgin*,[3] and *Fogel v. Chestnutt*,[4] to name a few. None of those derivative actions involved large recoveries for the corporations for whom they were brought. And certainly if you calculated the recoveries on a share by share basis, they would have been picayune. But they were of immeasurable importance to the integrity of corporate governance by setting

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1 445 F.2d 1337 (2d Cir. 1971).

2 219 F.2d 173 (2d Cir. 1955).

3 445 F.2d 369 (1st Cir. 1971).

4 533 F.2d 731 (2d Cir. 1975).

standards for corporate actors. So, I would agree with Jim that the success of the derivative actions must not be measured solely in compensatory terms.

Now, with respect to the class action, here again we hear that the shareholders receive pennies on the dollar. This negative perception is what drives so much of the argument. The perception, however, is far removed from reality.

In 1998, the cash component of securities class action settlements–just securities settlements–was over $2 billion.[5] Now, that is a lot of pennies. And in the years prior we saw similar extraordinarily large recoveries on behalf of class members.

So, where do we get this notion of pennies on the dollar? The answer, I submit to you, lies in nothing more than advocacy of those who oppose the class actions and the tremendous amount of corporate resources that have been used to perpetuate that myth.

Advocates of those seeking to diminish the effectiveness of the class actions, cloaking themselves as reformers, put these various positions before Congress in 1995. But many of those positions they have now walked away from, or they have been discredited by others. I doubt that there is a person sitting in this room today who hasn't heard the hue and cry that a class action suit is virtually a Pavlovian response to a 10% price drop in a stock, that as sure as night follows day, after that drop there is a class action lawsuit.

But in a paper prepared by Professor Charles Yablon of Cardozo Law School, which is scheduled for publication in the Northwestern University Law Review, he discusses a recent study of securities class actions by the noted academicians, Professors Carlton and Weiss, and another independently prepared by Joe Grundfest of Stanford. Yablon says that they are all in accord, and I quote here: "[T]he claim that 10% stock drops automatically result in the filing of a securities class

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[5] *See Securities Class Action Alert, Settlement Summary Table,* at 30 (Jan. 1999).

action appears to be untenable."[6] While the revelation of facts supporting a securities case will typically result in a large decline, the converse is not true.

Well, congratulations. This is what we at the plaintiffs' bar have been explaining for years. This is what we argued before Congress, before the passage of the Private Securities Litigation Reform Act of 1995.[7] All that was needed to debunk this myth was to review *The Wall Street Journal* any day of the week to see that there are at least 100 companies whose shares declined at least 10% the previous day. But this perception is still promoted to this day.

Now, let's get back, if we can, to the pennies-on-the-dollar argument. To determine the relationship of a settlement to the potential damage recovery, obviously one must make an assessment of what the damages are. That valuation is far from anything that experts will agree upon.

Again, Carlton and Weiss now concede, after the Reform Act was passed, that "unambiguous observation of investors' damages is impossible."[8] Of course, when arguing their cases before the court, the plaintiffs will bias the damage number upwards. At settlement negotiations or at trial, plaintiffs come in with their damage studies, which are high, and predictably the defendants will come in with their damage studies showing that they're just a fraction of that. Yet it is the plaintiffs' calculations which the class action critics use in support of their pennies-on-the-dollar argument.

In one recent case that I settled, we had attended negotiations before a former federal judge, and we had with us our expert, a noted Stanford University economist, who had damage estimates of approximately $60 million for that case. The defendants came in with a noted professor from the Stern School of Business at NYU. His damage estimate was $4 million for the same case. The case settled for $20 million. Pennies on the dollar? Well, you tell me.

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[6] Charles M. Yablon, *A Dangerous Supplement?: Longshot Claims and Private Securities Litigation*, 94 NW. U. L. REV. (forthcoming Mar. 2000).

[7] Pub. L. No. 104-67, 109 Stat. 737 (1995) [hereinafter Reform Act].

[8] Willard T. Carleton et al., *Securities Class Action Lawsuits: A Descriptive Study*, 38 ARIZ. L. REV. 491, 492 n.5 (1996).

Now, Jim, I believe you point out in your paper that empirical data released after the passage of the Reform Act show that in approximately 83% of the cases studied, the settlements represented a significant portion of the damages estimated for the case. Yet it is on this very faulty pennies-on-the-dollar perception that so much of the debate and so much of the criticism is based. So much so that Jim is prepared to throw up the flag and agree that viewing success of these cases against compensatory measures dooms them to failure.

Another strongly agreed point casting shadows on securities class actions is that cases which settle for under $2 million are frivolous. There has been so much written on the subject that academics have accepted this as a given. But the fact is, a study just announced, again after passage of the Reform Act, that of more than 200 corporate fraud cases brought by the SEC between 1987 and 1997 related to financial statement fraud, the majority of those cases involved companies with capitalizations of under $100 million.[9] The cases are small, the damages are small, the insurance policy (if it exists) is small, and the settlement is small.

Now, I have to tell you I was on a panel like this several years ago down in Washington, D.C. with District Court Judge Stanley Sporkin. He was highly critical of the plaintiffs' bar. He said, "Stan, you guys only go after the big money cases. There's a lot of fraud involving small companies. You guys have an obligation to bring those suits as well." So, if you bring them and you settle them for small amounts, you're damned. If you don't bring them, you're damned as well.

Now, I agree if there are problems with the class actions, we should address them. But if the problems are with the perceptions, we should address those as well. Let us not merely accept the faulty perception and proceed from there.

I would like to pick up on some observations of Jim concerning the private aspects of the class action and the settlement process; I do believe that there are improvements that could be made here.

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[9] *See* Elizabeth MacDonald & Joann S. Lublin, *Proposals for Strengthening Corporate Audit Panels Influenced by New Data,* WALL ST. J., Mar. 25, 1999, at A2.

I would suggest that a big step forward could be taken if the courts would remove the cloak of secrecy concerning the evidence uncovered during the discovery process. At the commencement of these litigations there is the obligatory announcement by the defendants that they did nothing wrong, that the case against them is nothing but a nuisance suit, and that the case will be defended vigorously. When the case settles, whether it be for $10 million, $20 million or $100 million, defendants again announce that the case was meritless and that it was settled to avoid the distraction, inconvenience, and burden of further litigation.

The public never learns the true facts underlying these claims, because discovery is taken pursuant to protective orders, making the most critical evidence in the case unavailable to the public, no matter how egregious the conduct. The evidence is sealed forever. Neither the class members nor the future shareholders will know whether there was serious wrongdoing perpetrated by the trustees of their investments.

If class actions are to serve a social purpose, and I agree that they should, it is important that these facts be made publicly available. The courts should not block significant corporate wrongdoing from public scrutiny. The court should require that the briefs in support of the settlement discuss those findings made in discovery. The notice to the class should make specific reference to the availability of the briefs and their discussions of the legal and factual issues in the case. I submit that the disclosure of that information would go far not only in meeting the concerns about the private nature of these cases and their settlements, but would add greatly to the deterrent effect.

The disclosure of this information would be particularly significant given what we are seeing as a change in the composition of the class actions. Regarding the members of a class since the passage of the Reform Act, as Jim mentioned, one of the things that Congress intended was to bring large institutions into these cases to be the representative class members. In that connection, notice goes out, typically on wire services, on the Internet, etc., announcing the filing of the case and inviting shareholders to come join the action.

Well, we have not found that there are a great number of institutions coming in. But what we have found is that there are hundreds and in some cases thousands of investors in those companies who have come forward and expressed their willingness and desire to act as lead plaintiffs. In order to do that, they must file a document certifying that they are prepared to testify at a deposition, that they are prepared to come and testify at trial, and that they will receive no compensation for doing so.

Now, you have a very active class constituency that you have never seen before. You have people whose level of sophistication has increased immeasurably over the years because of everyone's involvement, through mutual funds or otherwise, in the securities market.

If there is a settlement that is inadequate, you have a group of interested people who are not only active but well informed. They're informed not only by the class notices approved by the court, but in some jurisdictions the courts require that pleadings and briefs be filed and posted on the various wire services to be available for full evaluation by the class members.

I suggest to you that if there is an inadequate settlement, you have a group of people out there ready to go into court and attack it. If they were willing to come in and at their own expense serve as lead plaintiffs in an action, you can be sure that when the money is on the table for a settlement, but is inadequate, these people have the means, the sophistication, and good reason to come in and object.

I'd like to briefly comment on the issue of insurance; it's a very serious problem, of course. I think Jim in another paper has observed that most companies do buy sufficient insurance to cover the risks that they are exposed to. And it's obviously extremely difficult to attract good directors to a public corporation if you don't have that insurance in place.

We would like very much in most of our cases to obtain contributions to the settlements by the individual defendants. I think that it would be terrific for a number of reasons, which you've expressed. But it's difficult. The settlement process for those of us who have been involved in complex actions involving large sums of money can be as difficult as the litigation itself.

Just imagine that you have this $100 million that Jim referred to before in terms of settlement. You are attempting to negotiate with the individuals to make a contribution to that settlement. And they're not willing.

Now, sure, these shareholder suits are supposed to have a deterrent effect, but their principal purpose for our clients is compensatory. Do we walk away from the $100 million that's available to our clients if it's a good settlement because an individual won't make what's most likely to be a marginal contribution to the settlement? I don't think so.

I think a way to approach this problem is not to impose a requirement in the class action to demonstrate to the court why the individuals didn't contribute, but in the derivative action. After all, in many of these cases the proper derivative action would lie. It's the corporation that has been damaged by the wrongdoing of its officers and directors. And a shareholder derivative action can lie if you get over that very difficult burden, which you referred to before as a demand on the directors, to bring the action first.

I would suggest that in the court's determination of whether or not to permit that derivative case to go forward the defendant should have the burden of showing why they did not contribute to the settlement. Let the court assess those justifications. And if the reasons do not justify the failure to make the contribution, let the derivative action go forward and let the recovery be made there.

I'd just like to comment on the thought with respect to consideration of merits on the class certification issue. I think that would depend very greatly on when the class is to be certified. The class is supposed to be certified at an early stage of the litigation, a stage of the litigation when typically we on the plaintiffs' side have available in terms of merits only public disclosures made by the corporation itself. We have not yet had an opportunity to see that hard evidence, to see the soft underbelly of the defendants in the case.

So, if there's going to be consideration of the merits in connection with class certification, I think it should be far down the litigation road, when the plaintiffs have had an opportunity to take discovery and to demonstrate to the court whether or not the case justifies being prosecuted. If it is certified, let the defendants take their risk at that point.

Let me just conclude by going back to Jim's beginning, where he suggests that the Supreme Court has abandoned its positive view of the private securities lawsuit that it had stated was so important back in the *Borak*[10] decision.

In 1985, in *Bateman Eichler*,[11] a decade after *Blue Chip*,[12] and again in 1986 in *Randall*,[13] the Supreme Court repeated once again the exact words of *Borak* and placed emphasis upon the importance of the private securities action in the enforcement of the securities laws. I submit that in *Blue Chip* the Court was not condemning the securities class action, but recognizing the dangers when it's misused.

As Madison said, "'Some degree of abuse is inseparable from the proper use of everything.'"[14] Shareholder derivative suits or class actions are not immune from that. But the current climate on Wall Street, perhaps more than ever, requires the vigilance of those prosecuting these cases, both in the public and the private sector. The public sector has already admitted it does not have the resources to cope with the problems. In the past 12 months numerous corporations have been forced to restate their financial statements previously issued to the public because of accounting irregularities. At the same time, the basis of executive compensation has changed dramatically, so that executives have the potential of reaping tens and in some cases hundreds of millions of dollars in potential bonuses if their stock options pan out. The motivation to control and to distort corporate information has probably never been greater.

If there are issues relating to the shareholder litigation, let us be cautious about how we attempt to deal with them, because the alternatives could be very damaging to what has been a very credible securities market in this country.

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[10] J.I. Case Co. v. Borak, 377 U.S. 426 (1964).

[11] Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299 (1985).

[12] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

[13] Randall v. Loftsgaarden, 478 U.S. 647 (1986).

[14] New York Times Co. v. Sullivan, 376 U.S. 254, 271 (1964) (quoting 4 ELLIOT'S DEBATES ON THE FEDERAL CONSTITUTION 571 (1876)).