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

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I'm particularly pleased to have been asked to participate in this program honoring Abe Pomerantz. I first met Abe in 1962-63 when I was working on the SEC study of mutual funds. One of the issues with which we were grappling was how to make advisory fees paid by mutual funds reflect the economies of scale realized by the advisor as the funds grew in size. Abe was testing those questions in court. As you can imagine, he was quite willing to educate us at the SEC on the subject.

When I left the SEC and went into the academic world, one of my early ventures was organizing a conference on mutual funds. Abe signed on as an early speaker. His presence assured that I would get some top-flight speakers from the industry side. I was always grateful to Abe for that early signing on.

After that Abe would periodically invite me to New York to chat. One of the things he always talked about were the "malefactors of great wealth"–that was his phrase, which I can't forget–against whom he thought of himself as a very important counterweight. He liked that private attorney general concept, Jim, with which you opened your paper.

Now, his other great theme in our conversations was his pride in having a screen credit for the movie, "Judgment at Nuremburg." I don't know whether you knew about that.

Turning to the subject of this evening. I agree that shareholder suits are one of a number of tools for seeking to

 The following discussion is presented in its original transcript format, with minor editorial changes by the author.

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assure that management serves the interests of shareholders. As has been pointed out, one difficulty with shareholder suits is that lawyers typically drive them. That is, there is no client to exercise control, because usually no client has a sufficient stake to want to do so.

Because the interests of the shareholders and the lawyers are often seen to diverge, suits often seem to be concluded in a way which does not command public respect for the case brought or the process. In Jim Cox's terms, the expressive value of the shareholder suit is diminished.

And Jim concludes that's not good because the erosion of public confidence in shareholder suits lessens the deterrent value of that tool. In other words, the shareholder suit as conducted doesn't achieve its full utility in controlling management behavior. I think that's his theme.

There is substantial literature on the degree to which shareholder suits are frivolous or, more correctly, more frivolous than suits brought in other areas. And there is also substantial literature for evaluating suggestions to make plaintiffs' counsel in these shareholder suits more accountable.

In commenting, I labor under two disadvantages. One, I'm playing in Stan's home court, which is always a disadvantage. And the second, I don't really know much about litigation. That's never been my particular field. So, I'm going to address this subject from the perspective of an advisor to senior management and to directors. Because that, at least, is something I've done.

Although, as Jim argued, lawsuits have probably come to be recognized as a cost of doing business, I still think that senior management and directors do not like to be personally sued. I can remember only one case, the inevitable lawsuit questioning the adequacy of the price Salomon got from Travelers in the Travelers acquisition of Salomon, in which some of the Salomon directors in effect said, "We'd just love to defend that transaction. And I don't want you"—me—"to yield one inch in that lawsuit." We didn't, and the suit went away.

But more typically, the shareholder suit, even if ultimately won by defendants, is seen by senior management and board members as taking time, putting people in the uncomfortable position of having to submit to questions testing their ability to remember past events accurately and articulate answers with clarity. And if you've been on that end of it, it's no fun. There is also the risk of generating unfavorable publicity.

So, I would say a credible threat of suit, particularly one that can get beyond a motion to dismiss, is unwelcome. And that has an important consequence. The desire to avoid suits, and certainly the desire to be able to construct very good defenses, provides a lever for influencing the conduct of senior management and the board. Thus, in assessing the impact of suits, I would focus less on public confidence and its relation to deterrence, and more on the role of counsel, because it seems to me that one of the primary roles of counsel is education of the board and senior management.

And that means the impact of a particular suit goes beyond the board or the management being sued. Those suits are looked at by many lawyers who then decide whether they contain lessons for the boards and managements that they counsel. It really does get back to the story that Stan told of the lawyer who says, "If you do that, Abe Pomerantz [or now Stanley Grossman] is going to sue you."

Using that lens to focus on potential deterrence or influencing conduct, let's look at a few specifics. And I'm not going to confine myself solely to shareholder suits for reasons you will understand. I'm also going to draw essentially on situations that I have experienced in my Salomon life.

In the wake of the Salomon mishap in trading U.S. government securities in 1990 and 1991, there was a settlement with the government and later an SEC order setting forth deficiencies in supervision by certain Salomon senior management, including significant penalties for three of them. Now, both that settlement and the order, as well as the underlying facts, were carefully studied by counsel all over the country. They were discussed at countless continuing legal education seminars. And as a consequence many companies made adjustments in their approach to compliance. The government action was the first step in the process of educating managements in the financial services area and in other related industries.

As Stan knows even better than I, there were also two sets of shareholder suits in the wake of the SEC settlement. Those two shareholder suits were settled with substantial awards to shareholders. I'm not arguing they were pennies. Substantial.

I ask you, however, what did those shareholder suits add on the deterrence side? Did they add much on the compensation side? Clearly, yes. But you should ask, could the compensation element have been more effectively accomplished by the SEC ancillary to its enforcement procedures? That's a question worth talking about.

A similar set of issues arose out of the Department of Justice and SEC inquiries a few years ago into market-making practices on the NASDAQ. The U.S. government thought it had made a strong case that there were anti-competitive practices, which kept spreads in the over-the-counter market wider than they otherwise would be. Again, the settlement with the Department of Justice prompted a re-examination of practices by the firms. And the SEC settlement mandated a review of such practices by a specially designated consultant. Shareholder suits piggy-backed on the government action—I know I'm being provocative when I use that term—and resulted in a roughly $1 billion settlement. Again, not pennies. Those shareholder suits sought anti-trust damages, which had a punitive aspect through the trebling of compensatory damages.

Question: Did those actions add much to the government inspired behavioral changes? Stan would say yes, perhaps on the ground that the lessons will be longer remembered because of the significant damages. And that may be a fair point.

However you come out on the question of piggy-backing private actions on government action, that doesn't challenge the value of shareholder suits as an enforcement tool where the government has not acted. For example, the SEC has been withdrawing resources from pre-effective date review of registration statements. The adequacy of disclosure and management, director, and accountant adherence to the due diligence standards for preparing registration statements has to be tested in some way. The most likely test is going to be private shareholder litigation.

Let me take one other little fact situation. In the Salomon/Travelers merger, the Salomon board met for one long evening to examine the merger as explained by management, counsel, and Salomon investment bankers. Although the board was probably ready to vote before it went home, outside counsel strongly advised that the board sleep on the proposal and vote at a meeting the following morning.

Now, why did counsel do that? Because they had read *Smith v. VanGorkum*, where directors were held liable for damages and chided for rushing to make their decision. You may recall that's the case where one of the directors signed some of the documents at the opera.

This case involved compensatory damages. The Delaware Supreme Court took the opportunity the case presented to remind counsel about the importance of process in determining whether directors had reached an appropriate business judgment. The court looked at lawyers as the audience to which it spoke. Lawyers were the critical lever for influencing management behavior.

The next question is, will counsel look at lawsuits filed or settlements negotiated to re-evaluate internal actions or procedures of a company? At Salomon, postmortems were part of the procedures we followed. Indeed, we had a very active audit committee. If the Salomon audit committee heard of a set of problems at another financial institution, it would likely ask for a "could it happen here?" analysis. Those analyses, those responses to audit committee questions are an important part of the process for developing advice to management on how it ought to conduct its business with the least chance of getting into trouble.

For example, I recall the early publicity about customer unhappiness and the later commencement of suits involving the sale by a bank of derivative instruments. Now, we didn't have to wait for any lawsuit to be decided for us to take the signal and say, "You know, we better study our institutional sales practices," and to produce a set of guidelines for future sales of similar investments by the company.

As I think of that last example, I suppose you might ask me: if those circumstances triggered only damages, economic costs, could lawyers effectively educate management? Or would management say, "Well, don't bother us with that. We just figure that in as a cost, and therefore we'll continue to behave in this way even though somebody else might say it constitutes highly questionable behavior"?

I think most often the answer to that question is that management would take the advice seriously. One of the reasons, of course, is that neither counsel nor management can confidently predict the remedy at that juncture.

Now, I guess that part of my assignment is to make a few comments on some of Jim Cox's specific suggestions. And here I'm on dangerous ground, because I've already admitted I don't know much about this area. But nevertheless.

One of the things Jim talked about is the lead plaintiff provisions of the Private Securities Litigation Reform Act of 1995.[1] And one thing that intrigues me is, why have courts been hospitable to efforts by traditional class action lawyers to undercut that provision? And by undercutting it, I mean by permitting aggregation of plaintiffs or creating a committee which includes those traditional class action lawyers.

Although Stanley tried to address that question, I actually didn't find that I was persuaded by his answer. If you've got a large number of plaintiffs, you probably won't have anybody who's got enough of an interest to control that litigation, to make counsel accountable. You may disagree with that and you may be right, but at least that's the way it looks to an amateur.

Now, my guess, and I just put it out as a guess, would be that judges actually like to see cases settled. And they think the Stanley Grossmans of the world know how to settle cases relatively quickly and with an appropriate degree of balance. And as long as judges have that attitude, I think you will find that the lead plaintiff provisions are going to be watered down.

Second, Jim suggests that the settlement procedures should either include payment by the individual defendants or an affirmative finding by the court that it's appropriate not to require such a payment. Now, you've got to remember that Jim's suggestion includes capping liability for the directors–under the ALI standard it would be roughly two or three times their annual compensation from the company.

Now, if you think about what would happen if you took Jim's suggestion seriously, it's going to force more cases to trial, or at least to prolong the process. Since the directors' legal expenses are likely going to be reimbursed by indemnification or insurance, the individual directors are going to have a low cost incentive to seek vindication. And you can't discount the degree to which somebody emotionally wants to

[1] Pub. L. No. 104-67, 109 Stat. 737 (1995).

be vindicated. And from a financial point of view, the upside risk to the defendant is not very great.

Jim might say, "The upside risk will still be great enough and I'd like to have that happen." But I wonder whether that's good for the defendant corporation, which, after all, may determine that litigation produces bad publicity, diverts management attention, produces other unproductive internal consequences, and creates an unacceptably high risk of a high damage award.

In other words, a 10% chance of a $1 billion award may counsel that you ought to do a $20 million settlement. If that's so, that may be in the interest of the company. Should there be incentives to prevent that result from occurring?

Third little point, on Jim's contemporaneous ownership position. I'd be surprised if that's really much of an obstacle in pursuing derivative suits. It seems to me, as Stan mentioned, Internets and things of that sort have created fairly efficient ways to find potential plaintiffs.