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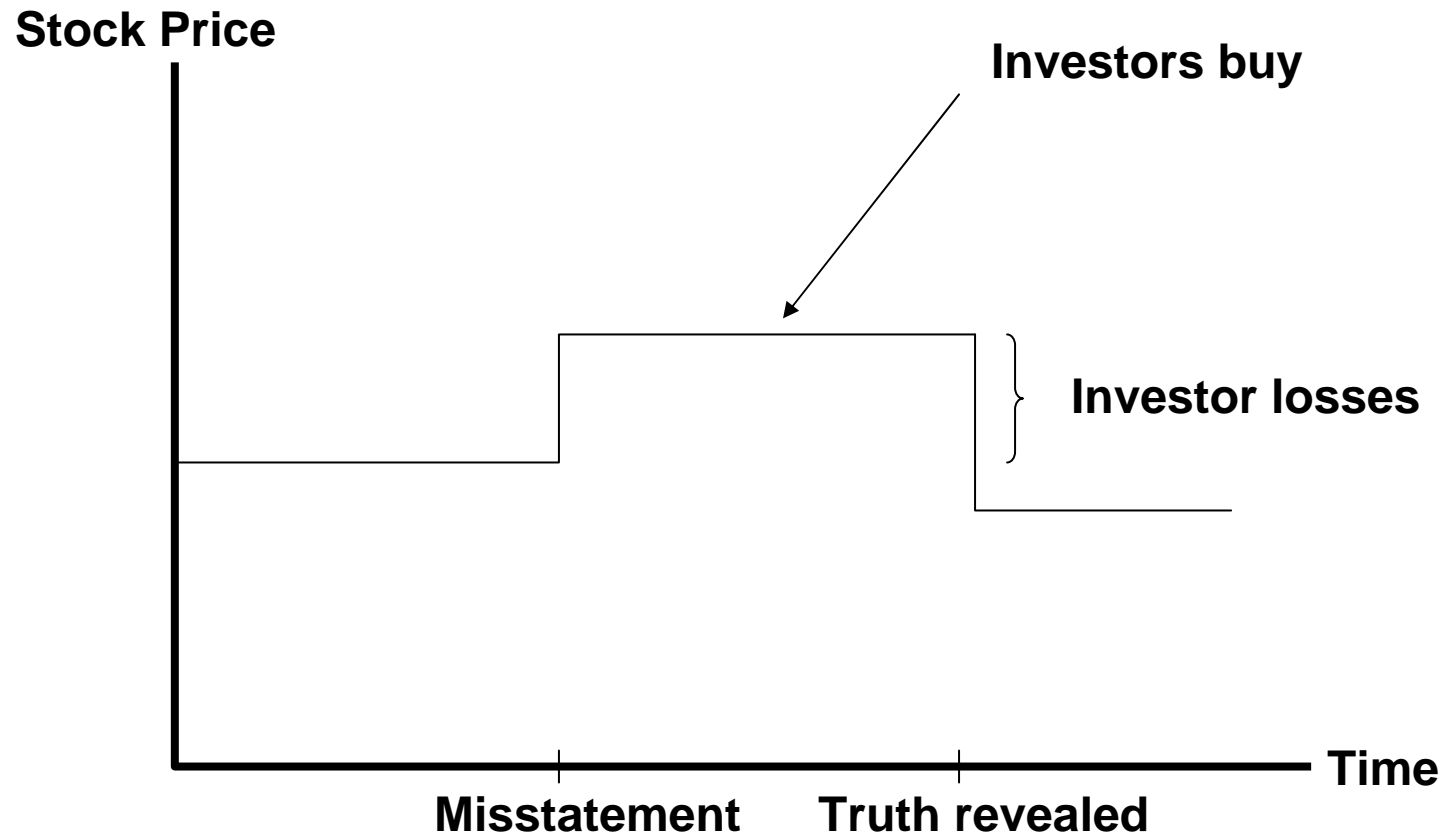
**Private Enforcement of Shareholder
Rights under U.S Securities Laws:
A Cautionary Tale**

Michael Klausner
Stanford Law School

Securities laws

- ⇒ Securities Exchange Act, Section 10(b)
 - No “material misstatements”
- ⇒ Requirements
 - Misstatement
 - Intentional or highly reckless
 - Causing a loss to investors

Time line of a violation



Securities laws

➔ Enforcement

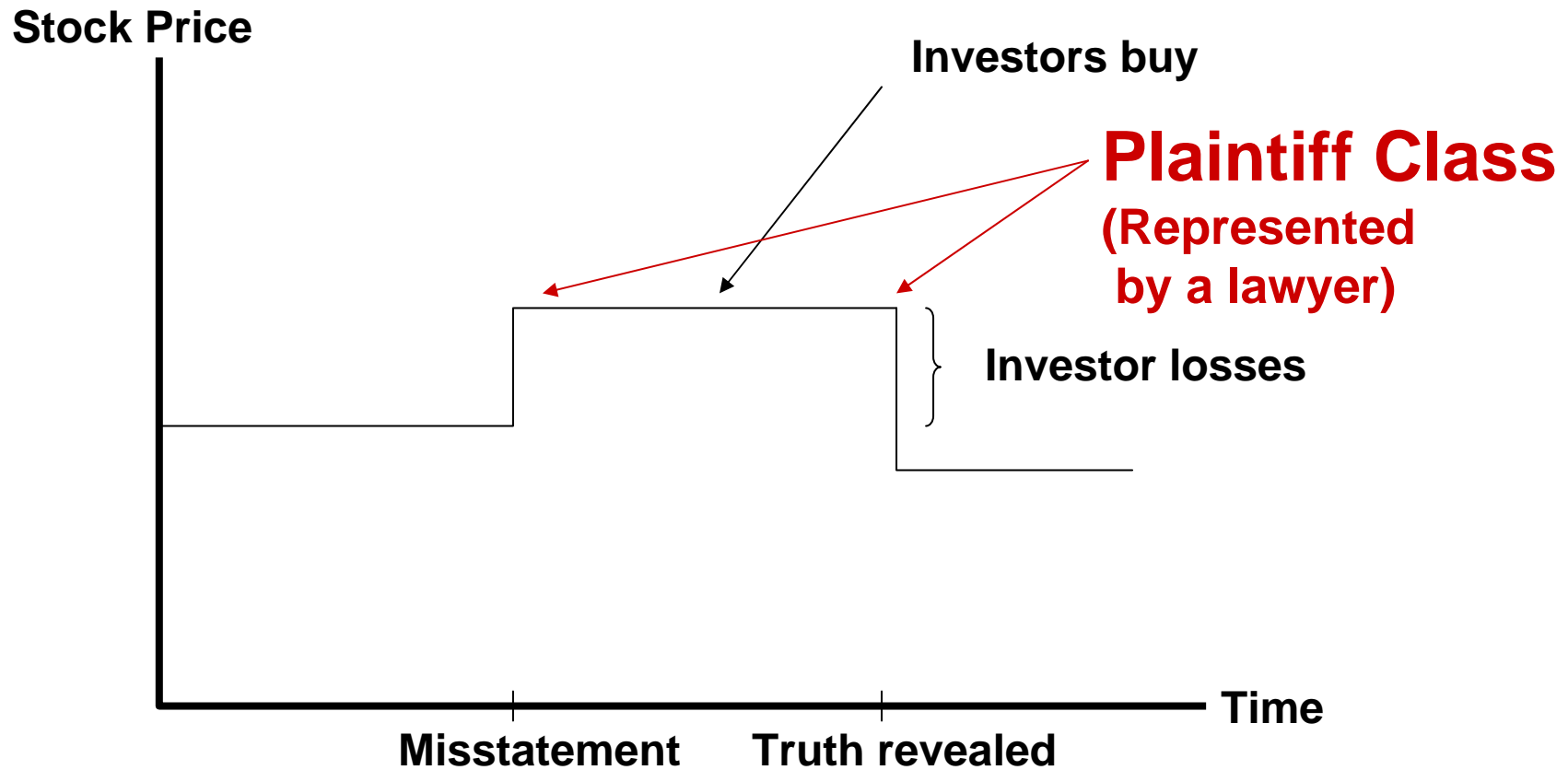
- Public

- Securities and Exchange Commission (SEC)

- Private

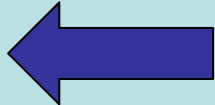
- Securities class actions
 - Plaintiffs are investors who lost
 - The lawsuit is controlled by a lawyer

Time line of a violation



Securities laws

⇒ Defendants

- Corporate officers
- Corporate directors
- Corporations themselves 
- Third-party advisors (accountants, investment banks)

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⇒ Director and Officer Insurance

- Except for “deliberate fraud”

What good do securities class actions do?

- ⇒ Compensation?
- ⇒ Deterrence?
- ⇒ Neither?

Why are we concerned?

- ⇒ Strong incentives to settle
 - With company money
 - With insurer money
 - Even if merits not strong
- ⇒ Result: Shareholders pay shareholders
- ⇒ If managers do not pay
 - Weaker deterrence
 - No compensation

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What are incentives to settle?

Managers' incentives

- ⇒ If they lose at trial, they are financially ruined
- ⇒ The company may be too
- ⇒ If they settle
 - The D&O insurer will probably pay
 - And the company will pay (less)
 - Perhaps officers can pay nothing

Plaintiffs' lawyer's incentives

- ⇒ He may want to win at trial
 - But trials are expensive
 - He is likely risk averse
- ⇒ Lose at trial → get nothing
- ⇒ Settle → get 25% to 33% of the payment
- ⇒ Does not care who pays

Empirical Questions:

- ⇒ Do class actions compensate?
- ⇒ Do they deter misconduct?
- ⇒ Do officers pay when they should?

Sample Cases, 2000-03

	<u>N</u>	<u>Percent of cases filed</u>
Total number of cases	746	100%
Cases dismissed or voluntarily dropped	263	35%
Cases settled	422	57%
Cases tried	3	0.4%
Cases ongoing	58	8%
Cases with parallel SEC enforcement action	147	20%
Cases with parallel criminal action	51	7%

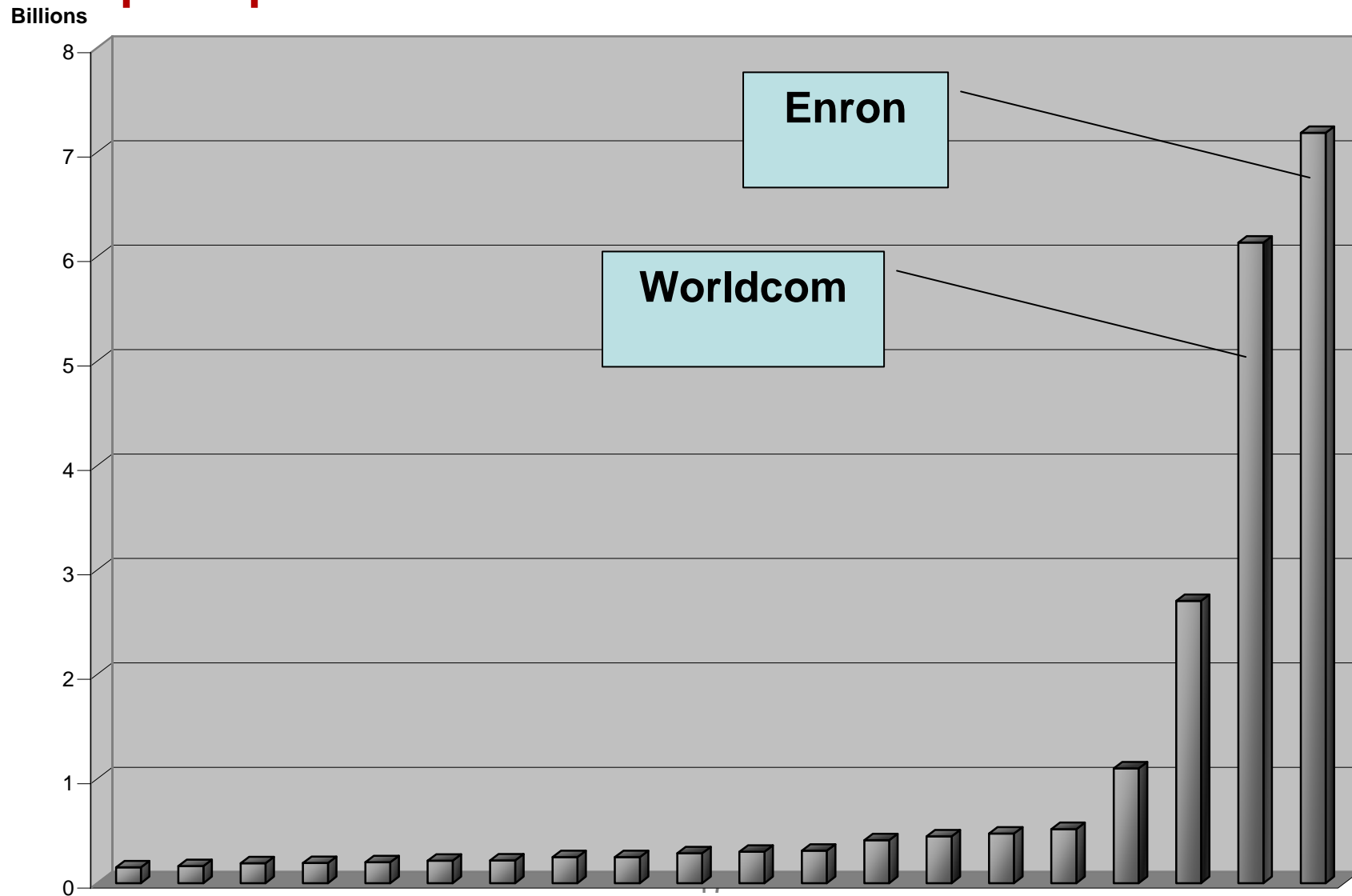
Sample Cases, 2000-03

	<u>Mean</u>	<u>Median</u>	<u>N</u>
Amount paid	\$82 million	\$7.5 million	425

Percent of investor losses recovered

All cases	5.6%	2.6%	425
Cases with over \$1 billion in losses	2%	1%	114

Top 5 percent of settlements



Sources of settlement payment

	<u>Number of Cases</u>	<u>Percent of Cases Settled</u>	<u>N</u>
Company	172	44%	387
D&O insurer	328	86%	383
Officers	27	7%	405
Third party (e.g. auditor)	77	18%	425

Settlement prediction model and officer payments

	<u>Total Payment</u>	<u>Officer Payment</u>	
Parallel SEC Action	.3469***	.7605	
Parallel Derivative Suit	.3871****	-.0302	
Restatement	.2341**	-.8217	
Log Damages	.4937****	-.1007	
Accountant Defendant	.3315*	2.306****	
Underwriter Defendant	.5826****	-.1427	
Public Pension Plan Lead Plaintiff	.7940****	1.358**	
R ²	0.69	.22	**** p < .001
N	374	374	*** p = .005
			** p = .05
			* P = .01

Officer payments and indications of merits

	<u>Officer Payment</u>		
	<u>Yes</u>	<u>No</u>	
Criminal Conviction	9**	13	22
Parallel SEC Action	18**	9	27
SEC 10(b) Action	16**	11	27
Officer Payment to SEC	13*	14	27

What happened in these cases?

** p-value = .001

* p-value = .005

Under-inclusiveness

	<u>Mean</u>	<u>Median</u>
Settlements with no officer payments	\$48.6 million	\$7 million
Settlements with officer payments	\$57.9 million	\$8.9 million

<u>Settlements with no officer payments</u>	<u>Number of cases</u>
Parallel SEC action	129
SEC monetary sanction against officer	67
SEC bars against serving	65
Criminal convictions	42

Conclusions

- ⇒ Officer payments very infrequent
- ⇒ Many meritorious cases with no officer payments
- ⇒ No compensation
- ⇒ Questionable deterrence
- ⇒ Shareholders pay the cost
- ⇒ Lawyers get the benefit

Additional points

- ⇒ Same problem for shareholder suits generally
- ⇒ Reform of private enforcement very difficult
 - Need large recovery to lure plaintiffs' lawyers
 - Officers (alone) cannot provide it
 - Cannot eliminate D&O insurance or corporate liability
 - Cases too imprecise and too large
 - Cannot eliminate D&O insurance
- ⇒ Legal mandate of officer contribution a bad idea
- ⇒ Potential solution: eliminate class actions

Additional points

- ➔ Potentially different with controlling shareholder
 - But controlling shareholder must be the defendant