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SECURITIES & EXCHANGE

Giving Shareholders the Right to Say No

Shareholders should be able to vote against pursuing securities class action suits.

BY ALBERT H. CHOI, STEPHEN J. CHOI, AND ADAM C. PRITCHARD

When a public company releases misleading information that distorts the market for the company's stock, investors who purchase at the inflated price lose money when (and if) the misleading information is later corrected. Under Rule 10b-5 of the Securities Exchange Act of 1934, investors can seek compensation from corporations and their officers who make materially misleading statements that the investors relied on when buying or selling a security. Compensation is the obvious goal, but the threat of lawsuits can also benefit investors by deterring managers from committing fraud.

The value of deterrence accrues to all investors and the market more generally, and only fractionally (based on share ownership) to the investor filing suit. A retail investor with only a few hundred shares will expect a minimal benefit from any recovery while bearing the entire cost of litigating a claim. This mismatch of individual and collective incentives means that, although the group of investors might collectively favor bringing a suit against a public company that releases misleading information, most individual investors will not be inclined to sue. Moreover, a fraud lawsuit against a public company can easily cost millions of dollars, so few investors can afford to litigate on their own.

The class action mechanism helps overcome these disincentives to bringing suit: the class representative represents the class members' collective interests. Individual class members need not expend their own resources to obtain a recovery. Plaintiffs' attorneys, compensated on a contingency basis, will bankroll the litigation and bear the risk of loss if the case does not settle. Investors do not even need to pay attention to the litigation until a settlement is reached. All they need to do is submit a claim form once the lawsuit is concluded.

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The class action ameliorates the collective action problem facing dispersed investors, but aggregation of claims brings its own set of problems. These problems stem from the incentives of the plaintiffs' attorney firms that serve as class counsel. The class counsel is paid—as a percentage of the recovery—only if there is a settlement or judgment. Typically, class counsel receives a fee of 10% to 33% of the settlement fund, a number that dwarfs the interest of any investor class member. Although in theory the class representative makes decisions on behalf of the class, in practice plaintiffs' attorneys make the critical decisions regarding the litigation. He who pays the piper calls the tune.

With potentially large sums at stake, plaintiffs' attorneys enjoy a lucrative practice, but the societal benefits of Rule 10b-5 class actions are less obvious. Particularly troublesome are suits alleging that corporate defendants have made public disclosures that distorted the price of the company's securities in the secondary market, but the company itself did not sell any securities. These "open market" fraud cases make up the lion's share of suits against public companies (approximately 80%). Investors who transact with other investors can recover from the company for their trading losses under the typical "out of pocket" measure of damages. Their counterparties—investors usually unconnected to the company other than through share ownership—make corresponding trading profits. The immediate net social cost of these trades, apart from the cost of executing them, is zero. Consequently, the out-of-pocket damages formula substantially overstates the social loss from the misstatements.

For companies with large trading volume, Rule 10b-5 damages in a class action can be enormous. Moreover, shareholders who find themselves on the losing end can often protect themselves at low cost through diversification: when an investor holds a well-diversified portfolio, even though the investor may be on the losing side of a trade because of one company's misleading statement, she

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may be on the winning side of a trade with a different company.

Outsized potential damages encourage nuisance litigation. Even when a company has not intentionally or even negligently made a materially misleading disclosure, the company may have reasons to settle a nuisance suit. Settlement not only allows the company to save the costs of defending the suit, but also avoids even a small possibility of losing. A loss after trial means paying potentially bankrupting damages. If companies are willing to settle nuisance litigation, opportunistic plaintiffs' attorney firms are encouraged to file such suits to exploit this corporate vulnerability.

Many of the developments in Rule 10b-5 legal doctrine over the past several decades have focused on filtering out nuisance litigation while allowing meritorious litigation to proceed. Doctrinal reforms to Rule 10b-5 implemented by both Congress and the courts—most notably the Private Securities Litigation Reform Act of 1995 (PSLRA)—have attempted to screen meritless suits. These reforms, however, have had only limited efficacy in more precisely distinguishing meritorious suits from frivolous ones.

We propose a new decision-maker for screening securities class actions involving corporate defendants: the corporation's shareholders. Our proposal would allow shareholders to vote on whether to limit or modify class actions across the board. Shareholders could also vote on whether to terminate a particular class action or allow it to move forward. We argue that empowering shareholders to make the key decisions about securities fraud class actions cannot only discourage nuisance litigation, but also can give shareholders the ability to encourage meritorious litigation that serves the deterrence purposes of the securities laws.

DECIDING WHO SHOULD DECIDE

Currently, two players largely decide whether a securities fraud class action should proceed from the filing of suit to past the motion to dismiss (which typically occurs soon after the selection of lead plaintiff for the class action and the filing of a complaint by the lead plaintiff):

- the plaintiffs' law firm, which decides to invest the resources in bringing a suit (including finding a shareholder-plaintiff with standing); and
- the court, which decides whether the complaint has enough indicia of merit to proceed past the motion to dismiss.

Plaintiffs' lawyers have incentive to bring suit whenever they think they can extract a settlement at a reasonable cost, which can leave plenty of room for nuisance settlements. So, the judge's decision on the motion to dismiss becomes the critical screening device. But that decision is necessarily a constrained one, restricted to the facts as alleged in the complaint, which typically provide a very one-sided picture. Legal doctrines that constrain the information that judges can consider in making their decision may increase the consistency of decisions across judges, but that consistency comes at the cost of accuracy in screening out nuisance suits. In the end, the accuracy of these decisions often turns on the expertise, experience, and temperament of a specific judge. Once a case has survived a motion to dismiss, settlements are nearly universal, as the expense of litigation and the possibility of a billion-dollar judgment make settlement a smart choice for most corporations.

More damning from a social welfare perspective, judges never address the question of whether the litigation is value-increasing for shareholders or for society. The topic is simply ignored by existing legal doctrine. Even if a judge were to address the question of what is best for shareholders (or more broadly for society), most federal judges are ill-equipped to answer this question.

Shareholders have their own money at stake in this question and might well have more insight into the question than the average federal judge. And yet, shareholders play almost no role in the decision of whether a securities fraud class action should proceed. In theory, a plaintiff who bought shares during the class period must decide to lend his or her name to the complaint, but plaintiffs' lawyers have thousands of shareholders to choose from, and the reach of the internet makes it easy to find at least one who is willing to file a claim.

Suppose an institutional investor—say, a mutual fund—believes that a securities class action is undesirable, perhaps frivolous, and wants to end it. Under the current regime, it is essentially impossible for that fund to stop a securities class action. To stop the litigation, the mutual fund must throw its hat in the ring to become lead plaintiff after the suit is filed and, assuming it is selected, move to dismiss the suit. Any mutual fund that does so, however, will likely find it impossible to convince a plaintiffs' attorney firm to represent the fund on a contingency fee basis in the future. The fund will therefore need to pay attorney fees to file the lead plaintiff motion—costs the fund will need to bear individually. Paying attorney fees to seek to become lead plaintiff only to terminate the litigation is irrational. As far as we know, no fund has ever done this in a securities class action.

In practice, funds that oppose the litigation can only express opposition to a class action by opting out. Opting out, however, does not result in the same payoff for the fund as terminating the class action. If other investors do not opt out and the fund continues to own shares in the corporate defendant, it will bear the burden of the compensation paid by the company to the other investors.

This lack of shareholder influence flies in the face of the dominant trend in corporate governance, which is to give shareholders more of a say in corporate decision-making. Shareholders have long had the power to vote for directors and to approve important transactions such as mergers, liquidation, and charter amendments. Institutional shareholders now take a much more active role in corporate governance, and a cottage industry of proxy advisers has emerged to assist those investors in exercising their governance rights. Proxy fights, once a rarity, have become a standard tool of activist investors like hedge funds. Congress, for its part, has given shareholders the right to an advisory vote on executive compensation ("say on pay"). Shareholder voting is an important influence on corporate governance these days.

WHY SHAREHOLDERS?

Unlike federal district judges, shareholders have a direct financial interest in securities class actions. Shareholders will focus on their own wealth maximization in weighing the pros and cons of allowing securities class actions. Even with respect to the narrower question of whether the suit is frivolous, there is a potential for more accurate assessment of a particular class action relative to an assessment made by an inexpert judge. Increased accuracy would reduce the need for further legal reform to weed out nuisance litigation and make the class action system overall more beneficial for investors and society. Our central claim is that shareholders voting as a group will make more accurate decisions compared with a federal district judge on the question of whether a securities class action is in the best interests of investors and, indirectly, of society.

Specifically, shareholders will consider the value of deterring fraud by their own firm. Reduced fraud lessens the risk to shareholders of purchasing overvalued (or selling undervalued) securities and will lead to more accurate corporate disclosures. More accurate disclosures also:

- promote increased market efficiency;
- reduce uncertainties and problems of information asymmetry that shareholders face when trading in securities, which can lower bid–ask spreads and increase market liquidity; and
- facilitate private capital market mechanisms, such as hostile takeovers, that discipline poorly performing managers and lead to better corporate financing and investment decisions.

All of these benefits are incorporated in the firm's stock price. Particularly relevant here, more accurate corporate disclosures also promote more informed shareholder votes in general, including the election of directors. More informed voting could improve the overall corporate governance of a firm.

Shareholders will also consider the corporation's costs in defending class actions, including the corporation's attorneys' fees and expenses. Although initially borne by the company (and its liability insurers to the extent the defense costs do not exceed policy limits), these costs will ultimately be borne by the shareholders. Insurers will incorporate the expected costs of litigation in insurance premiums charged to the firm. Firms will pay the premiums from corporate assets, thereby reducing shareholder value. Shareholders also will consider the harm to corporate value from indirect costs such as harm to its reputation and management distraction. To the extent the plaintiffs' litigation costs are paid for indirectly through an eventual settlement payment, shareholders will also internalize these costs. Other costs include the ex-ante chill on managerial risk-taking created by the possibility of litigation. Managers will tend to be conservative if decisions that do not pan out are met with second-guessing—sharpened by hindsight—in the form of a securities class action. We collectively refer to these costs as the enforcement costs.

On the other hand, shareholders will factor in the possibility that they may receive a payment as a member of a class action. To the extent that the company pays the settlement, the payment will decrease the value of their continued holdings. For any one shareholder, the balance of these two factors may vary. Compensation will transfer money from those shareholders who remain as shareholders when compensation is paid (or at the time the market anticipates compensation will be paid) to those shareholders who are members of the class who sold their shares prior to that time. Prior to any specific class action, the costs and benefits of expected settlement payments are likely to be a wash from a shareholder's perspective. Shareholders making an ex-ante decision on securities class actions may not know whether they will be the shareholder who will receive a transfer (if they are members of the class) or one who will pay a transfer (if they are not class members).

When the benefit from a payment and the cost to the firm of a payment wash out from the perspective of a shareholder, the net private benefit of a settlement to shareholders will come from potential benefits, represented by improved accuracy in security prices and other governance benefits, minus the enforcement costs.

The private costs and benefits that shareholders internalize may not match the social costs and benefits of securities class actions. From a societal perspective, the value of a securities class action turns on the overall deterrence produced. The social benefit from reduced fraud and more accurate disclosures includes not only the benefit to shareholders of a specific firm, but also potential spillover benefits to shareholders of other firms from an overall increase in investor confidence in the capital markets. Although there is a divergence between private and social costs and benefits, that gap may not be large. A shareholder with only one stock in her portfolio will presumably not care about spillover benefits. Such single-stock investors, however, are not the norm. Institutional investors, such as mutual funds and pension funds, typically own diverse portfolios of securities and therefore will assess the benefits of securities fraud deterrence from a portfolio-wide perspective.

WHAT SHOULD SHAREHOLDERS DECIDE?

Under our ex-ante proposal, shareholders would be allowed to "tailor" their company's securities class action regime before the filing of any specific class action. Shareholders could consider several modifications for Rule 10b–5 class actions. As a straightforward but drastic measure, shareholders may vote to eliminate Rule 10b–5 class actions altogether, eliminating the need for a company and its management to expend resources on such litigation. If shareholders believe that a significant number of securities class actions lack merit, then an ex-ante blanket prohibition saves the company from the costs of defending unfounded litigation. Blocking all class actions, of course, comes at the cost of eliminating the deterrence benefits of Rule 10b–5 class actions; the baby is thrown out with the bath water. Shareholders of some companies may find this tradeoff worthwhile. For example, if a company has a robust corporate compliance department with strong internal controls, its shareholders might waive Rule 10b–5 class actions entirely.

More narrowly, shareholders could limit recovery in securities class actions. Shareholders could opt for a disgorgement measure or place a cap on damages. These reforms would limit the pressure on firms to settle nuisance litigation to avoid even a low probability of paying outsized out-of-pocket damages in open market fraud cases. Disgorgement would largely eliminate liability for corporations while maintaining the exposure of corporate managers or intermediaries, such as auditors, in open-market fraud cases. Alternatively, shareholders could limit actionable allegations to those that can more easily be verified through litigation, such as Generally Accepted Accounting Practices (GAAP) accounting violations, thereby screening out "event driven" class actions caused by business reversals rather than fraud. In the same vein, shareholders could limit suits involving forward-looking statements, expanding the existing safe harbor in Section 21E of the Exchange Act. Shareholders could vote to remove all private liability for forward-looking statements regardless of cautionary language. Depending on the firm's circumstances, these limits may help tailor Rule 10b–5 liability to promote deterrence while reducing nuisance suits.

Shareholders could alter the compensation structure of class actions through fee-shifting. For instance, the shareholders can, ex ante, agree that the loser of the litigation will pay for the winner's litigation costs (for instance, attorney fees). This reform presumes that the plaintiff-shareholders (or, more realistically, the plaintiffs' attorneys) will have at least some information regarding the merit of the lawsuit at the time of filing. By implementing a loser-pays-all system, the shareholders can encourage more meritorious lawsuits while discouraging non-meritorious lawsuits from going forward. When a plaintiff's attorney is aware that the case has little chance of winning, the prospect of having to compensate the corporate defendant's litigation costs can be a powerful deterrent against instituting suit. Conversely, when she believes the suit has strong merit but is concerned about having to pay a lot to prosecute it, the fact that the expenses will be reimbursed by the corporation can bolster the incentive to file suit.

Shareholder modifications might go in the opposite direction. We can imagine shareholders choosing to expand liability or damages in certain situations. The present regime favors actions on larger public company defendants, leaving a gap in enforcement against smaller companies. Plaintiffs' attorneys face substantial fixed costs in litigating a securities class action, including drafting and filing a complaint, defending against a motion to dismiss, discovery, and class certification. Moreover, attorneys' fees correlate with potential damages, leading plaintiffs' attorneys to target smaller issuers less frequently. Shareholders of smaller issuers who value deterrence could bolster the incentives of plaintiffs' attorneys by increasing the fraction of the settlement award that goes to attorneys' fees, a bounty scheme of sorts. Currently, there is a de facto cap of one-third of the settlement for attorneys' fees, which may discourage suits against smaller issuers.

This bias against suing smaller issuers is exacerbated by the fraud-on-the-market presumption of reliance. Under the current doctrine, plaintiffs' attorneys must demonstrate market efficiency to obtain the fraud-on-the-market presumption to certify a class. Market efficiency is easier to demonstrate for large companies because they typically have greater trading volumes and are held principally by institutional investors. Shareholders could modify Rule 10b–5 liability by adopting a presumption of reliance that does not require a showing of market efficiency to facilitate class actions against smaller market capitalization issuers.

To improve the accountability of plaintiffs' attorneys, shareholders could choose to reward objectors to settlements. Properly incentivized objectors could provide the monitoring of attorneys' fees requests that is sorely lacking under the current regime. Ensuring that objectors receive a reasonable fee for their efforts on behalf of the class could help keep fee requests by class counsel in check.

Finally, allowing shareholders to vote on reforms for securities fraud class actions can promote learning over time. Companies adopting varying Rule 10b–5 regimes will serve as mini-laboratories of private ordering, providing information to the market on the efficacy of various reforms. That learning would promote more precise tailoring over time. If limiting liability or class action mechanisms lead to a noticeable increase in fraud and decrease in deterrence, shareholders can also vote to scale back their earlier tailoring.

Up or down? / Instead of deciding on an across-the-board, ex-ante approach, shareholders could assess each class action ex post after it was filed. This would allow shareholders to evaluate the merits of the case and its cost and benefits. We imagine an ex-post approach can be particularly effective in stopping nuisance litigation. For example, we are confident that shareholders would vote against "deal tax" suits filed in most public mergers and acquisitions, which are quickly settled with additional disclosure of dubious value. These suits rarely produce any tangible benefits for shareholders.

A shareholder vote would also reduce the role of judges. If the shareholders vote against a class action, then a judge may not need to assess the merits of the case. Judges lack expertise in assessing the business aspects of securities laws violations, so shareholders may be better equipped to make a more informed decision.

Unlike our reform proposals discussed above, which contemplate both reductions and expansions of the existing securities class action regime, our proposed ex-post shareholder vote would do only one thing: terminate or continue the securities class action. Shareholders would use the management's proxy statement for the annual meeting to propose terminating a class action as a shareholder proposal under Rule 14a-8 of the Exchange Act. If no proposal is made or the proposal does not garner a majority, the class action would continue. To avoid repeated disruption to an ongoing class action, only one vote would be allowed per suit. If more than one shareholder proposal to terminate a specific class action is received, management could reject substantially similar proposals. This approach is consistent with the current shareholder proposal regime under Rule 14a-8.

The timing of a vote may affect the amount of information available about a securities class action. One possibility would be to allow a vote to terminate a class action at any time after its filing. This would allow shareholders to eliminate nuisance litigation earlier, thereby reducing the corporation's defense costs. Weighing against those savings, however, is the need for time to uncover evidence to determine whether the action has merit. Complete information on the value of the class action may not be available until after discovery. Even with discovery, in the present class action regime much of the information that is produced is sealed by the court as confidential.

We think a vote to terminate a securities class action should come only after the litigation has progressed far enough to develop information on the underlying allegations and the suit's prosecution. In our view, allowing management or shareholders to make a proposal to terminate a securities class action at any time after the motion to dismiss has been decided could strike a reasonable balance. Having the case survive a motion to dismiss ensures that at least the presiding judge views the case as plausible. Moreover, it will provide the shareholders voting on the proposal more information in the form of the motion to dismiss briefs and the judge's decision. Finally, the costs of litigation are manageable until the motion to dismiss is decided.

An alternative would be to hold the vote after discovery. This would allow for plaintiffs' attorneys to uncover more information to help make a case to the shareholders to allow the class action to continue. On the other hand, delaying a vote until after discovery greatly diminishes the litigation savings available from termination because discovery tends to be the principal cost of securities class actions.

Another question raised by allowing shareholders to vote to terminate a class action is which shareholders should vote. A complete analysis of the voting allocation question is quite technical, but the basic intuition follows from our initial discussion of the costs and benefits of securities class actions. In a nutshell, deterrence is the principal social benefit produced by these suits, with compensation being a largely circular exercise of shareholders paying shareholders. To get the socially optimal answer to the question of whether a particular lawsuit should proceed, we should assign the voting power to people whose interests align with the goal of deterrence rather than the private goal of seeking compensation. Instead of those shareholders eligible to recover in the class action, we argue for a rule that allocates votes in proportion to the shares purchased in the class period and still held at the time of the vote.

Our rule limits the votes of shareholders who own shares at the time of the vote but either purchase no, or proportionally few, shares in the class period. These shareholders have little to no shares eligible for damages. Such investors will have sub-optimally high incentives to terminate the class action because they disproportionately bear the costs of compensating the class period investors. These will typically be individual buy-and-hold investors. So, who gets the majority of votes under our proposal? Votes will go primarily to active institutional investors because those investors will systematically trade more than individuals and index funds in the class period and thus obtain a greater fraction of the class damages relative to the buy-and-hold investors.

We conjecture that for active institutional investors, responsiveness to new information on a company is roughly proportional to the investor's ownership of the company's shares. An institutional investor with a significant fraction of shares in the company will pay more attention to news related to that company. When the company puts out fraudulent information overstating the value of its shares, the institutional investor with significant ownership, without knowing of the fraud, will be more likely to purchase shares in response to the information compared to other investors. As a result, at least a subset of these institutional investors will trade in the class period in a proportion roughly equal to the investors' long-term fractional ownership (i.e., a 5% block shareholder will account for 5% of the trades in the class period related to the alleged fraud). The benefit from damages will equal the cost to the investor from the firm paying the damages.

Similar with shareholders voting ex ante, this subset of institutional investors will consider compensation through damages a wash and only balance the deterrence value of the class action against the overall enforcement cost of litigation. Thus, their individual balance will approximate the overall social welfare balance from allowing (or terminating) the class action. For institutional investors that own a diversified portfolio of shares, the value of a class action will also include the overall deterrence benefit to the broader market.

Depending on the company, it is possible under our rule that the pivotal shareholder in a vote will trade proportionally *more* in the class period compared with the shareholder's long-term fractional ownership, thus biasing the voting base toward approving of a class action. Because individual buy-and-hold investors trade proportionally less in the class period compared with their long-term fractional ownership, the buy-and-hold investors implicitly subsidize the damages paid to institutional investors who frequently trade. Although the bias in our voting proposal (which gives no or few votes to the buy-and-hold investors) will not always result in a vote to terminate a class action when warranted from a societal perspective, our voting proposal nonetheless improves on the current securities class action regime. Because only termination of a class action would be subject to a vote, the pro–class action bias in voting will not expand the number of class actions compared to the status quo. This one-sided nature of our ex-post class action voting proposal would instead only allow shareholders to terminate those class actions when the value to such shareholders of the class action does not exceed the costs. Allowing a vote to terminate the class action will allow shareholders to terminate class actions for which the costs of litigation clearly outweigh the deterrence benefit to the shareholders.

CONCLUSION

Direct shareholder control through voting can potentially deliver increased accuracy in distinguishing between nuisance and meritorious securities litigation. The screening doctrines employed by judges inevitably have both false positive and false negative errors. Having a successful voting regime will take pressure off inexpert judges to screen meritless suits. More generally, direct shareholder control may help align the decision whether to allow securities class action litigation with society's interest in deterring fraud.

The growth of institutional ownership, the rise of activist investors, and the increasing influence of proxy advisory firms all support a bigger role for shareholders in controlling securities class actions. Transferring control to shareholders would also allow more positive inducements to encourage value-increasing class actions, such as increasing attorney fees in smaller cases. We should allow shareholders to "Just say no" to securities fraud class actions. When shareholders vote "Yes," we can be more confident that a shareholder class action actually serves shareholders' interests. R

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