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Securities class actions: improving corporate governance through accountability

In the aftermath of the near-fatal meltdown of the world's financial systems, an analysis of the causes of the crisis is under way by the United States Congress and by others to determine what changes need to be made to prevent future catastrophes. Among the obvious causes of the financial crisis is the problem of 'moral hazard', where a company's management has personal financial incentives to act despite, or even against, the interests of the company's shareholders. In the United States, and almost nowhere else, securities class actions serve to counterbalance management's incentives to commit fraud.

Gain from fraud must be counterbalanced by the threat and consequences of discovery

The current financial crisis is just one of seven major economic crises since the late 1980s, including the stock market crash of 1987, the savings and loan crisis, the Mexican financial crisis, the Asian Financial Crisis, the Long-Term Capital Management liquidity crisis and the bursting of the technology bubble of the late 1990s.[1] Despite the diverse causes for these crises, they share a 'single unifying thread': the existence of systemic moral hazard,[2] which refers to 'the distortions introduced by the prospect of not having to pay for your sins'.[3]

During these same 20+ years, the world has experienced some of the greatest individual securities frauds that have ever been perpetrated, including Enron, Adelphia, WorldCom and Tyco, among others. These frauds have focused a harsh light on the wanton greed and self-serving behaviour of corporate executives during a time of diminished regulation and increased hurdles for securities class action enforcement. In light of these cases and the recent near meltdown of the financial system, the proponents of a pure laissez-faire approach to market regulation are on the defensive, unable to justify their faith in self-control in the face of apparently insatiable greed. On the other hand, proponents of keeping an ever-vigilant eye on the handlers of our fortunes maintain a scepticism that comes not from a lack of faith in human nature, but from the belief in 'the relative impotence of moral self-restraint when pecuniary temptations are high'.[4]

Although the concept of moral hazard has received a lot of press in the context of the sub-prime government bailout,[5] it has also been found to be a cause of numerous financial crises.

During the savings and loan crisis, for example, the disassociation of risk and reward led to greater and greater risk-taking among lenders, and ultimately to the failure of 1,043 savings and loan associations.[6] The failure of Long-Term Capital Management, which caused a severe liquidity crisis in the late 1990s, is likewise attributable to the moral hazard of perverse incentives, which led to trading practices so risky that they were compared to 'picking up nickels in front of a bulldozer'.[7] In these cases, moral hazard played a role because decision-makers (whether individual traders or managers) who stood to reap substantial rewards from risky behaviour believed that they would not suffer the consequences of failure.[8]

Most troubling are situations where the managers of publicly traded companies act in their own self-interest rather than in the interest of shareholders.[9] Indeed, one study concluded that the majority of securities fraud cases reviewed were attributed to this 'agency problem'.[10] This agency problem is exacerbated by the current legal environment in the United States in which there is a near absence of consequences for management guilty of securities fraud, in part because of restrictions placed on securities class actions.

Limits on securities class actions

Class actions allow plaintiffs to pursue claims that are too small to justify the expense of an individual action. Even shareholders with relatively large holdings may find that the expense of litigating an individual action is too great to justify filing suit. To help alleviate this problem, the class action procedure in the United States allows those who have suffered losses as a result of similar allegations of securities fraud to aggregate their claims into a single case – a class action – so that the damages are large enough to justify the risk and expense of filing a lawsuit, when the following requirements are met:

1. the class is so numerous that joinder of all members is impracticable;
2. there are questions of law or fact common to the class;
3. the claims or defences of the representative parties are typical of the claims or defences of the class; and
4. the representative parties will fairly and adequately protect the interests of the class.

In addition, the court must find that the questions of law or fact common to class members predominate over any questions affecting only individual members, and that a class action is superior to other available methods for fairly and efficiently adjudicating the controversy.[11]

Procedural impediments to successful prosecution of securities class actions, however, have contributed to an explosion of fraud. The source of many of these limits is the Private Securities Litigation Reform Act of 1995 (PSLRA), which greatly reduces the risk that a perpetrator of securities fraud will face liability.[12] In particular, the PSLRA requires a heightened pleading standard that makes it extremely difficult for a shareholder to plead his case for securities fraud by requiring the complaint to state 'both the facts constituting the alleged violation, and the facts evidencing scienter, ie the defendant's intention "to deceive, manipulate, or defraud".'[13] In short, before any discovery, the plaintiff must plead actual evidence, while most other litigation requires only a 'short and plain statement of the claim showing that the pleader is entitled to relief'.[14] As a result, complaint dismissal rates after the passage of the PSLRA are between 60 per cent and 65 per cent compared to between 24 per cent and 40 per cent prior to its passage.[15]

In addition to the heightened pleading standard, the PSLRA shields auditors – the 'gatekeepers' that have the ability to prevent accounting fraud – from liability for securities violations.[16] This, in turn, has led to aggressive accounting practices and may have contributed to increased accounting manipulation since enactment of the PSLRA at the end of 1995.[17]

The agency problem and the PSLRA's barriers to liability have combined to exacerbate corporate actors' perverse incentives leading to an explosion of corporate fraud.[18] Not surprisingly, the incidence of securities fraud in the United States skyrocketed since the passage of the PSLRA at the end of 1995: between January 1997 and June 2002, earnings restatements (a proxy for fraud) amounted to more than $100 billion, with ten per cent of all companies listed on the New York Stock Exchange or NASDAQ restating their earnings at least once.[19]

Securities class actions are important and necessary

What can be done to reverse these perverse incentives and help deter fraud? At least in the financial industry, increased regulatory oversight can reduce trading-related moral hazard.

Such regulation is often slow in coming, however, and is almost always enacted *after* a crisis has occurred, if it is enacted at all. In fact, there is current speculation that despite the recent near-death experience of the financial markets, the frequently discussed regulatory 'enhancements' may not materialise.[20] Regulation does not, of course, address the moral hazard created by the agency problem or the resulting securities fraud. Because corporate officers and directors are motivated by pecuniary self-interest – money – securities fraud can only be prevented by either increasing the likelihood of detection or increasing the punishment when perpetrators are caught.[21]

Unfortunately, government enforcement provides insufficient deterrence because government agencies, such as the United States Securities and Exchange Commission (SEC), simply do not have the resources, or the will, to identify and prosecute most securities law violations.[22] Both the SEC and the judiciary have recognised that government enforcement is inadequate on its own to combat securities fraud.[23] Securities class actions, then, are the best available option for creating healthy incentives for corporate officers and directors to discharge their fiduciary obligations.[24] With lower barriers to civil litigation, class action attorneys can more effectively serve as private attorneys general because only class action attorneys have the incentive and resources to vigorously prosecute securities fraud cases. In addition, whereas government enforcement of securities fraud ebbs and flows with each change in the political climate, private enforcement is predictable, thereby providing a consistent disincentive to corporate wrongdoing.[25] In short, securities class actions are not external to good corporate governance, but are a native part of the process.

A criticism concerning class action enforcement of the securities laws is that the lawsuits are driven more by class action attorneys' desire for fees than by the interests of shareholders.[26]

The desire for fees, however, aligns the class action attorneys' interests with the class's interests so that securities class actions have been very effective in recovering shareholder losses (despite the severe restraints of the PSLRA): in the ten-year period from 1999 to 2008, more than $56 billion was recovered in securities class action settlements.[27] Securities class actions have been far more effective than public enforcement, and 'even in major scandals where the SEC has brought its own action, the damages paid in securities class actions are usually (but not always) a multiple of those paid to the SEC', examples being WorldCom (SEC – $750 million; class action – $6.156 billion), Lucent (SEC – $25 million; class action – $517 million) and Gemstar (SEC – $10 million; class action – $92.5 million).[28] Indeed, 'securities class action settlements averaged an annual aggregate amount exceeding the sum of all public monetary sanctions', including those from the SEC, state regulators, the National Association of Securities Dealers and the New York Stock Exchange.[29]

Moreover, the financial interests of class action counsel work to the advantage of shareholders, because it is precisely this incentive that allows counsel to bring cases on a contingent basis where the payment of attorneys' fees and reimbursement of the substantial costs that must be advanced by the attorneys are contingent on the success of the case. Finally, there are numerous procedural devices employed by courts to keep the interest of shareholders and their attorneys aligned, including, but not limited to, the need for court approval of class action settlements.[30]

Conclusion

Corporate actors are making decisions in a political and legal environment that rewards fraud handsomely, and, at best, punishes fraud sporadically. Yet, it is clear from recent history that in order to prevent fraud there must be a system of disincentives in place that encourages corporate actors to put the interests of shareholders first. Securities class actions are the best tool available for the job.

Notes

1 Lawrence H Summers, 'The Future of Market Capitalism Keynote', Harvard Business School Global Business Summit, 14 October 2008, **www.hbs.edu/centennial/businesssummit/market-capitalism/the-future-of-marketcapitalism.html**.

2 James Dow, 'What Is Systemic Risk? Moral Hazard, Initial Shocks, and Propagation', Monetary and Economic Studies, December 2000, at 19, **www.imes.boj.or.jp/english/publication/mes/fmes00.html**; Karl S Okamoto, 'After the Bailout: Regulating Systemic Moral Hazard' (2009) 57 UCLA L Rev 183; John C Coffee, Jr, 'What Caused Enron? A Capsule Social and Economic History of the 1990s' (2004) 89 Cornell L Rev 269, 278 n 34.

3 'Economists' "Moral Hazard" Applies Only to the Poor', *Deseret News*, 21 March 2008.

4 Daniel T Ostas, 'When Fraud Pays: Executive Self-Dealing and the Failure of Self- Restraint' (2007) 44 Am Bus LJ 571, 593.

5 See, eg, 'Subprime Bailout: Good Idea or "Moral Hazard"?' www.npr.org, 27 November 2007, **www.npr.org/templates/story/story.php?storyId=16734629**.

6 Timothy Curry and Lynn Shibut, 'The Cost of the Savings and Loan Crisis: Truth and Consequences', FDIC Banking Review, at 26, **www.fdic.gov/bank/analytical/banking/2000dec/brv13n2_2.pdf**; Coffee, note 2 above, at 278 n 34 (noting that 'economic misincentives' best explain the savings and loan crisis).

7 Roger Lowenstein, *When Genius Failed: the Rise and Fall of Long-term Capital Management* (Random House, 2000), 102.

8 Dow, note 2 above, at 16.

9 *Ibid* at 18.

10 See, eg, Jennifer H Arlen and William J Carney, 'Vicarious Liability for Fraud on Securities Markets: Theory and Evidence' (1992) U Ill L Rev 691, 724–25, 730.

11 Federal Rule of Civil Procedure 23(a) and (b)(3).

12 Coffee, note 2 above, at 290.

13 *Tellabs, Inc v Makor Issues & Rights, Ltd*, 551 US 308, 313 (2007) (citation omitted).

14 Federal Rule of Civil Procedure 8(a)(2).

15 Michael A Perino, 'Did the Private Securities Litigation Reform Act Work?' (2003) U Ill L Rev 913, 937.

16 Coffee, note 2 above, at 290.

17 *Ibid*; Ho Young Lee and Vivek Mande, 'The Effect of the Private Securities Litigation Reform Act of 1995 on Accounting Discretion of Client Managers of Big 6 and non-Big 6 Auditors', *Auditing: A Journal of Practice & Theory*, March 2003, at 2.

18 Coffee, note 2 above, at 278 ('Perverse incentives, not declines in ethics, cause scandals').

19 Ostas, note 4 above, at 597.
20 Mark Whitehouse, 'Economists See Crisis Response as Risky', *The Wall Street Journal*, 6 January 2010 (noting that the political window of opportunity for changes in banking regulations is rapidly closing).
21 Ostas, note 4 above, at 585.
22 Brian S Sommer, 'The PSLRA Decade of Decadence: Improving Balance in the Private Securities Litigation Arena with a Screening Panel Approach' (2005) 44 Washburn LJ 413, 419.
23 *Ibid.*
24 *Cf* Christine Hurt, 'The Undercivilization of Corporate Law' (2008) 33 J Corp L 361, 438.
25 *Ibid.*
26 Hurt, note 24 above, at 443.
27 Ellen M Ryan and Laura E Simmons, *Securities Class Action Settlements: 2008 Review and Analysis*, Cornerstone Research (2009), **http://securities.stanford.edu/Settlements/REVIEW_1995- 2008/Settlements_Through_12_2008.pdf**.
28 John C Coffee, Jr, 'Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation' (2006) 106 Colum L Rev 1534, 1543.
29 *Ibid* at 1542.
30 Federal Rule of Civil Procedure 23(e).

27TH INTERNATIONAL FINANCIAL LAW CONFERENCE

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Enforcing security interests in banking transactions

Session Co-Chairs
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The session was based on a multi-jurisdictional survey on 'Enforcement of Security Interests in Banking Transactions' carried out by the Banking Law Committee and the conclusions of which have been published in the Banking Law Committee newsletter volume 17, issue 1, May 2010.

Gwendoline Godfrey, Chair of the Banking Law Committee, set out the background on the survey and introduced the subject.

Fedor Poskriakov of Lenz & Staehelin presented the different types of assets which are typically subject to security arrangements in financing transactions insisting on practical issues such as identification of the assets to be subject to security and ongoing monitoring of the location of those assets given the potential impact on enforcement.

David Vietor of NautaDutilh, Amsterdam analysed the different types of security insisting specifically on security over shares and legal issues to consider in case of enforcement of share pledges in Holland. The issue of the level of control of the pledgee in the enforcement process was stressed.

Kim Rasmussen of Kromann Reumert, Copenhagen, concentrated on the issue of the security trustee and the requirement in some jurisdiction to have recourse to parallel debt structures where local security arrangements do not allow the right for the creditors to appoint an agent to hold and enforce the security. It was agreed among