Shareholder Litigation After the Meltdown

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SHAREHOLDER LITIGATION AFTER THE MELTDOWN

Daniel J. Morrissey*

I. INTRODUCTION: THE NEED FOR EFFECTIVE SHAREHOLDER ACTIONS ................................................... 532

II. CORPORATE CORRUPTION, ECONOMIC COLLAPSE, AND GOVERNMENTAL RESPONSE ........................................ 534
A. Significant New Deal Legislation Responding to the Great Depression .................................. 534
B. Continuing Scandals, Bubbles, and Sarbanes-Oxley .......... 535
C. More Frauds During the Past Decade .......... 537
D. The Meltdown .......... 539
E. Dodd-Frank: Addressing the Issues .......... 541

III. THE IMPORTANCE OF SHAREHOLDER REMEDIES ........................................ 545
A. The Need for Effective Investor Actions .......... 545
B. Class Actions: The Investor's Best Friend ........... 547
C. Derivative Suits: Keeping Management Honest .......... 550

IV. THE ALLEGED SHORTCOMINGS OF SHAREHOLDER CLASS ACTIONS AND DERIVATIVE SUITS ................................ ....... 552
A. The Pocket-Shifting Problem............................. 552
B. The Circularity Issue ................................ 555
C. Questions About Plaintiffs in Derivative Suits .......... 558
D. Surowitz and Fuqua Industries .......... 559
E. The Lawyer/Client Relationship in Derivative Suits ......... 561

V. THE FEDERAL CAUSES OF ACTION FOR SECURITIES FRAUD ............... 563
A. The Strong Investor Remedy Under Section 11 ............. 563
B. Gustafson's Body-Blow to Defrauded Shareholders ............. 565
C. The Shrinking 10b-5 Remedy .......... 568
D. Contrasting 10b-5 with Section 11 ................. 569
E. Congress Should Overrule Gustafson or Otherwise Broaden the 10b-5 Remedy .......... 570

VI. CONCLUSION ............................................. 571

531
"Imagine that. Another financial/corporate scandal/crisis. But which of the current ‘scandals’ or ‘crises’ are we talking about? There are, after all, so many."

—Professor M. Thomas Arnold

“You know, half the people in this place could be prosecuted.”

—Oliver Stone

I. INTRODUCTION: THE NEED FOR EFFECTIVE SHAREHOLDER ACTIONS

Since at least the Watergate era almost forty years ago, American business has been plagued by a long, sorry history of corrupt and dishonest activity. While it appears that the large majority of U.S. companies have operated in an ethical and reputable fashion, a significant number have not. Just in the last decade, after the bursting of the Dot-com bubble, the litany of major corporate frauds has been unending. The economic meltdown of 2008 has yielded the latest and most damaging fruits of this deceitful business behavior.

As a consequence, America needs strong and productive shareholder remedies not only to compensate investors for losses they suffer because of such wrong-doing, but also to combat and deter it. To that end, this Article will first present a brief account of these corporate scandals, focusing particularly on

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3 For an excellent summary of these dishonest dealings, see Arnold, supra note 1, at 420–24.

4 For a report on this finding, see MARK S. BEASELEY ET AL., COMMISSION OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION (“COSO”), FRAUDULENT FINANCIAL REPORTING, 1998–2007: AN ANALYSIS OF U.S. PUBLIC COMPANIES (2010). “The vast majority of public companies appear to provide financial reports that are free from material misstatements due to fraud.” Id. at 2.

5 See infra text accompanying note 30.

6 See infra text accompanying note 57.
those that have come to light in the last decade. Part of that story is the generally ineffective efforts of government regulators to police such harmful conduct.

As a piece of that history, this Article will then describe several legislative initiatives since the Watergate era that were passed in response to those frauds. The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), signed into law by President Barack H. Obama in July 2010, is only the most recent. One can hope that its ambitious attempts at financial reform will end or at least substantially stifle corrupt business activity. However, the mixed results from similar law-making efforts during earlier times do not offer encouragement for such optimism.

Of necessity then, this Article will next present the case for keeping some viable complements to those laws targeting corporate fraud. These alternative remedies are vigorous class action law suits and derivative actions. These remedies are needed so that defrauded shareholders may effectively seek redress under causes of action provided in the federal securities laws. Unfortunately, those substantive claims have been weakened by several recent judicial decisions.

Then, this Article will focus on the principal legal mechanisms that shareholders can use to enforce those rights: class actions and derivative suits. This Article will answer the three principal criticisms leveled at them. Two of those arguments question the efficacy of shareholder class actions. "Pocket-Shifting," charges that, in those suits, stockholders indirectly end up paying their own claims, and "Circularity" alleges that investor gains and losses from such frauds often cancel each other out over time. As such, these remedies are said to produce only insignificant benefits for stockholders. While there may be some negligible truth in those observations, the benefits from these actions—most importantly, their deterrent and punitive impact—far outweigh any shortcomings.

The other criticism, the perceived problem of the professional plaintiff, is no longer an issue in class actions, but it continues to be raised as an argument against derivative suits, a remedy that is much needed to hold corporate officials accountable for breaches of their fiduciary duties. As with the "Pocket-Shifting" and "Circularity" charges, this criticism is also an insignificant distraction to a meritorious legal mechanism. The final segment of this section will suggest ways that class action law suits and derivative actions can be strengthened by legislative activity that will correct those regrettable decisions.

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8 See discussion infra Parts II.C.--D.
9 See discussion infra Part II.C.
10 See discussion infra Part II.E.
12 See discussion infra Parts II.A.--B.
13 See discussion infra Part V.E.
The Article will conclude by urging courts to remain receptive to these vital antidotes to corporate misconduct. They cannot be oblivious to the scandals and meltdowns that continue to weaken the United States economy. For instance, a renowned business journalist stated that "corporate fraud is sort of like grass, it grows, it gets cut down, and it grows again."

Unless alert shareholders and their lawyers are given these tools to keep it in check, corruption may overruns the American economy and destroy the integrity it must have if truly productive enterprises are to thrive.

II. CORPORATE CORRUPTION, ECONOMIC COLLAPSE, AND GOVERNMENTAL RESPONSE

The link between securities fraud and financial calamity goes back at least to the Great Depression. A congressional committee found in 1933 that "[w]hatever may be the full catalogue of the forces that brought to pass the present depression, not least among these has been this wanton misdirection of the capital resources of the Nation." In response, Congress passed two landmark pieces of reform legislation.

A. Significant New Deal Legislation Responding to the Great Depression

The first legislation, the Securities Act of 1933 ("Securities Act"), required that securities be registered with a government agency before sale and made it a crime in that context not to disclose all material aspects of a business. The companion legislation, the Securities Exchange Act of 1934 ("Exchange Act"), contained a host of provisions regulating the trading of securities, including a requirement that widely-held companies make periodic and current reports about their operations to the public which must include audited financial statements. It also established a federal regulatory agency, the Securities and Exchange Commission ("SEC" or "Commission"), to administer and enforce the new federal securities laws.

Next, in the mid-1970s, Watergate-related investigations revealed that hundreds of public companies had kept off-book funds that they used for what were euphemistically called “questionable payments.” According to a 1976 cover story in Time magazine, “[t]he record of U.S. corporations indulging in bribes, kickbacks and political payoffs is already voluminous; yet it is sure to swell.” In response Congress passed the Foreign Corrupt Practices Act of 1977 (“FCPA”), which not only explicitly made such activity illegal, but also reinforced the Exchange Act’s reporting requirements. This act mandated that public companies keep accurate books and records and maintain a system of accounting controls to ensure compliance.

B. Continuing Scandals, Bubbles, and Sarbanes-Oxley

Deregulation of the financial industry began early in President Ronald Reagan’s first few years in office and quickly led to the thrift scandals. The foremost of those involved the notorious Lincoln Savings and Loan scandal; it even implicated Senator John McCain, a future Republican presidential nominee. The 1980s also saw a boom in mergers and hostile takeovers. The signature statement of that era was “Greed is Good,” made in a business school commencement address by financier Ivan Boesky shortly before he was indicted for insider trading. Another emblematic figure of that time, junk-bond king Michael Milken, financed many of those maneuvers, and also went to prison for securities law violations.

In the next decade, “irrational exuberance” led to a run-up of technology stocks in the late 1990s. When that Dot-com bubble burst, it revealed nu-

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22 See Arnold, supra note 1, at 427.
23 Scandals: A Record of Corporate Corruption, Time, Feb. 23, 1976, at 30. Another notorious fraud of that era was Equity Funding. It was engineered by the creation of hundreds of false insurance policies and ultimately reached the Supreme Court in a storied case. Dirks v. SEC, 463 U.S. 646 (1983). There, a securities analyst who brought the scandal to light had been censured by the SEC, but his sanction was overturned by the High Court. Id.
27 PATRICK DILLON & CARL M. CANNON, CIRCLE OF GREED 108 (2010). Boesky’s remarks served as the template for Gordon Geico’s famous “Greed is Good” address to a shareholders’ meeting in Oliver Stone’s 1987 movie WALL STREET. See Sorkin, supra note 2.
28 DILLON & CANNON, supra note 27, at 109.
merous frauds. Most notorious were Enron and other high-flying energy and telecom companies. Over two dozen of those large public companies admitted to inflating their revenue through improper accounting practices, with those falsified financial reports making possible a wanton system of executive greed. Corrupt market analysts were fellow-travelers with those dishonest corporate officials. They supplied them with doctored research reports on their companies and touted soaring internet stocks in public at the same time they were calling them "junk" and other, more vulgar epithets in their personal emails.

Once again Congress responded with tough legislation: the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"). Among other things, it required top executives of public companies to personally certify the accuracy of their financial statements and to vouch for the integrity of their systems of internal accounting controls. Sarbanes-Oxley also contained provisions designed to check executive dishonesty, including rules requiring forfeiture of bonuses based on improper accounting statements and rules prohibiting loans to corporate officials. In addition, it set up an oversight panel, the Public Company Accounting Oversight Board ("PCAOB"), to police the practices of public accountants.

provided the title of a fine book about those boom years: ROBERT J. SHILLER, IRRATIONAL EXUBERANCE (2d ed. 2000).


For a good summary of the most notorious of those scandals, see ROBERT W. HAMILTON ET AL., CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES, 540-47 (11th ed. 2010).

In 1965, a CEO made "twenty-four times as much as the average worker; in 2007, the multiple [increasing by ten fold] was two hundred and seventy-five." David Owen, The Pay Problem: What's To Be Done About C.E.O. Compensation, NEW YORKER, Oct. 12, 2009, at 58, 58.


Id. § 302.

Id. § 304.

Id. § 402.

Id. §§ 101-09. In Free Enterprise Fund v. Public Co. Accounting Oversight Board, the Supreme Court upheld the constitutionality of Sarbanes-Oxley, but ruled that the method by which members of the PCAOB can be removed violates the separation of powers. 130 S. Ct. 3138, 3151 (2010).
C. More Frauds During the Past Decade

Yet throughout the last decade, high-profile corporate scandals continued unabated. Those included late trading and market-timing schemes where mutual fund managers enriched themselves at their investors' expense.39 A similarly egregious practice that also came to light then was the back-dating of stock option grants—a particularly pernicious form of corporate kleptomania involving hundreds of corporate officials.40

In those situations, corrupt executives searched for a time before such purchase rights were issued when the underlying shares were trading at a lower price. They then clandestinely changed the grant dates of the options to make it appear they were awarded at that earlier time, thus increasing the executives' potential for gain when they exercised the options to buy the stock. One perceptive court compared this practice to betting on a winning horse after the race had been won.41

A study released in May 2010 presented the big picture of financial fraud during the last decade, cataloging 347 cases of false and misleading reporting brought by the SEC in the years from 1998 to 2007.42 That compared to 294 such matters initiated by the agency in the previous decade. Not only did the raw number of those frauds increase, but also the dollar amounts jumped precipitously to a total of $120 billion.

Those deceptive financial reports occurred in a number of industries and most often involved either improper revenue recognition or overstatement of assets. More than 80% of the chief executive officers and/or chief financial officers of those companies fraudulently presented a false impression of success at their firms. That misleading information included untrue representations about meeting earnings expectations, concealment of deteriorating conditions, and inflation of stock prices.43 During the two days after those frauds were announced, the companies suffered, on average, abnormal stock price declines of 16.7%.44


41 David Phelps, A Little Hollywood Logic Keeps UnitedHealth Lawsuit in Court, MINNEAPOLIS STAR TRIB., June 5, 2007, at 2D.

42 BEASELEY ET AL., supra note 5.

43 Id. at 3.

44 Id. at 6.
However, the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") report only detailed the SEC’s detection and prosecution of financial frauds. The SEC, throughout its history, has generally enjoyed a fine reputation for aggressively pursuing corporate wrongdoing. Yet even in the late 1970s when the SEC’s reputation was at its zenith, the author, then a junior staff attorney in its Enforcement Division, was told by a senior SEC lawyer that it had the resources to prosecute no more than 2% of the occurring securities law violations. Recent events have presented an even more dismal assessment of the SEC’s effectiveness.

During the last several years, the SEC, according to knowledgeable observers, “lost its watchdog soul to the interests it was created to regulate” and was “drained and demoralized throughout the Bush administration[.]” Inadequate resources compounded that problem. As the SEC’s current chairwoman, Mary L. Schapiro, told Congress recently, “While the markets were growing exponentially in size and complexity during the last several years, the SEC’s workforce actually decreased and its technology fell further behind.” The piece de resistance of the Commission’s incompetence was the Bernard Madoff affair. There a leading figure on Wall Street got away with a decades-long Ponzi scheme that bilked investors out of tens of billions of dollars. Despite the longevity and magnitude of his crime, Madoff was never caught by the SEC, but was only prosecuted when he turned himself in.

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45 See generally id. The Committee of Sponsoring Organizations of the Treadway Commission ("COSO") is a joint initiative of five private sector accounting and financial organizations. It states its mission as “providing thoughtful leadership through the development of comprehensive frameworks and guidance on enterprise risk management, internal control, and fraud deterrence.” Id. at Inside Cover.

46 See, e.g., David L. Ratner, Response, The SEC at Sixty: A Reply to Professor Macey, 16 CARDOZO L. REV. 1765, 1779 (1995) (remarks of a former chairman of the Commission lauding the SEC’s generally high standard of performance during its first sixty years) (“The SEC is one important reason why the securities industry is in so much better shape than other financial service industries, and why U.S. securities markets are the best securities markets in the world.”).

47 More recently, in December 2007, a well-respected commentator wrote, “It’s no secret that the Securities and Exchange Commission is terrifically understaffed and wildly underfunded compared with the populous and wealthy Wall Street world it is supposed to police.” Gretchen Morgenson, Quick, Call Tech Support for the S.E.C., N.Y. TIMES, Dec. 16, 2007, § 3, at 1. Shortly thereafter, three former SEC chairmen echoed those sentiments with this statement: “The problem with the S.E.C. today is that it lacks the money, manpower and tools it needs to do its job.” William Donaldson et al., Muzzling the Watchdog, N.Y. TIMES, Apr. 29, 2008, at A19.


49 Paul M. Barrett, While Regulators Slept, N.Y. TIMES, Aug. 9, 2009, at 10 (reviewing DAVID WESSEL, IN FED WE TRUST: BEN BERNANKE’S WAR ON THE GREAT PANIC (2009)).


Madoff’s long-running fraud exemplified a regrettable aspect of our justice system. Most business criminals act with impunity. For instance, more than three years after the options backdating scandal was exposed, executives at only one-third of the 500 companies where such flagrant activity apparently occurred had been investigated. Only twelve executives were ultimately criminally convicted of this illegal activity, with just five of those receiving prison sentences. As one expert on corporate wrong-doing put it succinctly, “[O]nly a fraction of corporate executives who manipulate or misrepresent their companies’ performances get exposed by regulators for such misdeeds.”

D. The Meltdown

Between 2000–2008, in what has been called “an era of rapacious capitalists and heedless self-indulgence,” the entire financial system became dependent on a credit bubble based on shaky home loans. After the collapse of Dot-com stocks, speculative capital turned to the housing market. Almost all the participants in that credit market were at least willfully ignorant of the fact that many home borrowers could not afford their mortgages. When the inflated real estate values supporting those loans disintegrated, they took down long-established financial firms that had recklessly dealt in myriad derivative forms of those debts.

Regulatory safeguards that might have prevented such improvidence had been swept away during the previous decades on the theory that they inhibited...
bited growth.\textsuperscript{58} That made private rating agencies, which were supposed to certify the creditworthiness of those mortgage-backed securities, the only guarantors of their value. Many of these agencies gave high grades to those financial instruments even though they were of doubtful value.\textsuperscript{59} In doing so they ignored conclusive evidence that the collateral supporting those loans was as insubstantial as a house of cards.\textsuperscript{60}

After the ensuing collapse, the credit markets froze up, and the whole economy was thrown into a tailspin, causing wide-spread unemployment. In response, the government undertook hugely expensive bailout and stimulus measures, including the nationalization of the auto industry. “The national debt rose by more than a third over a one-year period, far more than it ever did at anytime since World War II.”\textsuperscript{61}

As of Fall 2010, no senior financial or investment bank executive had been successfully prosecuted for any of these events.\textsuperscript{62} Knowledgeable observers are alarmed that the federal government has not brought resources to bear in that effort in the same fashion it does when pursuing organized crime figures.\textsuperscript{63}

\textsuperscript{58} For instance, the Commodities Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763A, added sections 2A and 3A to the Securities Act and the Exchange Act respectively to provide that credit default swaps (CDSs) are not securities. CDSs are a form of insurance that purchasers of mortgaged backed bonds bought to guarantee their investments against default. When the market in CDSs grew to $62 trillion in 2007 they were thus completely unregulated and lacking in transparency. James B. Stewart, \textit{Eight Days: The Battle to Save the American Financial System}, THE NEW YORKER, Sept. 21, 2009, at 58. At the time of the meltdown one of the major issuers of CDSs was the insurance giant AIG that lacked the necessary reserves to make good on its obligations and had to be bailed out by $180 billion in payments by the U.S. Treasury. \textit{Id.} at 79. For the author’s broader views on how deregulation of the sale of securities has undermined the stability of the capital markets, see Daniel J. Morissey, \textit{The Road Not Taken: Rethinking Securities Regulation and the Case for Federal Merit Review}, 44 U. RICH. L. REV. 647 (2010).


\textsuperscript{60} As one credit rating analyst wrote in an email about securities backed by subprime mortgages, “Let’s hope we are all wealthy and retired by the time this house of cards falters.” Michael M. Grynbaum, \textit{Study Finds Flawed Practices at Ratings Firms}, N.Y. TIMES, July 9, 2008, at C1.

\textsuperscript{61} Floyd Norris, \textit{A Rich Uncle Is Picking up the Borrowing Slack}, N.Y. TIMES, Sept. 26, 2009, at B3.

\textsuperscript{62} See Frank Rich, Editorial, \textit{What Happened to Change We Can Believe In?}, N.Y. TIMES, Oct. 24, 2010, at WK10 (highlighting that “so many know that the loftiest perpetrators of this national devastation got get-out-of-jail-free cards”).

\textsuperscript{63} A documentary film on the meltdown that makes that point well is \textit{INSIDE JOB} (Representational Pictures 2010) by Charles Ferguson. In a review of the movie, A.O. Scott aptly described the meltdown as “a crime without punishment.” A.O. Scott, \textit{Who Maimed the Economy, and How}, N.Y. TIMES, Oct. 8, 2010, at C1.

The Department of Justice has a task force called Operation Broken Trust which has brought a number of cases against various financial criminals that one commentator called “small-timers: penny-stock frauds, a husband-and-wife team charged with insider trading and mini-Ponzi schemes.” Andrew Ross Sorkin, \textit{Pulling Back the Curtain on Inquiries}, N.Y. TIMES, Dec. 7, 2010, at B1. The commentator found that many top corporate officials were unaware of that, stating,
The lone criminal action so far involving allegations of fraud and insider trading in mortgaged-back securities resulted in an acquittal.\textsuperscript{64}

State officials by contrast have had some success in redressing wrongs from the meltdown. The Attorney General of Ohio for example has “wrested about $2 billion” in settlements from investment banks, rating agencies, and “foreclosure scammers[.\textsuperscript{65} and the Attorney General of Massachusetts secured a $102 million fine from investment banker Morgan Stanley for knowingly placing dubious mortgages in securitized pools.\textsuperscript{66} However, these actions may not have lasting impact. As one knowledgeable observer commented, “The settlements are large, but the changes in behavior don’t seem to be that large. . . . These targets have massive amounts of money to pay off and continue on their merry way.”\textsuperscript{67}

\textbf{E. Dodd-Frank: Addressing the Issues}

After a lengthy process that did not conclude until July 2010, almost two years after the meltdown, Congress finally passed broad-reaching legislation to address the issues which caused the catastrophe.\textsuperscript{68} Dodd-Frank contains a number of provisions designed to forestall profligate speculation and promote

\"That’s because in the two years since the peak of the financial crisis the government has not brought one criminal case against a big-time corporate official of any sort.\" \textit{Id.}

The Wall Street Journal, however, in an editorial called Operation Broken Trust “good news for the small investor” went on to say that government prosecutors should not make “arcane corporate accounting cases” a priority because they pose only “theoretical harm to investors.” \textit{The Real Bad Guys, WALL ST. J., Dec. 7, 2010, at A18.} In the same vein, the editorial went on to state that options backdating cases should not be a priority for prosecutors. \textit{Id.}

The Wall Street Journal failed to understand the seriousness of those crimes. Corporate officials who illegally backdate their company’s options are doing the same thing as store managers who take money out their cash registers and give it to themselves and other employees. Shareholders in those situations are cheated out of the full revenue their corporations would receive if those shares were sold at their fair market value. For the author’s full perspective on that, see Morrissey, \textit{Path of Corporate Law, supra} note 40.

In addition, companies that publish false financial statements typically mislead investors into paying more for shares than their true value. See discussion infra Part III.B. Investors are defrauded by this dishonest conduct, and it should be vigorously prosecuted.

\textsuperscript{64} William D. Cohan, Op-Ed., \textit{How the Scapegoats Escaped, N.Y. TIMES, Nov. 12, 2009, at A35.}

\textsuperscript{65} Michael Powell, \textit{The States v. Wall St., N.Y. TIMES, Oct. 12, 2010, at B1.}

\textsuperscript{66} Aaron Lucchetti & Brett Philbin, \textit{Morgan Stanley Pays for Subprime, WALL ST. J., June 25, 2010, at C3; Powell, supra note 65.}

\textsuperscript{67} Powell, \textit{supra} note 65.

\textsuperscript{68} The author drafted one of the initial versions of a provision in the Act that grants investors a direct cause of action against credit rating agencies that give unjustifiably high marks to financial instruments. Dodd-Frank, Pub. L. No. 111-203, § 933, 124 Stat. 1376, 1883–84 (2010). For a good general discussion of this legislation, see \textit{DAVID SKEEL, THE NEW FINANCIAL DEAL} (2011).
financial stability. Most importantly, it establishes an oversight council of regulators charged with monitoring the soundness of the entire economy.69

Dodd-Frank also creates the Consumer Financial Protection Bureau to safeguard the public against abusive credit practices, and it mandates that the details of financial derivatives, like collateralized debt obligations ("CDOs") and credit default swaps ("CDSs") be transparent.70 Securities like CDOs, where speculative mortgages were packaged for sale to investors and CDSs, the contracts that were supposed to insure the CDOs, will now be open to public scrutiny.

In addition, Dodd-Frank puts restrictions on Wall Street firms who would use their depositors' money for proprietary trading. In an improvident move that contributed to the collapse of those firms, the SEC lessened the amount the firms were required to hold in reserve against such speculation.71 Dodd-Frank now restores limits on that leveraging so that government-guaranteed funds will not be put at risk for those losses.72 Dodd-Frank also gives the SEC new regulatory power over hedge funds73 and protects investors by tightening up the Regulation D exemption to the requirement that securities first be registered before they can be sold to the public.74

Unfortunately though, much of the legislation's effect is uncertain. The two major agencies that it creates, the Oversight Council and the Bureau of Consumer Finance Protection, have only generalized mandates, and almost all Dodd-Frank's impact in the securities area will depend on rules enacted by the SEC.75 As one noted political commentator therefore put it, it is "a financial regulation bill that still needs to be interpreted by regulators because no one could agree on crucial provisions."76 In addition, powerful interests are set to

69 Dodd-Frank §§ 111–123. This board, the Financial Stability Oversight Council, has recently proposed a rule that would impose stricter regulation of large financial companies that are not banks, such as insurance companies, hedge funds and asset managers. Edward Wyatt, Fed Oversight of Nonbanks Is Weighed, N.Y. TIMES, Oct. 11, 2011, at B1.

70 Dodd-Frank §§ 721–774.


72 This is the so-called Volcker rule. It allows banks to invest up to three percent of their tier-1 capital in private equity and hedge funds, but they cannot own more than three percent of any of those entities. Dodd-Frank § 614. The Treasury Department has recently released a 298-page proposal to implement that. Scott Patterson & Alan Zibel, Putting the Clamps on Banks, WALL ST. J., Oct. 12, 2011, at C1.

73 Dodd-Frank §§ 401–419.

74 Dodd-Frank § 413.


oppose much of the law's mandates. The president of the U.S. Chamber of Commerce recently "called [Dodd-Frank] a 'regulatory tsunami' that represents 'the biggest single challenge to jobs . . . and the future of American enterprise.'"\footnote{77}

Dodd-Frank also attempts to reinvigorate the Commission by doubling its budget over five years and giving increased incentives for whistleblowers to come forward with inside information about corporate corruption.\footnote{78} Planning to use that funding increase, SEC chair Mary Schapiro announced that the SEC will hire 800 new lawyers.\footnote{79} Dodd-Frank also charges the Commission to undertake a host of initiatives that include studies and extensive rule-making in various areas of financial regulations.\footnote{80}

Congress, however, has yet to appropriate funds for those endeavors, stifling not only the Commission's hiring of new personnel, but also handicapping its ability to carry out its basic responsibilities. "Operating under [the current budget] is already forcing the agency to delay or cut back enforcement and market oversight efforts," SEC spokesperson John Nester told the press in early January 2011.\footnote{81} Because of this lack of funding, the Commission has also had to delay the creation of a number of new offices mandated by Dodd-Frank.\footnote{82} Nevertheless, by September 2011, the Commission had proposed or adopted rules for approximately three-quarters of the 90 provisions in Dodd-Frank that required SEC rule-making.\footnote{83}

In addition, the Commission has to recover from some very unfortunate recent history.\footnote{84} To its credit, the SEC produced a 477-page report detailing its...
failings in the Madoff matter, and that painful self-examination may be generating some improvements in its operations. A new team of dedicated attorneys appears to have taken over the Commission’s enforcement responsibilities and has streamlined those procedures. For example, the SEC initiated a high-profile action against Goldman-Sachs in April 2010 for double-dealing in the derivative market. This action resulted in the prominent investment bank paying a significant fine, and an admission that its marketing materials contained “incomplete information” about its conflict of interest in those transactions.

Yet some of the telling criticisms made about the SEC in post-Madoff investigations may be hard to remedy. Chief among them is the perennial problem that government attorneys, especially those handling sophisticated matters like SEC lawyers, never receive anywhere near the compensation of their counterparts in private law firms. One of the Commission’s chief detractors during its examinations by Congress was Harry Markopolos, a securities analyst who furnished credible information to the SEC for years about Madoff’s wrongdoing yet was unable to get the Commission to take action. In testimony he expressed these continuing misgivings about the Commission “Right now there is no accountability in government . . . [and] [t]he problem is that the SEC pays peanuts and then wonders how it ended up with so many monkeys.”

In fact, things may get worse in that regard. The “Pledge to America” published by Republican candidates anticipating control of Congress promise to freeze the pay of federal employees, President Obama acquiesced, announcing after the 2010 mid-term elections that there would be no raises for most federal workers for two years. Such action may also compound the deficiencies in the criminal prosecution of securities fraud where the only action by Justice Department attorneys so far resulting from the meltdown was unsuccessful.

87 Goldman Sachs to Pay Record $550 Million to Settle SEC Charges Related to Subprime CDO, Release No. 2010-123 (July 15, 2010).
91 See Lattman, supra note 53.
Further, future activity by the judicial branch may diminish the power of regulatory agencies like the SEC even more. In *Free Enterprise Fund v. Public Co. Accounting Oversight Board*, decided in June 2010, the Supreme Court invalidated the provision of Sarbanes-Oxley allowing for removal of members of a federal panel set up to oversee the accounting profession. The Court reasoned that its members could be removed by the SEC, not the president. In dissent, Justice Stephen Breyer warned that precedent could jeopardize the authority of thousands of federal regulators.

III. THE IMPORTANCE OF SHAREHOLDER REMEDIES

Due to those concerns with the impact of Dodd-Frank and the challenges facing the SEC, it is vital that shareholders have effective remedies. This section explores not only the need for effective investor actions, but also the mechanisms shareholders may use to curb and rectify fraudulent activity, specifically class actions and derivative suits. This section will first describe those two actions and discuss their meritorious qualities. It will then explain why their alleged deficiencies lack substance and are insignificant when balanced against the benefits they provide for society. The section will conclude by proposing legislative reforms to counter several Supreme Court decisions that inhibit the ability of investors to maintain those suits.

A. The Need for Effective Investor Actions

It is hoped that the array of reforms enacted in Dodd-Frank will prevent some of the corrupt and speculative practices that brought about the disastrous collapse of our economy. However, it is hard to see how they can curb even a substantial minority of the myriad fraudulent activities that are endemic in our financial and commercial communities. Strong laws attacking that wrongdoing have existed since the securities reforms of the 1930s, and new ones were passed to re-enforce them in the FCPA legislation of 1977 and the Sarbanes-Oxley Act of 2002. Yet, those entrusted with other people's money have continued to find ways to cheat them.

93 Id. at 3164; see also Jeffrey Toobin, *Without a Paddle*, THE NEW YORKER, Sept. 27, 2010, at 34–35. The current Supreme Court is also seen as the most pro-business in recent memory. See, e.g., Roger Parloff, *On History's Stage: Chief Justice John Roberts, Jr.*, FORTUNE, Jan. 17, 2011, at 63.
95 See discussion *supra* Part II.D.
96 The classic work there, now almost 100 years old, is *Louis D. Brandeis, Other People’s Money and How the Bankers Use It* (1914). More recently, William R. McLucas, the former Director of the SEC’s Division of Enforcement, testified in front of Congress, stating “the absolute certainty that persons seeking to perpetuate financial fraud will always be among us.” Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Sec. of the S.
However needed the legislative reforms may be, the Dodd-Frank's reforms and the administrative measures that will come from them will not lessen society's need to deter and punish corrupt business practices. In particular, the mandatory disclosure requirements which have been the heart of the federal securities laws since the 1930s are vital to underwriting the honesty of the entire United States economy. Adequate sanctions must thus be available to make sure that the disclosures are strictly observed.

Fraudulent corporate reports and financial statements should therefore receive, in the words of a renowned jurist, "a formal and solemn pronouncement of the moral condemnation of the community." And those who publish them must be meted out unpleasant consequences for their harmful conduct. As the Supreme Court put it in the recent Stoneridge case, "a dynamic, free economy presupposes a high degree of integrity in all of its parts, an integrity that must be underwritten by rules enforceable in fair, independent, accessible courts."

Just a year earlier, in 2007, the Supreme Court noted the importance of shareholder suits to police corrupt corporate activity. "The Court has long recognized that meritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by the Department of Justice and the Securities and Exchange Commission (SEC)." Noted commentators have also pointed to the important role that such suits serve in deterring corporate fraud.

Even when it had a sterling reputation as the "Cops of Wall Street," the SEC itself readily admitted that it could prosecute only a small percentage of

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99 Id.

100 Id. at 161.


securities frauds.\textsuperscript{103} Citing "the continued growth in the size and complexity of our securities markets,"\textsuperscript{104} the Director of its Enforcement Division welcomed efforts by private litigators to pick up the slack. He also noted that private suits provide more complete remedies for shareholders than the SEC’s actions because they "enable defrauded investors to seek compensatory damages and thereby recover the full amount of their losses."\textsuperscript{105}

The need for such actions is even more pronounced now in light of the SEC’s recent, unfortunate history.\textsuperscript{106} Even though the Commission has owned up to its embarrassing short-comings and is attempting to rectify them,\textsuperscript{107} public investors can hardly be re-assured that the Commission will be adequately protecting their interests. Consequently, the two major mechanisms that give shareholders viable remedies for fraud—class action suits and derivative actions—are needed now more than ever.

B. Class Actions: The Investor’s Best Friend

In the mid-1960s the Federal Rules of Civil Procedure were amended to allow individual plaintiffs, such as small shareholders, to aggregate their claims.\textsuperscript{108} That made the class action a marvelous weapon to police corporate fraud. One well-regarded corporate scholar has given this fitting description of how it can be put to that use.

Where the single claimant could not proceed individually because her expenses would dwarf the expected recover, the class action can be brought on behalf of all who are similarly situated. And the sheer size of the aggregated claim attracts not only the entrepreneurial instincts of the class action lawyer but also commands the full attention of the defendant. The class action thereby has an important deterrent feature which give it a quasi-public character; it can thus be seen as an extension of the state’s enforcement arm and an expression of society’s will.\textsuperscript{109}

\textsuperscript{103} See supra note 47 and accompanying text.
\textsuperscript{104} Private Litigation Under the Federal Securities Laws, supra note 96.
\textsuperscript{105} Id. The amounts recovered for defrauded investors in private class actions far outstrip awards secured by SEC actions. For instance in 2000, amounts collected in private actions were $4.9 billion, compared to just $488 million in SEC proceedings. DILLON & CANNON, supra note 27, at 347. In 2001 the figures were $1.9 billion garnered for investors from private suits versus only $522 million recovered by the SEC. Id.
\textsuperscript{106} See Burrows, supra note 51.
\textsuperscript{107} See SEC, supra note 85.
\textsuperscript{108} FED. R. CIV. P. 23(b)(3).
\textsuperscript{109} James D. Cox, Making Securities Fraud Class Actions Virtuous, 39 ARIZ. L. REV. 497 (1997). Another leading authority made much the same point:
In 1988, the Supreme Court gave added impetus to this remedy with a decision, accepting the "fraud on the market" theory to show that false corporate information causes investors' losses. It assumes that share purchasers can rely on a stock's market price as reflecting its true worth. When that is skewed because of misleading information, buyers then suffer losses caused by those falsehoods and have a commonly provable claim for damages. All of those investors can therefore be certified as a class without showing that they individually took the untruthful information into account in buying their stock.

The "fraud on the market" theory thus presumes that all purchasers of stock in companies that have published material falsehoods are victimized by paying distorted values for their shares. The typical situation involves falsely optimistic information that inflates the worth of a stock. When the truth comes out, share prices will drop, and the resulting losses can be combined to measure the damages of all the class members. In a heavily-traded stock, that amount can be quite large.

Consequently, settlements in these cases during the last two decades have totaled in the tens of billions of dollars. Major examples were Enron ($7.1 billion); WorldCom, Inc. ($6.1 billion); and Cendant ($3.5 billion). One of the foremost law firms that specialized in these actions sued hundreds of public companies and secured recoveries of more than $45 billion. Defendants found liable in those proceedings included not only the corporations themselves, but also the officers and directors of those companies and investment banking firms that underwrote their public offerings. In WorldCom, for instance, former directors contributed $55 million to the settlement.

Given such results, it is hardly surprising that those actions provoked considerable hostility from the business community. Many were said to be frivolous "strike suits": cases with flimsy evidence brought only to extract a quick settlement from harassed corporate defendants. Lawmakers responded to

Securities class actions have an appealing attraction to those seeking to deter fraud. If a party commits fraud that affects hundreds, if not thousands of dispersed shareholders, allowing a plaintiffs' attorney to aggregate the claims into a single class action makes the pursuit of such claims both more manageable and economical.

Choi, supra note 102, at 1522.


111 See generally Donald C. Langevoort, Basic at Twenty: Rethinking Fraud on the Market, 2009 Wis. L. Rev. 151 (2009).


113 DILLON & CANNON, supra note 27, at 2.

114 NAGY ET. AL., supra note 112, at 396–97.

115 The notion that many of these suits were "vexatious litigation" even started appearing in Supreme Court decisions that cut back the reach of substantive claims under the federal securities laws. See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739 (1975). See also discussion infra Part V.
those concerns, but not as some had urged by eliminating the federal causes of action for securities fraud or over-ruling the “fraud on the market” theory that made them economically viable.

Instead, Congress took a more measured approach by enacting amendments to the securities laws in 1995, such as the Public Securities Litigation Reform Act (“PSLRA”), which merely required a higher initial showing that such actions were meritorious. In suits under the implied cause of action of Rule 10b-5, Congress, among other things, required that fraud be pled with particularity, and prohibiting discovery until plaintiffs could demonstrate by a “strong inference” that the defendants acted with the requisite state of mind.

In addition, the amendments required that courts overseeing such litigation appoint lead counsel for plaintiffs based on considerations that would assure that the largest investors would control the suit. Among other things, it also included a requirement that plaintiffs show that their losses were actually caused by the misleading statements.

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117 NAGY ET AL., supra note 112, at 397.


119 Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5 (2011). See also discussion infra Part V.C.

120 Fed. R. Civ. P. 9(b); Exchange Act § 21D(b)(2), 15 U.S.C. § 78u-4 (2006). The Supreme Court recently held that class action plaintiffs met the PSLRA’s pleading standards by alleging that certain statements made by a pharmaceutical company were materially misleading because of a possible link between one of its products and a nasal disorder. Matrixx Initiatives v. Siracusano, 131 S. Ct. 1309, 1313 (2011).

121 Consequently, PSLRA added sections 27(b) to the Securities Act and 21D(b)(3) to the Exchange Act.

122 Exchange Act § 21D(b)(2). See also Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314 (2007) (holding such a standard would be satisfied if the pleading was “cogent”).

123 An implied cause of action under Rule 10b-5 requires a showing of scienter. See discussion infra Parts V.C.—D.


125 Exchange Act § 21D(b)(4). In Erica P. John Fund, Inc. v. Halliburton Co., the Supreme Court held that a plaintiff need not prove loss causation at the class certification stage of the litigation. 131 S. Ct. 2179 (2011).
C. Derivative Suits: Keeping Management Honest

The other major weapon for shareholders seeking redress against corporate wrongdoing is the derivative suit. In the mid-19th century, equity courts in England began allowing shareholders to hold managers of their companies liable for breaches of their fiduciary duties. This process, as it has evolved, consists of two separate causes of actions. The first is a suit by shareholders against their corporation for failing to pursue its rights against the malefactors. The second authorizes stockholders to then maintain a claim on behalf of their company against those officials.

About that time, American courts also began to recognize derivative suits, although the Supreme Court conditioned them upon a requirement that acknowledged the board's prerogative to manage the corporation's affairs. Before initiating the suit, the shareholders first had either to make demand on the directors themselves to bring it or to show why that request would be futile. Although some states now require that stockholders always take this preliminary step of making demand on the board, many, like the leading jurisdiction of Delaware, will excuse it if the directors are so interested in the questioned transaction that they lack the independence to make that judgment.

In the twentieth century, the derivative suit thus became what the Supreme Court called, "the chief regulator of corporate management." As one commentator put it succinctly, it was a "needed policeman" to hold officers and directors accountable for breaches of their fiduciary duties. Another leading jurist praised the action's virtues saying, "It is recognized that while minority corporate members are often actuated by selfish interests, they are sometimes useful gadflies which become the most effective instruments for ferreting out wrongdoing, for pursuing it publicly and for giving point to the only sanctions actual and potential wrongdoers fear."

Over the last several decades, however, it seemed that this great tool of reform had become eclipsed by shareholder class actions and other remedies

128 Hawes v. City of Oakland, 104 U.S. 450 (1881).
130 Aronson v. Lewis, 473 A.2d 805 (Del. 1984), overruled by Brehm v. Eisner, 746 A.2d 244 (Del. 2000); see also FED. R. CIV. P. 23.1; In re F5 Networks, Inc., 207 P.3d 433 (Wash. 2009).
that offered stronger potential to redress offensive corporate behavior. Derivative suits were, therefore, virtually ignored in legal scholarship where the more high-profile class actions got all the attention. Supporting that neglect was an old complaint that derivative suits were only motivated by "the hope of handsome fees to be recovered by plaintiffs' counsel" and achieved little real substance for shareholders.

Originally, derivative suits produced a monetary recovery for the corporation, but courts gradually accepted that substantial non-financial benefits such as therapeutic changes in a corporation's governance structure would also justify the payment of attorneys' fees. That brought charges that such reforms produced little real benefit for shareholders.

A recent study echoes that criticism, albeit with some ambivalence. It also reports that "contrary to the conventional wisdom, shareholder derivative suits are anything but dead. Shareholders actually file more shareholder derivative suits than securities class actions . . . ." Despite some misgivings, the author there also lauds all the good derivative suits have done in making corporate managers attentive to their fiduciary duties.

In the same vein, a recent observer made this insightful comment about certain landmark derivative cases: "These decisions changed the rules for future legal practice by allowing well-motivated legal counselors to get their clients to accept better conduct and procedures. Moreover, derivative suits against private companies perform an important, if less heralded, role in policing conflict of interest transactions and duty of care violations." Another commentator put it

135 See, e.g., Langevoort, supra note 111.
136 Joy v. North, 692 F.2d 880, 887 (2d Cir. 1982), superseded by statute, CONN. GEN. STAT. § 33-724 (2010). However, the court in Joy approved of the derivative suit saying, "[t]he derivative action is the common law's inventive solution to the problem of actions to protect shareholder interests[,]" and "[t]he derivative action constitutes a major legal bulwark against managerial self-dealing." Id. (citing CARY AND EISENBERG, CASES AND MATERIALS ON CORPORATIONS 938 (5th ed. 1980)).
139 FRANKLIN A. GEVURTZ, CORPORATION LAW 446 (2d ed. 2010).
140 Romano, supra note 137.
142 Id. at 1829.
even more succinctly, "We cannot dispense with the derivative suit without doing absolutely irreparable damage to our corporate governance system." 144

IV. THE ALLEGED SHORTCOMINGS OF SHAREHOLDER CLASS ACTIONS AND DERIVATIVE SUITS

This section addresses these supposed deficiencies of shareholder class actions and derivative suits: "Pocket-Shifting" problems, "Circularity" problems, and the role of the plaintiff in derivative suits. It then responds to those charges and refutes them.

A. The Pocket-Shifting Problem

Despite the demonstrated need for these actions some commentators have claimed they are superfluous because they provide little real compensation for defrauded shareholders. This is particularly true, they say, because of "Pocket-Shifting" problems, 145 which occur when corporate defendants have not sold securities themselves 146 but are liable because their officials have either concealed bad news or in other ways misrepresented the profitability of their companies. 147 When the true facts are revealed, the stock prices of those firms typically drop back to their real value undistorted by the falsely positive news. Investors who have purchased shares at such wrongfully inflated prices therefore suffer losses. 148

According to these critics, "Pocket-Shifting" problems then arise because corporate defendants and their officials almost always settle them either with the companies' funds or with payments provided by insurance policies taken out against such liability. 149 Since premiums on those come from the corporation, the shareholders' own money is directly or indirectly paying their claims—not funds from the corporate officials responsible for the wrongdoing. According to the opponent of these suits, the plaintiffs' lawyers and the insur-

146 See generally Merritt B. Fox, Why Civil Liability for Disclosure Violations When Issuers Do Not Trade?, 2009 Wis. L. Rev. 297 (concluding that substantial reasons exist for using a civil-liability scheme for enforcing mandatory disclosure).
147 For comments on how American corporate culture seems to encourage this type of false optimism that misleads shareholders, see Donald C. Langevoort, Capping Damages for Open-Market Securities Fraud, 38 Ariz. L. Rev. 639, 656 (1996).
149 Coffee, supra note 102, at 1549–51.
Shareholder litigation after the meltdown

Insurers are therefore the real players here.\textsuperscript{150} They profit by the fees they reap from these actions\textsuperscript{151} even though the settlements they reach often do not extract penalties from the true fraudsters—the corporate officials who have caused their firms to make false statements.\textsuperscript{152}

Those critics, however, fail to take into account the important role that enterprise liability plays in our jurisprudence to deter and punish harmful business activity.\textsuperscript{153} As Professor Cox has observed, there is a longstanding common law tradition and much academic support for the principle that businesses should pay for the wrongdoing of their employees.\textsuperscript{154} No less a venerable legal rule than respondeat superior\textsuperscript{155} is premised on the notion that a principal should be directly liable for its agent’s performance.\textsuperscript{156}

As the Supreme Court has also recently re-emphasized,\textsuperscript{157} corporations are legal entities with much the same rights and privileges as natural persons. As such they have corresponding legal responsibilities. Since corporations can only act through their officers and directors, fraud that those officials commit in their representative roles must be deemed wrongful acts by the artificial bodies that they run. Corporations are therefore not held liable unless at least one natural person who works for them is culpable.\textsuperscript{158}

One obvious goal then of shareholders suits is to stop wrongful conduct by corporate officials. This deterrent purpose has long been endorsed by courts who have hailed lawyers in these actions as “private attorney generals” supplementing government enforcement of the securities laws.\textsuperscript{159} A recent commentator has argued that private actions might even be seen as the principal mechan-


\textsuperscript{151}Legal fees on both sides in these matters have averaged about $2.5 billion per year in recent years. Fox, supra note 146, at 306–07.

\textsuperscript{152}Coffee, supra note 102, at 1550–51.

\textsuperscript{153}Professor Langevoort notes that there is strong federal support of enterprise liability. Langevoort, supra note 145, at 631 (citing Robert Thompson & Hillary Sale, Securities Fraud as Corporate Governance: Reflections on Federalism, 56 VAND. L. REV. 859, 865 (2003)).

Langevoort believes that enterprise liability does have a positive effect deterring corporate fraud but expresses skepticism because its efficacy is tempered by the historical reluctance of outside directors to monitor wrongful activity by corporate officers. Id. at 636.

\textsuperscript{154}Cox, supra note 109, at 511.

\textsuperscript{155}RESTATEMENT (THIRD) OF AGENCY §2.04 (2006); see also STEPHEN M. BAINBRIDGE, AGENCY, PARTNERSHIPS, & LLCs 71–73 (2004).

\textsuperscript{156}BAINBRIDGE, supra note 155, at 71–73.

\textsuperscript{157}Citizens United v. FEC, 130 S. Ct. 876 (2010).

\textsuperscript{158}Langevoort, supra note 147, at 653.

\textsuperscript{159}That term was first coined by the distinguished jurist Jerome Frank in Associated Industries of New York State, Inc. v. Ickes, 134 F.2d 694, 704 (2d Cir. 1943), vacated as moot, 320 U.S. 707 (1943). It was later cited with approval by the U.S. Supreme Court in a specific reference to stockholders who bring derivative suits. Alyeska Pipeline Serv. Co. v. Wilderness Soc’y, 421 U.S. 240 (1975).
ism to police securities fraud, constituting a governmental “outsourcing” of that important function. Among the benefits from these multiple and varied private litigators are innovative arguments to address the “changing circumstances” of securities fraud.\(^\text{160}\)

In the same vein, these suits should also make those ultimately in charge of corporations take action against their culpable officials to make sure such harmful conduct does not occur again. Professor Cox suggests that outsider directors and audit committees take control of corrupt corporations to reform their practices and discipline management guilty of such frauds.\(^\text{161}\) Others like Professor Langevoort are skeptical that these suits will result in corporations taking action against their wrongdoing officials because of the close ties boards traditionally have with the officers of their companies.\(^\text{162}\)

Yet, if that is the case, the shareholders themselves can step in and take further action against the wrongdoers. As a recent commentator has argued, stockholders are the true owners of their companies and therefore not mere innocent victims of such wrongdoing.\(^\text{163}\) As such, it is not unjust that the damages in these class actions should come from shareholder funds and such awards can awaken them to their proprietary responsibilities. A response like that goes well with recent movement in increased stockholder activism. The SEC’s new rule giving shareholders the right to nominate directors should accelerate that trend.\(^\text{164}\)

Shareholders also have another effective tool to pursue such recalcitrant directors—the derivative suit. As this Article has discussed, a stockholder may bring such an action on behalf of the corporation against officers and directors who have harmed it by requiring them to pay damages for those frauds.\(^\text{165}\) Even Professor Booth, who is generally quite negative on shareholder class actions,\(^\text{166}\) Fox, \textit{supra} note 146, at 329–31.

\(^\text{161}\) Cox, \textit{supra} note 109, at 511–12.


The Supreme Court recently indicated its support for “the procedures of corporate democracy” by citing it as a mechanism whereby dissenting shareholders might correct misuse of their funds for corporate political speech. \textit{Citizens United v. FEC}, 130 S. Ct. at 911 (citing \textit{First Nat’l Bank of Boston v. Bellotti}, 435 U.S. 765, 794 (1978)).

\(^\text{165}\) \textit{See supra} text accompanying note 126.
proposes that courts should turn them into derivative suits so that a corporation may recover from its insiders for the harm they have caused it and its shareholders.\textsuperscript{166}

The potential for attorneys' fees that such suits hold would therefore encourage shareholder lawyers to follow up and make sure the real wrongdoers are punished—blending class actions and derivative suits into an effective "one-two" punch against corporate corruption. Professor Coffee adds the helpful suggestion that plaintiffs' lawyers could then be rewarded with bonuses based on the source of the settlements (from corporate insiders) and not simply on their size.\textsuperscript{167}

In addition, insurance companies who are facing a crisis because of claims for such fraud,\textsuperscript{168} should have every incentive to be stern with their corporate policyholders and threaten to rescind their coverage unless such corrupt activity is curtailed. This re-enforces the importance of enterprise liability where the availability of insurance helps to deter harm.\textsuperscript{169} Insurance companies are profitable of course if they successfully manage risk.\textsuperscript{170} That gives them the incentive to make sure their corporate policy holders do not incur liability. Such self-interest, Professor Coffee notes, serves the same function that independent directors should play to police management and vigilantly assure that corporations are not injured by fraud.\textsuperscript{171}

\textbf{B. The Circularity Issue}

"Circularity" problems are also said to undercut the effectiveness of shareholder class actions. In the typical situation of securities fraud, an investor buys a stock that is overvalued because of deceitful actions by a company's officials thereby paying too much for it. Correspondingly, the shareholder on the other side of the transaction who sells her stock to that purchaser receives an unjustified gain. Since such a seller is usually innocent of the falsehood, she gets to keep her windfall.

It can be presumed, however, that many parties in these transactions hold diversified portfolios or invest indirectly through firms that do such as mu-

\textsuperscript{166} Booth, \textit{supra} note 145, at 144–46.
\textsuperscript{167} Coffee, \textit{supra} note 102, at 1581–82.
\textsuperscript{168} \textit{Id.} at 1580–81.
\textsuperscript{169} Enterprise liability, as it has developed in the classic doctrine of respondeat superior, is predicated in part on an employer's ability to spread the risk of loss caused by its employees through insurance and in part on the employer's ability to control their conduct. Steven A. Fishman, \textit{Inherent Agency Power—Should Enterprise Liability Apply to Agents' Unauthorized Contracts?}, 19 \textit{RUTGERS L.J.} 1, 48–49 (1987); \textit{see supra} text accompanying note 153.
\textsuperscript{170} Professor Cox notes this truism in discussing the role that insurance plays justifying enterprise liability. \textit{Cox, supra} note 109, at 513.
\textsuperscript{171} Coffee, \textit{supra} note 102, at 1580–81.
tual funds. Consequently, investors will “win some and lose some” in these fraud situations, with their gains and losses “washing out” over time. Legal fees and transaction costs in these suits are thereby said to bring net losses to these diversified investors in the same way that they also decrease the wealth of shareholders in “Pocket-Shifting” situations. Some critics therefore argue that shareholder class actions produce no real gains for most investors but ultimately cost them money.

This “Circularity” analysis of course does not apply to the simple shareholder with an unvaried portfolio who buys a particular stock at a falsely inflated price. She is injured by such wrongdoing and deserves recompense. Yet the losses of just one such individual are usually not sufficient to motivate an attorney to bring an action on her behalf. The possibility of aggregating them with like claims however can provide such an incentive, regardless of the diversified status of those other investors.

In addition, this “Circularity” argument is a fairly cynical “no-harm, no-foul” approach that does not take into account the important role these suits play in guaranteeing the integrity of the securities market. As Holmes put it so well, if we are to understand the role of law, we must look at it as a “bad man . . . wishing to avoid an encounter with the public force . . . .” Such civil suits are the only real sanctions that most of these corporate wrong-doers fear. Eliminating them would only embolden fraudsters, making investment a “rigged game” and thereby causing potential share purchasers to be reluctant to commit their capital to businesses.

172 Id. at 1559.
173 Booth, supra note 145, at 139–40.
175 As Professor Langevoort notes while discussing “Pocket-Shifting” and “Circularity” issues that may detract from fraud recoveries, “That does not mean that the unfortunate victims do not deserve compensation. . . . [N]ot all investors are active or diversified, and bad luck as a result of corporate fraud will predictably befall even some who are, in ways that are not washed away.” Langevoort, supra note 145, at 632, 634.
176 Professor Coffee, however, points out that many times these undiversified investors “buy and hold” stocks and therefore are more likely to have purchased their shares before the class period begins. This not only makes them ineligible to be plaintiffs but puts them at a disadvantage over the “in and out” traders who are more likely to be in the plaintiffs’ class. Coffee, supra note 102, at 1559–60.
177 See supra text accompanying notes 108–109.
178 OLIVER WENDELL HOLMES, The Path of the Law, in COLLECTED LEGAL PAPERS 170 (1920).
179 See supra text accompanying notes 111–114.
Shareholder class actions are rather needed now more than ever to deter and punish these fraudsters—and to hold them accountable through the publicity of a law suit. As Judge Richard Posner, the father of law and economics, wrote of shareholder class actions, “[T]he most important point, on an economic analysis, is that the violator be confronted with the costs of his violation — this achieves the allocative purpose of the suit — not that he pay them to his victims.”

Yet as Professor Jill Fisch has recently pointed out, disciplining management to be honest about the values of their companies is not the only benefit these suits provide. Investors are protected here not just by a system that compensates them for their losses, but also by one that rewards them for being informed traders. These suits encourage that activity by providing a mechanism to reimburse such share purchasers when they are deceived in reliance on falsehoods. Class actions thus facilitate the efficient pricing of securities that comes with such informed trading, providing “a positive corporate-governance externality” that increases the worth of all shares.

In addition, as Professor Coffee rightly points out, if class actions are replaced by mere civil penalties levied against the wrong-doers, the recovery will typically be much less than the current settlements of those suits. Correspondingly, the incentives that plaintiffs’ attorneys currently have to discover and prosecute such frauds will be greatly reduced. Those potential rewards are necessary because of the large amount of resources that shareholder lawyers must typically commit to effectively investigate and pursue these legal actions. Without such inducements, there would be much less investigation and exposure of corporate wrong-doing.

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180 See Choi, supra note 102, at 1524 (“[S]ecurities class actions do hold promise in harnessing private incentives to police for fraud.”).
183 Id. at 335.
184 Id.
185 Id. at 347.
186 Id. at 335.
187 Coffee, supra note 102, at 1563–64. For statistics showing how much better private suits are at recovering losses for defrauded shareholders than SEC actions, see supra text accompanying note 105.
188 For additional support on that point from the law and economics school, see BAINBRIDGE, supra note 156, at 365–68; Gary S. Becker, Crime and Punishment: An Economic Approach, 76 J. POL. ECON. 169 (1968); see also supra text accompanying notes 109, 174.
C. Questions About Plaintiffs in Derivative Suits

As has been discussed, the federal securities laws now require that courts overseeing class action litigation appoint lead plaintiffs to assure that the largest investors will control the action.\(^{189}\) No such requirement exists for the derivative suit. There the plaintiff needs only to have been a shareholder at the time of the alleged wrong-doing and remain one throughout the litigation.\(^ {190}\) A plaintiff shareholder in a derivative suit therefore may own just a small fraction of the outstanding shares. In dismissing such an action, a court recently made this comment questioning those different standing requirements in class actions and derivative suits:

In both contexts [shareholder class actions and derivative suits] there is a need to have plaintiffs who can adequately represent other shareholders and exercise a meaningful role in critical decisions such as whether to file suit or to settle. Otherwise, it is the attorneys who will completely control the litigation and make these decisions based on their own financial interests rather than the interests of the corporation and its shareholders.\(^ {191}\)

Remarks such as those misperceive the different functions that shareholder plaintiffs have in class actions and derivative suits. Unlike stockholders in class actions who are suing to vindicate their own rights and seek damages themselves, shareholder plaintiffs in derivative actions are redressing wrongs done to their companies. Recoveries in those actions inure not to the stockholders themselves but to their corporations. In class actions, therefore, it may be appropriate to have shareholders with the largest amount of their personal wealth at stake serve as lead plaintiffs. They arguably should control the litigation to safeguard their personal interests.\(^ {192}\)

But such a mechanism is not needed in derivative suits because the stockholder plaintiffs there are not looking for a personal recovery. Unlike securities class actions, which are typically brought under federal anti-fraud laws, derivatives suits usually seek to redress wrongs done by corporate management whose duties are governed by state law. Standing rules in derivative suits there-

\(^{189}\) See supra text accompanying note 124.

\(^{190}\) FED. R. CIV. P. 23.1(b)(1).


\(^{192}\) A recent study however indicates that many large financial institutions have been reluctant to assume that role and when they have they do not increase the dollar recoveries relative to the provable losses. Even more importantly, almost all of these lead plaintiffs have not been banks or mutual funds but rather public or labor pension funds—groups that might be motivated as much to achieve corporate reforms as by eagerness for remunerative gain. James D. Cox and Randall S. Thomas, Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions, 106 COLUM. L. REV. 1587, 1590 (2006).
fore just require that the plaintiff be able to "fairly and adequately represent the interests of the corporation in enforcing the rights of the corporation." Two leading cases, one from the Supreme Court and the other written by a distinguished Delaware Chancellor, cogently explain the wisdom of that jurisprudence and demonstrate the paramount role that competent and vigorous counsel play in these actions.

D. Surowitz and Fuqua Industries

In the first case, *Surowitz v. Hilton Hotels Corp.*, the plaintiff was an immigrant with a very limited English vocabulary. She had saved money she earned as a seamstress and bought stock in the defendant corporation at the suggestion of her son-in-law, a law school graduate who was also a professional investment advisor. When she received notice that the corporation was repurchasing a large amount of its shares she took it to her son-in-law. He then investigated the matter and concluded that officials of the corporation were engaging in a fraudulent scheme. After the company stopped paying dividends, Mrs. Surowitz agreed that a derivative suit be filed in her name.

Upon an oral examination, it became apparent that Mrs. Surowitz knew little about the specifics of the misconduct alleged in the complaint and had relied on her son-in-law to explain its facts to her. The defendants, therefore, sought dismissal on the grounds that Mrs. Surowitz was not a proper party plaintiff. In a unanimous opinion, however, the Supreme Court allowed the suit to go forward stating:

> [D]erivative suits have played a rather important role in protecting shareholders of corporations from the designing schemes and wiles of insiders who are willing to betray their company’s interests in order to enrich themselves. And it is not easy to conceive of anyone more in need of protection against such schemes than little investors like Mrs. Surowitz.

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194 See infra Part 4.D.
196 *Id.* at 368.
197 *Id.*
198 *Id.*
199 *Id.* at 369.
200 *Id.*
201 *Id.* at 372.
202 *Id.* at 366.
203 *Id.* at 371.
The lower court had considered "a woman like Mrs. Surowitz who is uneducated generally and illiterate in economic matters" to be unsuitable as a plaintiff in a derivate suit. But the Supreme Court would not allow her potentially meritorious action to be sidetracked on those grounds. Rather, it held that the rules on derivative suits were designed "to administer justice through fair trials" and "to get away from the old procedural booby traps which common-law pleaders could set to prevent unsophisticated litigants from ever having their day in court."

Next, In re *Fuqua Industries, Inc. Shareholder Litigation* contained similar allegations that its plaintiff shareholders were unfamiliar with many of the facts alleged in the derivative suit and had little control over it. One of them, Abrams, with her husband had held substantial shares in the company for a number of years and had become concerned about managerial misconduct by its officers and directors. The other plaintiff, Freberg, purchased a small number of shares in the company. Two years later, "presumably upon concluding that Fuqua directors . . . had engaged in self-dealing transactions[,]" he filed a suit that was ultimately consolidated with Abrams's complaint.

During the long pendency of the action, Abrams became ill and the court found that her memory and faculties suffered as a result. When deposed it was evident that she lacked a full understanding of the particulars of the suit although at times she appeared able to provide a general understanding of her claim.

As to Freberg, the court found "his knowledge of the case is at best elliptical." The defendants also sought dismissal of Freberg's claim because he had "a general ignorance of six or seven other lawsuits in which he was, or still is, the named representative plaintiff." The court then summed up the defendants' arguments by commenting "[t]he subtext of the defendants' motion is that Freberg has no knowledge of this case because he has no real economic interest at stake. In defendants' view, Freberg is a puppet for his fee-hungry lawyers."

Citing previous Delaware decisions however, Chancellor Chandler responded:

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204 *Id.* at 372.
205 *Id.* at 373.
206 752 A.2d 126 (Del. Ch. 1999).
207 *Id.* at 128.
208 *Id.* at 129.
209 *Id.*
210 *Id.*
211 *Id.*
212 *Id.*
213 *Id.*
214 *Id.*
215 *Id.*
[T]he Court of Chancery will not bar a representative plaintiff from the courthouse for lack of proficiency in matters of law and finance and poor health so long as he or she has the competent support from advisors and attorneys and is free from disabling conflicts. This conclusion is both just and sensible.\textsuperscript{216}

He then made these astute comments to refute charges that derivative suits should be disfavored because lawyers are rewarded for their efforts in bringing them:

\begin{quote}
[T]he mere fact that lawyers pursue their own economic interests in bringing derivative litigation cannot be held as grounds to disqualify a derivative plaintiff. To do so is to impeach a cornerstone of sound corporate governance. Our legal system has privatized in part the enforcement mechanism for policing fiduciaries by allowing private attorneys to bring suits on behalf of nominal shareholder plaintiffs. In so doing, corporations are safeguarded from fiduciary breaches and shareholders thereby benefit. Through the use of cost and fee shifting mechanisms, private attorneys are economically incentivized to perform this service on behalf of shareholders.\textsuperscript{217}
\end{quote}

The Chancellor then ruled that the suit should go forward since Freberg understood the basic nature of the derivative claims brought in his name.\textsuperscript{218} As to his involvement with other litigation, the Chancellor said, “For better or worse, however, no limit exists on the number of lawsuits one individual can bring in a lifetime.”\textsuperscript{219} The court likewise found Mrs. Abrams to be a suitable plaintiff saying, “[I]ke Mrs. Surowitz with the aid of her son-in-law, Mrs. Abrams discovered her injury and filed this lawsuit with the aid of her husband.”\textsuperscript{220}

\textbf{E. The Lawyer/Client Relationship in Derivative Suits}

Plaintiffs in derivative cases provide a much needed service to our economy by being catalysts for corporate reform. As Chancellor Chandler noted in a post-\textit{Fuqua} decision, “It is important for shareholders to bring derivative suits because these suits, filed after the alleged wrongdoing, operate as an \textit{ex post} check on corporate behavior.”\textsuperscript{221} That important observation, read together

\begin{footnotesize}
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\item \textsuperscript{216} \textit{Id.} at 131.
\item \textsuperscript{217} \textit{Id.} at 133.
\item \textsuperscript{218} \textit{Id.} at 134.
\item \textsuperscript{219} \textit{Id.}
\item \textsuperscript{220} \textit{Id.}
\item \textsuperscript{221} Seinfeld v. Coker, 847 A.2d 330, 333 (Del. Ch. 2000).
\end{itemize}
\end{footnotesize}
with Chancellor Chandler’s earlier comments in *Fuqua*, make a compelling case for the key role of counsel in derivative suits.

Because any recovery in a derivative action goes to the corporation, plaintiffs there gain only a small, indirect reward for their efforts. As one commentator put it, “Indeed it does not make economic sense for the usual plaintiff shareholder to bring the [derivative] suit. The individual who gains by bringing the suit is the shareholder’s attorney. The attorney hopes to collect fees out of any judgment or settlement.”

Courts therefore may have legitimate concerns about the ability of shareholder plaintiffs in potentially meritorious derivative suits to adequately represent the interests of their corporations. Derivative suit plaintiffs must not be mere “puppets” of others, unmotivated to bring the action and uninterested in it. Similar apprehension may exist in shareholder class actions where one judge feared that plaintiffs might be “nominees, indeed pawns, of the lawyer.”

Yet involved, active shareholders like Mrs. Surowitz and the plaintiffs in *Fuqua* are to be commended. Their suits not only redress fraudulent corporate behavior, but also, in the words of Chancellor Chandler, “deter improper behavior by similarly situated directors and managers, who want to avoid the expense of being sued and the sometimes larger reputational expense of losing in

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222 GEVURTZ, *supra* note 139, at 449. Safeguards exist to make sure that those suits are only brought when there is a good chance that such a valuable result will occur. First, a shareholder may not initiate a derivative suit unless a reasonable doubt exists about the ability of the directors to independently exercise their managerial prerogatives to decide whether the matter should be pursued. Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984), *overruled by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000) (holding that directors’ lack of independence and disinterest does not excuse pre-suit demand); see *supra* text accompanying notes 136–137.

Then, if the case does go forward, the court must approve any settlement to make sure that it produces appropriate benefits for the corporation. *FED. R. CIV. P* 23.1(c). One commentator has recently questioned whether courts adequately review these settlements allowing some which do not benefit shareholders. Erickson, *supra* note 141, at 1792–94. Similar review procedures, however, exist for the settlement of class actions which were strengthened by amendments in 2003. The advisory committee there noted, “Settlement may be a desirable means of resolving a class action. But court review and approval are essential to assure adequate representation of class members who have not participated in shaping the settlement.” *FED. R. CIV. P.* 23 advisory comm. notes (2003 amendments).

On that point, one experienced judge has recently written:

> This Court has ruled upon many applications for final approval of a class action settlement. . . . The fact that nearly all of those settlements have been approved is testament to the fact that class counsel generally do an excellent job in negotiating settlements which are fair, reasonable and adequate to the entire class and not just the class representatives.


To be successful, such shareholders need the assistance of competent and forceful counsel. As Chancellor Chandler rightly emphasized in *Fuqua:*

> Our legal system has long recognized that lawyers take a dominant role in prosecuting litigation on behalf of clients. A conscientious lawyer should indeed take a leadership role and thrust herself to the fore of a lawsuit. This maxim is particularly relevant in cases involving fairly abstruse issues of corporate governance and fiduciary duties.  

V. THE FEDERAL CAUSES OF ACTION FOR SECURITIES FRAUD

The Supreme Court and federal law have dealt devastating blows to shareholders' potential for recovery. The Court's decisions, compounded with and enabled by federal law, have watered down the potency of shareholders' remedies. Congress, however, holds the key to redress and should reinvigorate the remedies. The following sections of this Article discuss these issues.

A. The Strong Investor Remedy Under Section 11

Effective class actions and derivative suits are thus the principal procedural mechanisms that shareholders can use to bring fraud claims under the federal securities laws. If such suits are to be appropriate vehicles for redress, however, those substantive remedies must afford meaningful methods for recovery. Causes of actions provided in both the Securities Act and the Exchange Act can and should give defrauded investors that ability. Several judicial decisions, however, have weakened those rights.

The year of the meltdown, 2008, was also the 75th anniversary of the Securities Act of 1933, the key piece of legislation enacted to reform our capital markets after the disastrous Crash of 1929 that precipitated the Great Depression. The Securities Act mandates that before securities can be offered and sold to the public a registration statement including the issuer's prospectus has to be filed with an overseeing federal commission, the SEC.

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225 *Seinfeld*, 847 A.2d at 333.
228 The SEC has summarized the essential facts that a prospectus must contain in these four categories: "(1) a description of the company's properties and businesses; (2) a description of the security to be offered for sale; (3) information about the management of the company; and (4) financial statements certified by independent accountants." SEC, *Registration Under the Securities Act of 1933*, http://www.sec.gov/answers/regis33.htm (last modified Sept. 2, 2011).
229 Securities Act § 5, 15 U.S.C. § 77c. The author has recently published an article about the continuing importance of that mandate and the need to strengthen it. See Daniel J. Morrissey, *The Securities Act at its Diamond Jubilee: Reviewing the Case for a Robust Registration Requirement*,...
If any information in that document is materially false or misleading, section 11 of the Act gives investors a right to sue and recover damages directly from a number of individuals who are connected to the offering. Those defendants can only escape liability if they can establish one of the affirmative defenses the Act provides. The most significant of those are “due diligence” and “non-causation.” The former generally requires a showing of reasonable investigation to assure the accuracy of the registration statement. The latter bars liability if the defendants can show that the investors’ losses were caused by something other than the false statements in the registration statement.

Many parallels have been drawn between the Depression era and our current economic difficulties that were brought about by the financial meltdown. Unfortunately, the stringent registration requirements and the accom-


A number of foreign companies, many from China, may now be evading this registration requirement by going public “through the back door.” To go “through the back door,” foreign companies first purchase an American shell company which has a stock exchange listing but few assets. Next, they execute a reverse merger of their firm into that company. And finally, “[a] quick name change and presto, the Chinese company is traded on Nasdaq or the Amex.” James Surowiecki, Don’t Enter the Dragon, NEW YORKER, Jan. 31, 2011, at 25.

Securities Act § 11(a), 15 U.S.C. § 77k(a) (giving the right to sue not only the issuer, but also everyone who signs the registration statement, the company’s directors, and its auditors and underwriters).

Securities Act § 11(b), 15 U.S.C. § 77k(b). The classic case interpreting that provision is Escott v. Bar Chris Construction Corp., which allowed defendants to avoid liability if they could show they met a specific standard of knowledge or conduct with respect to the material misstatements or omissions. 283 F. Supp. 643, 692 (S.D.N.Y. 1968).


The credit crisis of Fall 2008 sounds like the same situation that was described in a congressional debate supporting the enactment of the Securities Act:

[The Act exists] to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by questionable securities offered to the public through crooked promotion; to restore the confidence of the prospective investor in sound securities; to bring into productive channels of industry and development capital which has grown timid to the point of hoarding; and to aid in providing employment and in restoring buying and consuming power.

77 CONG. REC. 2983 (1933). In the same vein Felix Frankfurter, the principal draftsman of the Securities Act, made these comments about the reasons for the Securities Act:

How to draw the savings of people into great streams of investment and at the same time to protect those savings from recklessness has been a problem for statesmanship ever since the advent of large corporate enterprise. Particularly exigent has this problem been in periods of crisis following speculative debauches. Man’s memory is short and hope of gain is an obdurate motive. When, however, confidence takes flight, it can be coaxed to return permanently only by prudent safeguards against future devastation.

panying civil remedies of the Securities Act, although in place for decades, did little to forestall the current debacle. Those protections were largely unavailable to investors who purchased the exotic financial products responsible for the meltdown.

Under the Commodities Futures Modernization Act of 2000, credit default swaps were effectively exempted from regulation when that Act provided they were not securities. In addition, credit derivatives and other securitized assets were almost always sold without registration because they were offered in exempt private placements. Thus, fraudsters during the meltdown were undeterred by section 11’s tough civil sanctions.

B. Gustafson’s Body-Blow to Defrauded Shareholders

There is no logical reason why those who are sold unregistered securities in Madoff-like private dealings should have any less robust legal redress for fraud than individuals who purchase them in an SEC registered offering. The Securities Act, in fact, appears to provide just such a cause of action, section 12(a)(2). It gives investors an unqualified right to sue persons who sell them securities “by means of” a false or misleading prospectus or oral communication without limiting that remedy, as section 11 does, to financial instruments registered with the SEC.

The elements of a section 12(a)(2) action roughly parallel those of section 11. Causation is satisfied if the offering, including the securities purchased by the plaintiff, is sold by means of a misleading prospectus. A plaintiff

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235 Securities Act § 2A(b); Exchange Act § 3A(a), (b), 15 U.S.C. § 78c-1 (2006); see also supra text accompanying note 58.
236 For a lengthy treatment and critical discussion of that exemption from registration by the author, see Daniel J. Morrissey, The Road not Taken: Rethinking Securities Regulation and the Case for Federal Merit Review, 44 U. RICH. L. REV. 647 (2010).

Dodd-Frank attempted to address some of those glaring regulatory deficiencies. See supra text accompanying note 69.

237 In the Securities Act, this was originally section 12(2) but it was amended to section 12(a)(2). MARC. I. STEINBERG, UNDERSTANDING SECURITIES LAW 208 (4th ed. 2007). The earlier cases thus refer to it as section 12(2) but this article will uniformly call it section 12(a)(2).
239 Id. Section 12, however, only gives shareholders a cause of action against those who “sell” them the security. In that regard, it is a narrower remedy than section 11 which provides an express cause of action against a number of individuals connected to a registered offering. See supra note 230 and accompanying text.

The Supreme Court has defined “seller” in the context of a section 12(1) action to include not just those who pass title to the securities but also those like brokers who solicit such transactions to benefit themselves or their owners. It does not, however, include participants like attorneys or accountants who may merely be substantial factors in causing those transactions to take place. Pinter v. Dahl, 486 U.S. 622, 623 (1988).
need not prove that she relied on the misrepresentation or even received the misleading prospectus. And like section 11, a defendant in a 12(a)(2) action will be liable unless he can establish a “quasi-due diligence” defense that “he did not know and in the exercise of reasonable care could not have known, of such untruth or omission.”

Since the term “prospectus” is defined broadly in the Securities Act as, among other things, “any . . . communication . . . which offers any security for sale[,]” it was, therefore, an “article of faith” and, until 1995, section 12(a)(2) applied to every sale of securities. That was “overwhelmingly, if not unanimously” the opinion of the lower courts and, consequently, unregistered private placements were done with due-diligence procedures similar to those in public offerings.

That all changed however in 1995 when the Supreme Court decided *Gustafson v. Alloyd Co.* and interpreted section 12(a)(2) narrowly, restricting its applicability to securities sold in public offerings. *Gustafson* involved the private sale of the stock in a company where the purchase agreement represented that the company’s financial statements were accurate. If an upcoming year-end audit showed otherwise, the disappointed party would be entitled to an alteration in the purchase price. When that turned out to be the case, however, the buyers did not pursue their contract right to an adjusted amount. Instead, they sued to rescind the entire sale under section 12(a)(2) claiming the financial statements in the purchase agreement were materially false.

That document literally met the definition of “prospectus” in section 2(a)(10) of the Act because it was “a communication . . . which . . . confirms the

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241 Id. at 1226.
242 The apt description is from STEINBERG, supra note 237, at 209.
243 Id.
248 Id. at 579.
249 Id. at 565–66.
250 Id. at 565.
251 Id. at 565–66.
sale of any security." The plaintiffs therefore asserted that company's stock was sold by means of a false prospectus thus giving them a right of action under section 12(a)(2). In a 5-4 decision, however, the Court's majority said the term prospectus in that section more logically referred to its usage in section 10 of the Securities Act which described the document employed in a public stock offering rather than its broader meaning in the definitional section.

Perhaps some of the Justices believed that the plaintiffs in Gustafson were seizing on a pretext to unfairly seek a broader remedy of rescission than the more limited price adjustment they had agreed to. Yet the decision brought immediate and justifiable criticism. In the first instance it came from the four dissenting justices who pointed out that under the Securities Act's definitional section the document in question fit squarely within the meaning of prospectus because it was "a communication . . . which . . . confirm[ed] the sale of any security." Strong disapproval also came swiftly from the scholarly community. The staff of the Harvard Law Review remarked that "the Gustafson majority reached a decision . . . using demonstrably mistaken reasoning." Another noted authority said, "the reasoning used by the [Gustafson] majority . . . is so flawed that its full implication will not be known for some time." And a well-respected former SEC commissioner assailed the decision as "motivated more by politics than any serious examination of the statute."

The Court's restrictive interpretation of section 12(a)(2) all but rendered that cause of action superfluous because it then became almost co-extensive with section 11. Like section 11, section 12(a)(2) is now confined only to public offerings. That seemed to conflict with an obvious intent by the drafters to give such potent rights to all those defrauded in the sale of securities, whether the financial instruments they purchased were registered or not.

253 Gustafson, 513 U.S. at 568–70.
254 Id. at 585–86.

One commentator, however, observed that such a limitation was not quite correct because certain issuances that were exempt from registration like intrastate offerings under section 3(a)(11) and certain small offerings so exempt under section 3(b) could be deemed public. Therefore section 12(a)(2) could apply to frauds committed there. Weiss, supra note 244, at 152.

259 Legislative history seems to point that way as well. Justice Ginsburg's dissent, which Justice Breyer joined, contains an extensive discussion of that. Gustafson, 513 U.S. at 599–600. It also notes that Felix Frankfurter, the principal drafter of the Act, unequivocally stated that view in other writings as did another future Supreme Court Justice, William O. Douglas, who was one of the early chairmen of the SEC. Id. at 601.
C. The Shrinking 10b-5 Remedy

With the widening of exemptions to registration that have occurred over the last several decades, Gustafson's harm to investor rights has become fully apparent. Purchasers of non-registered offerings now only have the implied right of action under Exchange Act Rule 10b-5 as a federal remedy for fraud. The SEC promulgated that rule in 1942 under authority granted it in section 10(b) of the Exchange Act. Among other things it prohibits the making of "any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made . . . not misleading . . . in connection with the purchase or sale of any security." 10

Section 10(b) and Rule 10b-5 are criminal provisions but for some time the lower federal courts, analogizing from common law tort principles, had been allowing victimized shareholders to bring civil suits under them against the perpetrators of those frauds. At first, those actions appeared to offer advantages over 12(a)(2) claims because the broader language of 10b-5 includes frauds in the purchase as well as the sale of securities, whereas 12(a)(2) only covers deceitful sales. Rule 10b-5 also does not, by its terms, contain a privity requirement like 12(a)(2) which limits recovery to just those who sold the securities.

In the mid-1970s, however, the Supreme Court decided a trio of cases that substantially restricted the reach of 10b-5 private actions. These cases required that the plaintiff allege an actual purchase of securities had occurred, that the defendant acted with scienter, and that the fraud had involved either a misrepresentation or a nondisclosure of material fact. The Court predicated its decision in each of those cases on the language of section 10(b) itself.

The first of those cases ruled out 10b-5 claims arising from a fraud that caused an investor not to purchase a particular security. The second case

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260 For the author's discussion of how those exemptions have been improvidently broadened in recent years see Morrissey, supra note 229, at 771–80.

261 A number of state securities codes are patterned after section 401(a)(2) of the Uniform Securities Act. It is like section 12(a)(2) but avoids the term "prospectus," simply giving an express cause of action against "any person who . . . offers and sells a security by means of any untrue statement of material fact . . . ." UNIFORM SECURITIES ACT § 410(a) (1956). The impact of that provision is limited, however, because federal law preempts state class action suits for fraud involving publicly-traded securities. See supra text accompanying note 24.


263 17 C.F.R. § 240.10b-5(b)–(c) (2011) (promulgated under the Securities Act § 10(b)).


266 Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201 (1976).


268 Blue Chip Stamps, 421 U.S. at 737, 755.
meant that a claim for negligent misrepresentation was no longer available under that provision and Congress, in 1995, made the obligatory showing of scienter even more difficult by requiring such state of mind to be pled with particular facts before a suit could go forward. The third ruling, demanding actual deception, seemed to preclude claims about fraudulent activity where misstatements or concealments of material fact were not present.

D. Contrasting 10b-5 with Section 11

Rule 10b-5 actions for fraud in non-registered stock sales are thus more difficult to prosecute than section 11 claims in at least three key ways. The scienter requirement in 10b-5 now demands that plaintiffs not just prove but also plead how defendants have acted with that state of mind. By contrast, section 11 provides liability for negligent material misrepresentations. If the defendants are to avoid liability, they must show they acted with due diligence to make sure such false statements were not made.

Further, plaintiffs in a fraud action under section 11 need only allege that the prospectus contained a materially misleading statement. It then becomes the defendants’ obligation to show the decline in the value of the investors’ securities was caused by factors other than the falsehoods. In the 1995 amendments, however, Congress codified a reverse burden of proof in 10b-5 actions by specifically requiring that plaintiffs prove that their losses resulted from the defendants’ false statements.

In the 2005 case of Dura Pharmaceuticals, Inc. v. Broudo, the Supreme Court further elevated that barrier to recovery. The Court had earlier, as discussed above, approved the “fraud on the market theory,” which assumes that a stock’s price can be distorted by false information. In Dura, however, the Court ruled that a decline in a share’s price after the disclosure of a falsehood may not automatically indicate that the untrue statement caused the plaintiff’s loss. The Dura case therefore makes it more difficult for all securities purchasers during the time of a fraud to join as a class to seek redress.

269 The Hochfelder case, however, left open the possibility that reckless behavior might be sufficient for civil liability under Rule 10b-5. 425 U.S. at 193 n.12.

270 See supra text accompanying note 119.

271 See supra text accompanying note 119.

272 See supra text accompanying note 231.

273 See supra text accompanying note 119.


275 Id. at 346.


277 As the Court in Dura put it:
The reach of 10b-5 recovery has also been substantially contracted by two Supreme Court decisions. In the 1994 case *Central Bank, N.A. v. First Interstate Bank*, the Court ruled that unlike section 11 of the Securities Act where a number of individuals who brought about the fraud can be held liable, 10b-5 liability does not extend to aiders and abettors. And the Supreme Court exacerbated that holding more recently in *Stoneridge Inv. Partners v. Scientific American* where it held that only those who actually make a materially false or misleading statement can be liable under 10b-5 even if other participants in the fraud knowingly scheme to bring it about.

E. **Congress Should Overrule Gustafson or Otherwise Broaden the 10b-5 Remedy**

In its deliberations on Dodd-Frank, Congress considered restoring aiding-and-abetting liability to 10b-5 actions but ultimately settled upon remanding the matter for further study. As part of its continuing oversight over the regulation of our financial institutions, Congress should go further and act to directly set straight the inconsistent remedies that our securities laws provide to defrauded investors.

The best approach would be for Congress to overrule *Gustafson* and make it clear that the section 12(a)(2) direct cause of action will operate as it was obviously originally intended. Investors would then be able to use it as a remedy for fraud in the sale of any security. Alternatively, Congress could achieve much the same result by making the elements of a 10b-5 action, involv-

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Given the tangle of factors affecting price, the most logic alone permits us to say is that the higher purchase price will *sometimes* play a role in bringing about a future loss. In that sense one might say that the inflated purchase price suggests that the misrepresentation "touches upon" a later economic loss. But, even if that is so, it is insufficient. To "touch upon" a loss is not to cause a loss, and it is the latter that the law requires.

*Id.* at 342–43.

279 For two fine pieces respectively speculating on *Dura*’s effect and discussing its progeny see Patrick J. Coughlin et al., *What’s Brewing in Dura v. Broudo? The Plaintiffs’ Attorneys Review the Supreme Court’s Opinion and Its Import for Securities-Fraud Litigation*, 37 LOY. U. CHI. L.J. 1 (2005) and Langevoort, supra note 111, at 181–84.


281 *Id.* at 190.

282 552 U.S. 148 (2008). The Supreme Court recently gave further support to that outlook by holding that an investment advisor to a mutual fund could not be held liable for false statements made in the fund’s prospectus. *Janus Capital Grp. v. First Derivative Traders*, 131 S. Ct. 2296, 2304 (2011).

283 *Id.* at 771–72.

ing state of mind, participant liability, and causation consistent with the parallel, forcible provisions of section 11.

All defrauded investors then, regardless of whether they acquired their financial instruments in public or private offerings, would have the same robust federal remedies. Unscrupulous promoters and banks would therefore be compelled to deal more honestly with those from whom they seek capital or face surer claims to redress their unjust dealings.

VI. CONCLUSION

The massive frauds that led to the meltdown not only cheated large numbers of investors but also ultimately took an unprecedented toll on our nation’s economy. Congress has responded with legislation that offers some promise of safeguarding our financial institutions from the worst of those abuses. If history provides any perspective, however, government action will hardly be effective to stop all such fraudulent practices in the future or to compensate those who are injured by them.

As two commentators put it recently, “[D]oes anyone seriously doubt that there is immense deterrent power in the contemporary class action? Executives tempted to lie about earnings are more concerned about Bill Lerach and Melvyn Weiss [renowned shareholder lawyers] than they are about the Securities and Exchange Commission (SEC).” Derivative suits and shareholder class actions are therefore the most powerful tools we have to deter and expose corporate corruption.

As this Article has discussed, “Pocket-Shifting,” and “Circularity” problems along with issues raised by so-called “professional plaintiffs” are red herrings. The first two claim that class actions achieve little compensation for victims of stock fraud, but that charge not only neglects the obvious deterrent effect of those actions but also cynically undervalues the real damage awards and other share enhancements that they bring. In the derivative suit context, courts cannot forget that lawyers for the shareholders are acting as private attorney generals to fight corporate wrong-doing. In those actions, if a particular plaintiff fails to meet the formal statutory standards, courts should liberally allow another one to be substituted who so qualifies.

Rather than focusing on those trivial issues, lawmakers should strengthen the causes of action available to investors for securities fraud. As this Ar-

285 The work of Messieurs, Lerach and Weiss is well described in a fine current study of shareholder litigation. DILLON & CANNON, supra note 27. Their firm returned more than $45 billion in fraud judgments or settlements to millions of shareholders. Id. At the end of their careers, however, both Lerach and Weiss pled guilty to conspiring to obstruct justice by misrepresenting fee arrangements in those matters. Id. As a result, they served prison terms and forfeited their licenses to practice law. Id.

ticle has suggested, one important way to do that would be to restore the direct cause of action provided in section 12(a)(2) of the Securities Act for fraud in the sale of any security.

Alternatively, legislative reforms could correct unduly narrow Supreme Court cases involving state of mind, causation, and aiding-and-abetting liability in 10b-5 actions. We must take this action as we go into the future to avoid the mistakes of the past. Such legislation, more than any additional government regulation, would go a long way to restoring the financial integrity that is essential to any truly prosperous economy.