SHAREHOLDER LITIGATION AFTER THE MELTDOWN

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“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,¹

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

Oliver Stone²


I. Introduction: The Need for Effective Shareholder Actions

Since at least the Watergate era almost forty years ago, the 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 just 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 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 also describe several legislative initiatives since the Watergate era that were passed in response to those frauds. The Dodd-Frank Wall

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3 See infra notes ** and accompanying text.
4 For an excellent summary of these dishonest dealings, see Arnold, supra note *, at 420-24.
5 The Committee of Sponsoring Organizations of the Treadway Commission (COSO) has recent issued this finding. “The vast majority of public companies appear to provide financial reports that are free from material misstatements due to fraud.” COSO, Fraudulent Financial Reporting, 1998-2007: An Analysis of U.S. Public Companies 2 (May, 2010).
6 See infra notes ** and accompanying text.
7 See infra notes ** and accompanying text.
8 See infra notes ** and accompanying text.
9 See infra notes ** and accompanying text.
10 See infra notes ** and accompanying text.
Street Reform and Consumer Protection Act (Dodd-Frank)\textsuperscript{11} signed into law by President Obama in July, 2010 is only the most recent.\textsuperscript{12} One can hope that its ambitious attempts at reform of the financial community will end or at least substantially stifle corrupt business activity. The mixed results from similar law-making efforts during earlier times however don’t offer encouragement for such optimism.

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

The final segment of this Article will suggest ways that those rights can be strengthened by legislative activity that will correct those regrettable decisions.\textsuperscript{13} But first the Article will focus on the principal legal mechanisms that shareholders can use to enforce those rights, class actions and derivative suits. And it will answer the three principal criticisms leveled at them.

Two of those arguments question the efficacy of shareholder class actions. One, “Pocket-Shifting,” charges that in those suits stockholders indirectly end up paying their own claims. The other, “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

\textsuperscript{11} Pub. L. 111-203, H.R. 4173
\textsuperscript{12} See infra notes ** and accompanying text.
\textsuperscript{13} See infra notes ** and accompanying text.
these actions—most importantly their deterrent and punitive impact—far out-weight any shortcomings.

The other criticism, the perceived problem of the professional plaintiff, is no longer an issue in class actions but 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 Article will conclude by urging that Courts remain receptive to these vital antidotes to corporate misconduct. They cannot be oblivious to the scandals and meltdowns that continue to weaken our economy. As a renowned business journalist has put it, “Corporate fraud is sort of like grass, it grows, it gets cut down, and it grows again.”¹⁴ Unless alert shareholders and their lawyers are given these tools to keep it in check, corruption may overrun 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

A. Landmark New Deal Legislation Responding to the Great Depression

The link between securities fraud and financial calamity goes back at least to the Great Depression. As a Congressional committee found in 1933, “Whatever 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.

The first, 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.

B. Watergate, Questionable Payments, and the Foreign Corrupt Practices Act

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.” As Time magazine put it in a 1976 cover story, “The record of U.S.

17 Section 5(a) of the Securities Act; 15 U.C.S. §77e(a) (2008)
18 Section 24 of the Securities Act; 15 U.C.S. §77x (2008)
22 See Arnold, supra note *, at 427.
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 (FCPA) which not only explicitly made such activity illegal but also re-enforced the Exchange Act’s reporting requirements by mandating that public companies keep accurate books and records and maintain a system of accounting controls to make sure that was done.

C. Continuing Scandals, Bubbles, and Sarbanes-Oxley

Deregulation of the financial industry begun early in the Reagan years quickly led to the thrift scandals. The foremost of those involved the notorious Lincoln Savings and Loan implicating even a future Republican presidential nominee, Senator John McCain. 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, the


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. 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. Dirks v. SEC, 464 U.S. 646 (1983).


Boesky’s remarks served as the template for Gordon Geicko’s famous “Greed is Good” address to a shareholders meeting in Oliver Stone’s 1987 movie Wall Street. See supra note *.
junk bond king Michael Milken who financed many of those maneuvers, also went to prison for
securities law violations.\(^{28}\)

In the next decade “irrational exuberance”\(^{29}\) led to a run-up of technology stocks in the
late 1990s. When that dot.com bubble burst it revealed numerous frauds. Most notorious were
Enron and other high-flying energy and telecom companies.\(^ {30}\) Over two dozen of those large
public companies admitted to inflating their revenue through improper accounting practices,\(^ {31}\)
with those falsified financial reports making possible a wanton system of executive greed.\(^ {32}\)
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.\(^ {33}\)

\(^{28}\) Dillon, supra note *, at 109.

\(^{29}\) The famous phrase, of course, comes from a speech by Federal Reserve Chairman Alan
Greenspan in December, 1996. Among other things, it provided the title of a fine book about those boom

\(^{30}\) Two good books about the Enron scandal are Bethany McLean & Peter Elkind, The Smartest
Guys in the Room: The Amazing Rise and Scandalous Fall of Enron (2003) and Rebecca Smith & John
R. Emshwiller, 24 Days: How Two Wall Street Journal Reporters Uncovered the Lies that Destroyed
Faith in Corporate America (2003).

\(^{31}\) For a good summary of the most notorious of those scandals, see Robert W. Hamilton, Jonathan
R. Macy & Douglas K. Moll., Corporations including Partnerships and Limited Liability Companies, 540-47
(11th ed. 2010).

\(^{32}\) In 1965, a CEO made twenty-four times as much as the average worker, but by 2007 that had
increased by more than 10 fold to a multiple of 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).

\(^{33}\) See Statement of Attorney General Eliot Spitzer Regarding the “Global Resolution” of Wall Street
Investigations (April 28, 2003); Affidavit in Support of Application for an Order Pursuant to General
Once again Congress responded with tough legislation, this time the Sarbanes-Oxley Act. 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. The Act also contained provisions designed to check executive dishonesty, including rules requiring forfeiture of bonuses based on improper accounting statements and prohibiting loans to corporate officials. In addition it set up an oversight panel, the Public Corporation Accounting Oversight Board (PCAOB), to police the practices of public accountants.

D. 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. 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.

35 Id. at § 302
36 Id. at § 304
37 Id. at § 402
38 Id. at §§ 101-09; In Free Enterprise Fund v. Public Co. Accounting Oversight Board, 130 S. Ct. 3138 (2010) the Supreme Court upheld the constitutionality of Sarbanes-Oxley but ruled that the method by which members of the PCAOB are removed violates the separation of powers.
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 their potential for gain when they exercised them to buy the stock. One perceptive Court compared the 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 the dollar amounts involved jumped precipitously totaling $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 CEO and/or CFOs of those companies were involved in the frauds seeking by various means to present a false impression of success at their firms. That misleading information included untrue representations about meeting earnings expectations, concealment of deteriorating

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41 David Phelps, A Little Hollywood Logic Keeps UnitedHealth Lawsuit in Court, Minneapolis Star Tribune, June 5, 2007 at 2D.

42 COSO, supra note *. 

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conditions, and inflation of stock prices.\textsuperscript{43} During the two days after those frauds were announced, the companies suffered on average abnormal stock price declines of 16.7\%.\textsuperscript{44}

E. Disappointing Response from the SEC

The COSO report only detailed the financial frauds detected and prosecuted by the SEC. The Commission, throughout its history, has generally enjoyed a fine reputation for aggressively pursuing corporate wrongdoing.\textsuperscript{45} 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 Commission lawyer that it had the resources to prosecute no more than 2\% of the securities law violations that were occurring.\textsuperscript{46} Recent events have presented an even more dismal assessment of the Commission’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”\textsuperscript{47} and was “drained and demoralized by

\begin{flushright}
\textsuperscript{43} \textit{Id.} at 3.
\textsuperscript{44} \textit{Id.} at 6.
\textsuperscript{45} See e.g., David Ratner, \textit{The SEC at Sixty: A Reply to Professor Macey}, 16 Cardozo L. Rev. 1765, 1779 (2005), where a former chairman of the Commission made these remarks, among others, lauding the SEC’s generally high standard of performance during its first 60 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.”
\textsuperscript{46} More recently, in December, 2007, a well-respected commentator wrote, [i]t’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, \textit{Quick, Call Tech Support for the S.E.C.}, N.Y. Times, BU1, (Dec. 16, 2007).
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the Bush administration.\textsuperscript{48} Inadequate resource compounded that problem. As the SEC’s current chair, Mary Shapiro, 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.”\textsuperscript{49} The piece de resistance of the Commission’s incompetence was the 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.\textsuperscript{50}

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.\textsuperscript{51} Only twelve executives were ultimately criminally convicted of this illegal activity, with just five of those receiving prison sentences.\textsuperscript{52} As one expert on corporate wrong-doing put it succinctly, “Only a fraction of corporate executives who manipulate or misrepresent their companies’ performances get exposed by regulators for such misdeeds.”\textsuperscript{53}

\textsuperscript{48} Paul M. Barret, \emph{While Regulators Slept}, N.Y. Times Book Review, 10, (Aug. 9, 2009).
\textsuperscript{50} Peter Burrows, \emph{The SEC’s Madoff Misery}, Bus. Wk. 24-25 (Jan. 12, 2009).
\textsuperscript{51} Mark Maremont, \emph{Backdating Likely More Widespread}, Wall St. J., C1, (Aug. 18, 2009) citing a study by Rick Edelson & Scott Whisenant of the University of Houston.
\textsuperscript{52} Peter Lattman, \emph{Former KB Home Official Given Probation in Backdating}, N.Y. Times, Nov. 12, 2010, at B5.
\textsuperscript{53} James A. Kaplan, \emph{Why Corporate Fraud is on the Rise}, Forbes, (June 10, 2010).
F. The Meltdown

During the last decade, in what has been called “an era of rapacious capitalists and heedless self-indulgence”\(^54\) the entire financial system became dependent on a credit bubble based on shaky home loans.\(^55\) 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 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.\(^56\)

Regulatory safeguards that might have prevented such improvidence had been swept away during the previous decades on the theory that they inhibited growth.\(^57\) That made private


\(^{56}\) The debacle reached its climax in mid-September, 2008. A report stated the situation bluntly. “Global finance suffered a near-fatal heart attack. In the space of two days Merrill Lynch fell into the arms of Bank of America. Lehman went bust and American International Group (AIG), a mighty insurer, buckled under suicidal derivative bets and had to be bailed out. Lehman’s demise marked the onset of the worst financial crisis and global recession since the 1930s.” *Rearranging the Towers of Gold*, Economist 75 (Sept. 12, 2009).

\(^{57}\) For instance, the Commodities Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763A added Sections 2A(a)-(b) and 3A(a)-(b) 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. 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. See James B. Stewart, *Eight Days: The Battle to Save the American Financial System*, New Yorker (Sept. 21, 2009).
rating agencies which were suppose to certify the creditworthiness of those mortgage-backed securities the only guarantors of their value. Many of them gave high grades to those financial instruments even though they were of doubtful value.\textsuperscript{58} In doing so they ignored conclusive evidence that the collateral supporting those loans was as insubstantial as a house of cards.\textsuperscript{59}

After the ensuing collapse, the credit markets froze up and the whole economy was thrown into a tail-spin causing wide-spread unemployment. In response the government undertook hugely expensive bail-out and stimulus measures that included 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 since World War II.\textsuperscript{60}

As of fall, 2010 no senior financial or investment bank executive has been successfully prosecuted for any of these events.\textsuperscript{61} Knowledgeable observers are alarmed that the federal government has not brought resources to bear in that effort in the same fashion it does when

\textsuperscript{58} Gretchen Morgenson, \textit{Raters Ignored Proof of Unsafe Loans, Panel is Told}, N.Y. Times, B1, (Sept. 26, 2010).

\textsuperscript{59} As one credit rating analyst wrote in an email about securities back 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 Rating Firms}. N.Y. Times, C1, (July 9, 2008).

\textsuperscript{60} Floyd Norris, \textit{A Rich Uncle is Picking up the Borrowing Slack}, N.Y. Times, B3, (Sept. 26, 2009).

\textsuperscript{61} As one commentator put it, “...so many know that the loftiest perpetrators of this national devastation got get-out-of-jail-free cards...” Frank Rich, \textit{What Happened to Change We Can Believe in?}, N.Y. Times, Wk at 10, (Oct. 24, 2010).
pursuing organized crime figures. The lone criminal action so far involving allegations of fraud and insider trading in mortgaged-back securities resulted in an acquittal.

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” and the Attorney General of Massachusetts secured a $102 million fine from investment banker Morgan Stanley for knowingly placing dubious mortgages in securitized pools. These actions may not

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The Department of Justice has a task force called Operation Broken Trust which has brought a number of cases against various financial crimes that one commentator called “small-timers: penny-stock frauds, a husband-and-wife team charged in an insider trading scheme and mini-Ponzi schemes.” The commentator found that many top corporate officials were unaware of that stating, “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.” Andrew Ross Sorkin, *Pulling Back the Curtain on Inquiries*, N.Y. Times Dec. 7, 2010 at B1.

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

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 share were sold at their fair market value. For the author’s full perspective on that see Daniel J. Morrissey, *The Path of Corporate Law in the 21st Century*, 86 Or. L. Rev. 975 (2008).

In addition, companies that publish false financial statements typically misled investors into paying more for shares that their true value. See infra notes ** and accompanying text. Investors are defrauded by this dishonest conduct and it should be vigorously prosecuted.

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however have lasting impact. As one knowledgeable observer commented, “These 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.”66

G. Dodd-Frank

After a lengthy process that didn’t conclude until July, 2010, almost two years after the meltdown, Congress finally passed broad-reaching legislation to address the issues which caused the catastrophe.67 This Dodd-Frank Act contains a number of provisions designed to forestall profligate speculation and promote financial stability. Most importantly it establishes an oversight council of regulators charged with monitoring the soundness of the entire economy.68

The Act also creates a Bureau of Consumer Financial Protection 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.69 Securities like CDOs, where speculative mortgages were packaged for sale to investors and CDSs, the contracts that were supposed to insure them, will now have to 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

66 Powell, supra note *, at B4
67 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 H.R. 4173 § 933
68 For a good general discussion of this legislation see David Skeel, The New Financial Deal, (2011)
69 Dodd-Frank H.R. 4173 § 111 et seq.

Dodd-Frank H.R. 4173 § 721 et seq.
collapse of those banks, the SEC had lessened the amount they were required to hold in reserve against such speculation.\textsuperscript{70} Dodd-Frank now restores limits on that leveraging so that government guaranteed funds will not be put at risk for those losses.\textsuperscript{71} The Act also gives the SEC new regulatory power over hedge funds\textsuperscript{72} and protects investors by tightening up the Reg. D exemption to the requirement that securities first be registered before they can be sold to the public.\textsuperscript{73}

Yet 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.\textsuperscript{74} As one noted political commentator therefore put it, [it is] “a financial regulation bill that needs to be interpreted by regulators because no one could agree on crucial provisions.”\textsuperscript{75} In addition, powerful interests are set to oppose much of the law’s mandates. The


\textsuperscript{71} This is the so-called Volker rule. It allows banks to invest up to 3% of their tier 1 capital in private equity and hedge funds, but they cannot own more than 3% of any of those entities. Dodd-Frank Title VI § 614

\textsuperscript{72} Dodd-Frank Title IV

\textsuperscript{73} Dodd-Frank Title IV §413

\textsuperscript{74} See generally, Donna M. Nagy, C. Ben Button, Richard W. Painter, S. Walter Richey, Margaret V. Sachs, Securities Litigation and Enforcement: Cases and Materials (2nd ed.). (Summer 2010 Cumulative Update) 1-6.

\textsuperscript{75} See e.g., Deborah Solomon, Volker on His ‘Rule’ – Keep It Broad, Wall St. J., C1, Oct. 29, 2010 that describes how former Federal Reserve Chairman Paul Volker is seeking to influence the provision of Dodd-Frank that bears his name which restricts investment by banks, supra note *, and accompanying text.

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.”

G. **A Rejuvenated SEC?**

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. Using that funding increase, SEC chair Mary Shapiro has announced that the SEC will hire 800 new lawyers. The Act also charges the Commission to undertake a host of initiatives that include studies and extensive rule-making in various areas of financial regulations.

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. 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.

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76 Mark Schoeff, Jr., Chamber President Seeks to Slow Dodd-Frank, Decries “Regulatory Tsunami,” http://www.investmentnews.com/article/20110111/FREE/10119983

77 *Dodd Frank § 922 et seq.*

78 *See supra* note * and accompanying text at 6.

79 *Dodd Frank § 911 et seq.*

80 Riley, supra note *.
In addition, the Commission has to recover from some very unfortunate recent history.\textsuperscript{82} To its credit the SEC produced a 477 report detailing its failings in the Madoff matter\textsuperscript{83} 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.\textsuperscript{84} A high-profile action that it initiated against Goldman-Sachs in April, 2010 for double-dealing in the derivative market resulted in the payment of a significant fine by that prominent investment bank and an admission that its marketing materials contained “incomplete information” about its conflict of interest in those transactions.\textsuperscript{85}

Yet some of the telling criticism 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 that their counterparts in private law firms do. One of the Commission’s chief detractors during its examinations by Congress was Harry Markopolis, a securities analyst who

\textsuperscript{81} \textit{Id.}

SEC chair Mary L. Schapiro made this statement on February 4, 2011 about the Commission’s financial woes: “It is a strain that is already having an impact on our core mission – separate and apart from the new responsibilities that Congress gave us to regulate derivatives, hedge fund advisers and credit rating agencies.” Andrew Ross Sorkin, \textit{Wall St. Aids S.E.C. Case for Budget}, N.Y. Times, Feb. 8, 2011 at B1.

\textsuperscript{82} \textit{See supra} note * and accompanying text.


\textsuperscript{84} Jenny Anderson and Zachery Kouwe, \textit{S.E.C.’s Cops on the Beat}, N.Y. Times, B1, (Feb. 9, 2010)

\textit{See also} Suzanne Barlyn, \textit{SEC Streamlines Its Tips Process}, Wall St. J., at C4, Oct. 25, 2010 reporting new technological procedures at the Commission to process complaints about securities fraud. According to Robert Khuzami, Director of the Division of Enforcement, “It’s to allow us to better analyze and prioritize our resources in a context of risk, so that we can better figure out where to put our efforts.”

furnished credible information to the SEC for years about Madoff’s wrong-doing yet was unable to get it to take action. In testimony he expressed these continuing misgivings about the Commission, “Right now there is no accountability in government” and “the problem is that the SEC pays peanuts and then wonders how it ends 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 promised to freeze the pay of federal employees and 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.

And future activity by the judicial branch may diminish the power of regulatory agencies like the SEC even more. In Free Enterprise Fund v. Public Accounting Oversight Board (PCAOB) decided in June, 2010 the Supreme Court invalidated the provision of Sarbanes-Oxley establishing a federal panel to oversee the accounting profession because 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.

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87 http://pledge.gop.gov/
88 Peter Baker, Obama to Freeze Pay for Most Federal Workers for 2 Years, N.Y. Times, Nov. 29, 2010.
89 See supra note * and accompanying text.
90 See supra note * and accompanying text.
91 Free Enterprise Fund, 130 S. Ct. at 3165 (2010).
III. The Importance of Shareholder Remedies

A. The Need for Effective Investor Actions

It is hoped that the array of reforms enacted in Dodd-Frank\textsuperscript{92} will prevent some of the corrupt and speculative practices that brought about the disastrous collapse of our economy.\textsuperscript{93} Yet 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 wrong-doing have existed since the securities reforms of the 1930s and new ones were passed to re-enforced 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.\textsuperscript{94}

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\textit{See also} Jeffery Toobin, \textit{Without a Paddle}, New Yorker, Sept. 27, 2010, at 34, 40-41.

The current Supreme Court is also seen as the most pro-business in recent memory, Roger Parloff, \textit{On History’s Stage: Chief Justice John Roberts, Jr.}, Fortune, Jan. 17, 2011, 63.
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\textsuperscript{92} See supra notes ** and accompanying text.

\textsuperscript{93} See supra notes ** and accompanying text.

\textsuperscript{94} The classic work there, now almost 100 years old, is Louis Brandeis, \textit{Other People’s Money} (1914).

Supporting that insight is more recent Congressional testimony by William R. McLucas, the former Director of the SEC’s Division of Enforcement on “…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 Securities of the Senate Comm. on Banking, Housing & Urban Affairs, 103d Cong., 1\textsuperscript{st} Sess. 280 (1993).

The evidence indicates that investment fraud is particularly wide-spread among the elderly. See SEC Investor Information, \texttt{www.sec.gov/investor.shtml} (providing special information for seniors). In a 2006 study, the SEC reported the astounding finding that approximately 5 million senior citizens are victims of financial abuse and fraud each year. \texttt{http://www.sec.gov/spotlight/seniors/elderfraud/pdf}

However needed they may be, the Dodd-Frank 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 our entire economy.\(^\text{95}\) Adequate sanctions must thus be available to make sure that they 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.”\(^\text{96}\) And those who publish them must “be meted out unpleasant consequences”\(^\text{97}\) 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 its parts, an integrity that must be underwritten by rules enforceable in fair, independent, accessible courts.”\(^\text{98}\)

Just a year earlier the Supreme Court had 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 by the Justice Department and the Securities and Exchange Commission.”\(^\text{99}\) Noted commentators have also pointed to the important role that such suits serve in deterring corporate fraud.\(^\text{100}\)


\(^{97}\) *Id.* at 404


Even when it had a sterling reputation as the “Cops of Wall St.,” the SEC itself readily admitted that it could prosecute only a small percentage of securities frauds.\textsuperscript{101} Citing “the continued growth in the size and complexity of our securities markets,”\textsuperscript{102} 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{103}

The need for such actions is even more pronounced now in light of the SEC’s recent, unfortunate history.\textsuperscript{104} Even though the Commission has owned up to its embarrassing shortcomings and is attempting to rectify them,\textsuperscript{105} public investors can hardly be re-assured that it will be adequately protecting their interests. Consequently the two major mechanisms that give

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\textsuperscript{101} See supra note * and accompanying text.

\textsuperscript{102} McLucas, supra note * at 113.

\textsuperscript{103} Id.

\textsuperscript{104} See supra note * and accompanying text.

\textsuperscript{105} See supra note * and accompanying text.
shareholders viable remedies for fraud, class action suits and derivative actions, are needed now more than ever.

This Article 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 those actions provide for society. The Article will close by proposing legislative reforms to counter several Supreme Court decisions that inhibit the ability of investors to maintain those suits.

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.\(^{106}\) 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 potential recovery, 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 gives 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.\(^ {107}\)

\(^{106}\) Fed. R. Civ. Pro. 23(b)(3).


Another leading authority made much the same point. “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.” Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 Vand. L. Rev. 1465, 1522 (2004).
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 a 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. 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 officers and directors of those companies and investment banking firms that underwrote their

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109 Donald C. Langevoort, Basic at Twenty: Rethinking Fraud on the Market, 2009 Wis. L. Rev. 151.
110 Nagy, supra note * at 396.
111 Dillon, supra note *, at 2.
public offerings. In WorldCom, for instance, former directors contributed $55 million to the settlement.\textsuperscript{112}

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,” i.e. cases with flimsy evidence brought only to extract a quick settlement from harassed corporate defendants.\textsuperscript{113} Lawmakers responded to those concerns, but not as some had urged by eliminating the federal causes of action for securities fraud\textsuperscript{114} or over-ruling the “fraud on the market” theory that made them economically viable.\textsuperscript{115}

Instead Congress took a more measured approach by enacting amendments to the securities laws in 1995, the Public Securities Litigation Reform Act (PSLRA),\textsuperscript{116} that merely required a higher initial showing that such actions were meritorious. In suits under the implied cause of action of Rule 10b-5,\textsuperscript{117} Congress, among other things, required that fraud be pled with particularity,\textsuperscript{118} prohibiting discovery\textsuperscript{119} until plaintiffs could demonstrate by a “strong inference,”\textsuperscript{120} that the defendants acted with the requisite state of mind.\textsuperscript{121}

\begin{footnotesize}
\begin{itemize}
  \item \textsuperscript{112} Nagy, \textit{supra note *}, 396-97.
  \item \textsuperscript{113} 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. \textit{See} Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739 (1975). \textit{See also infra note *} and accompanying text.
  \item \textsuperscript{115} Nagy, \textit{supra note *}, at 397.
  \item \textsuperscript{117} Exchange Act Rule 10b-5; 17 C.F.R. § 240.10b-5. \textit{See infra notes **} and accompanying text.
  \item \textsuperscript{118} Fed. R. Civ. Pro. 9(b). This is provided in Section 21D(b)(2) of the Exchange Act.
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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.

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.

The U.S. Court of Appeals has 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. The U.S. Supreme Court has granted cert. to hear the matter on appeal. Siracusano v. Matrixx Initiatives, 585 F. 3d 1167 (9th Cir. 2009), cert granted 130 S. Ct. 3411 (2010).

The Act added Sections 27(b) and 21D(b)(3) to the Securities Act and Exchange Act respectively to provide for that.

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

In an implied cause of action under Rule 10b-5 that requires a showing of scienter, see infra notes ** and accompanying text.

The Act added Sections 27(a)(3) and 21D(a)(3) to the Securities Act and Exchange Act respectively to provide for that.


Section 21D(b)(4) of the Exchange Act.

In Erica P. John Fund, Inc. v. Halliburton Co, 597 F.3d 330 (5th Cir., 2010), a case that alleged manipulation of a company’s stock price, the U.S. Court of Appeals affirmed a lower court ruling denying class certification because shareholders had not established that they lost money because of the alleged fraud. The Supreme Court has granted cert. to hear the matter on appeal. 131 S. Ct. 856 (2011).

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. 125

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. 126 Before initiating the suit, the shareholders first had either to make demand on the directors themselves to bring it or 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, 127 many like the leading jurisdiction of Delaware 128 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.” 129 As one commentator put it succinctly, it was a “needed policeman” 130 to hold officers and directors accountable for breaches of their fiduciary duties. Another leading jurist praised the action’s virtues saying “[I]t is recognized that while

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126 Hawes v. City of Oakland, 104 U.S. 450 (1881)

127 This position is taken by the American Law Institute and the Model Business Corporation Act, 2 Principles of Corporate Governance §7.03 (1994) and Model Bus. Corp. Act. §7.42 (1994).


minority corporate members are often activated 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 that 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 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 of real substance for shareholders.

Originally derivative suits produced a monetary recover for the corporation but Courts gradually accepted that substantial non-financial benefits such as therapeutic changes in a

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133 See e.g The Continuing Evolution of Securities Class Actions Symposium, 2009 Wis. L. Rev. 151 et. seq.
134 Joy v. North, 692 F. 2d. 880, 887 (1982). The case, however, approved of the derivative suit saying “The derivative action is the common law's inventive solution to the problem of actions to protect shareholder interests” and “The derivative suit constitutes a major bulwark against managerial self-dealing.” Citing Cary and Eisenberg, Corporations 938 (5th ed.). Id.
136 See e.g. Giesecke v. Pittsburgh Hotels, Inc., 180 F.2d 65 (3d Cir. 1950).
corporation’s governance structure would also justify the payment of attorneys’ fees.\textsuperscript{137} That brought charges that such reforms produced little real benefit for shareholders.\textsuperscript{138}

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.”\textsuperscript{139} Despite some misgiving, the author there also lauds all the good derivative suits have done in making corporate managers attentive to their fiduciary duties.\textsuperscript{140}

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 counsel 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.”\textsuperscript{141} Another commentator put it even more succinctly, “We cannot dispense with the derivative suit without doing absolutely irreparable damage to our corporate governance system.”\textsuperscript{142}

\textsuperscript{137} Franklin A. Gevurtz, \textit{Corporation Law}, 446 (2d ed. 2010)

\textsuperscript{138} Romano, \textit{supra note *}.  

\textsuperscript{139} Jessica Erickson, \textit{Corporate Governance in the Courtroom: An Empirical Analysis}, 51 Wm. & Mary L. Rev. 1749, 1754 (2010).

\textsuperscript{140} \textit{Id.} at 1829.


III. The Alleged Shortcomings of Shareholder Class Actions and Derivative Suits

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 which occur when corporate defendants have not sold securities themselves but are liable because their officials have either concealed bad news or in other ways misrepresented the profitability of their companies. 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.

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. Since premiums on those come from the corporation, the shareholders’ own money is directly or indirectly paying

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145 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).

146 Booth, supra note *, at 136-38.

147 Coffee, supra note *, at 1549-51.
their claims—not funds from the corporate officials responsible for the wrongdoing. According to the opponent of these suits, the plaintiffs’ lawyers and the insurance companies are therefore the real players here. They profit by the fees they reap from these actions 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.

B. Response to Pocket-Shifting

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

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149 Legal fees on both sides in these matters have averaged about $2.5 billion per year in recent years. Fox, *supra* note *, at 306.

150 Coffee, *supra* note *, at 1550.


Langervoort himself believes that enterprise liability does have a positive effect deterring corporate fraud, but expresses skepticism there because its efficacy is tempered by the historical reluctance of outside directors to monitor wrongful activity by corporate officers. Langervoort, *supra* note *, at 636.

152 Cox, *supra* note *, at 511.


As the Supreme Court has also recently re-emphasized, corporations are legal entities with much the same the 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.

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. A recent commentator has argued that private actions might even be seen as the principal mechanism 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.

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.

156 Langervoot, supra note *, at 648.
157 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 (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, Mills v. Electric Auto Lite Co., 396 U.S. 375, 394 (1970).
158 Fox, supra note *, at 329-31.
159 Cox, supra note *, at 511-12.
Others like Professor Langervoort 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.\footnote{Langervoort, \textit{supra} note *, at 36.}

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.\footnote{Lawrence E. Mitchell, \textit{The “Innocent Shareholder”: An Essay on Compensation and Deterrence in Securities Class-Action Lawsuits}, 2009 Wis. L. Rev. 243.} 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.\footnote{Securities and Exchange Commission, \textit{SEC Adopts New Measure to Facilitate Director Nomination by Shareholders}, Release 2010-155, Aug. 25, 2010}

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.\footnote{See \textit{supra} notes ** and accompanying text.} Even Professor Booth, who is generally quite negative on shareholder class actions, 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{164}

The potential for attorneys’ fees that such suits hold would therefore encourage shareholder lawyers to follow up and make sure the real wrong-doers 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{165}

In addition insurance companies, who are facing a crisis because of claims for such fraud,\textsuperscript{166} should have every incentive to be stern with their corporate policyholders—threatening 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{167} Insurance companies are profitable of course if they successfully manage risk.\textsuperscript{168} That gives them the incentive to make sure their corporate policy holders do not incur liability. Such self-

\textsuperscript{164} Booth, \textit{supra} note *, at 144-46.
\textsuperscript{165} Coffee, \textit{supra} note *, at 1581.
\textsuperscript{166} \textit{id.} at 1580.
\textsuperscript{167} 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. Fishman, \textit{Inherent Agency Power—Should Enterprise Liability Apply to Agents’ Unauthorized Contracts?}, 19 Rutgers L. J. 1, 48-49 (1987).
\textsuperscript{168} See also \textit{supra} note * and accompanying text.
\textsuperscript{168} Professor Cox notes this truism in discussing the role that insurance plays justifying enterprise liability. Cox, \textit{supra} note *, at 513.
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{169}

C. 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 mutual funds.\textsuperscript{170} Consequently investors will “win some and lose some” in these fraud situations, with their gains and losses “washing out” over time.\textsuperscript{171} 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.\textsuperscript{172}

\textsuperscript{169} Coffee, \textit{supra} note *, at 1580.
\textsuperscript{170} \textit{Id.} at 1559.
\textsuperscript{171} Booth, \textit{supra} note *, at 139.
\textsuperscript{172} Professor Booth strongly asserts this citing the Interim Report of the Committee on Capital Market Regulation published by the Treasury Department under the leadership of Secretary Henry Paulson. \textit{Id.} at 143.
D. Response to Circularity Criticism

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.\(^\text{173}\) She is injured by such wrongdoing and deserves recompense.\(^\text{174}\) 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.\(^\text{175}\)

It 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.”\(^\text{176}\) Such civil suits are the only real sanctions that most of these corporate wrong-doers fear.\(^\text{177}\) 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.

\(^\text{173}\) As Professor Langervoort 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….not 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.” Langervoot, supra note * at 632-33.

\(^\text{174}\) 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 *, at 1560.

\(^\text{175}\) See supra note * and accompanying text.

\(^\text{176}\) Oliver Wendell Holmes, Jr., The Path of the Law, in Collected Legal Papers (1920).

\(^\text{177}\) See supra notes ** and accompanying text.
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

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178 “…securities class actions do hold promise in harnessing private incentives to police for fraud.” Choi, supra note *, at 1524.
181 Id. at 335.
182 Coffee, supra note * at 1563-64.
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.

E. 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. 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. 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.

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*See supra* notes ** and accompanying text for statistics showing how much better private suits are at recovering losses for defrauded shareholders than SEC actions.

183 For additional support on that point from the law and economics school, see Bainbridge, *supra*; Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. Pol. Econ. 169 (1968).

*See also supra* note * and accompanying text.

184 *See supra* note * and accompanying text.

185 FRCP 23.1(b)(1)
F. The Role of Derivative Suit Plaintiffs

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 directly 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.\(^{187}\)

But such a mechanism is not needed in derivative suits because the stockholder plaintiffs there are not looking for a personal recovery. And 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 therefore just require that the plaintiff be able to “fairly and adequately represent the interests of the corporation in enforcing the rights of the corporation.”\(^{188}\) Two leading cases, one from the U.S. Supreme Court and the other written by a distinguished Delaware Chancellor,


\(^{187}\) 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 Col. L. Rev. 1587, 1590 (2006)

\(^{188}\) MBCA § 7.41(2)
cogently explain the wisdom of that jurisprudence and demonstrate the paramount role that competent and vigorous counsel play in these actions.

G. Surrowitz and Fuqua Industries

In the first case, Surrowitz v. Hilton Hotels Corp.,\textsuperscript{189} 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. Surrowitz agreed that a derivative suit be filed in her name.

Upon an oral examination, it became apparent that Mrs. Surrowitz 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. Surrowitz was not a proper party plaintiff. In a unanimous opinion, however, the Supreme Court allowed the suit to go forward stating, "...derivative suits have played a rather important role in protecting shareholders of corporations from the deigning 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. Surrowitz."\textsuperscript{190}

\textsuperscript{189} 383 U.S. 363 (1966)

\textsuperscript{190} \textit{Id.} at 371
The lower court had considered “a woman like Mrs. Surrowitz who is uneducated and generally 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 trails” 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.”

In re Fuqua Industries, Inc. Shareholder Litigation contained similar allegations that its plaintiff shareholders were unfamiliar with many of the facts alleged in that 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. The Court found that two year later “presumably upon concluding that the Fuqua directors…had engaged in self-dealing transaction…” 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.

191 Id. at 373
192 752 A.2d 126 (Del. Ch. 1999)
193 Id. at 129
As to Freberg, the Court found "his knowledge of the case is at best elliptical."\textsuperscript{194} 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."\textsuperscript{195} The Court then summed up defendants' arguments by commenting "the 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."\textsuperscript{196}

Citing previous Delaware decisions however, Chancellor Chandler responded "...the 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{197} 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.

...the 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{198}

\textsuperscript{194} \textit{Id.}
\textsuperscript{195} \textit{Id.}
\textsuperscript{196} \textit{Id.}
\textsuperscript{197} \textit{Id. at 131}
\textsuperscript{198} \textit{Id. at 133}
The Chancellor then ruled that the suit should go forward since Freberg understood the basic nature of the derivative claims brought in his name. As to his involvement with other litigation, the Chancellor said, “For better or worse no limit exists on the number of lawsuits one individual can bring in a lifetime.” The Court likewise found Mrs. Abrams to be a suitable plaintiff saying, “like Mrs. Surrowitz with the aid of her son-in-law, Mrs. Abrams discovered her injury and filed this lawsuit with the aid of her husband.”

H. 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 therefore noted in a post-Fuqua decision, “It is important for shareholders to bring derivative suits because these suits, filed after the alleged wrongdoing, operate as an ex post check on corporate behavior.” That important observation, read together with Chancellor Chandler’s earlier comments in Fuqua, make a compelling case for the key role of counsel in derivative suits.

Since any recovery in a derivative action goes to the corporation, plaintiffs there gain only a small, indirect reward for their efforts. As one commentator therefore 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.”

199 Id.
200 Id.
202 Gevertz, supra note *, at 421.
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.\(^\text{203}\) Similar apprehension may exist in shareholder class actions where one judge feared that plaintiffs might be “nominees, indeed pawns, of the lawyer.”\(^\text{204}\)

Yet involved, active shareholders like Mrs. Surrowitz 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

\[\text{Safeguards exist to make sure that those suits are only brought when there is a good chance that such a valuable result will occur. First a shareholder may not initiate a derivative suit unless a reasonable doubt exists about the ability of the directors to independently exercise their managerial prerogatives to decide whether the matter should be pursued. Aronson v. Lewis, 473 A.2d at 814. See also supra notes ** and accompanying text.}\]

Then if the case does go forward, the Court must approve any settlement to make sure that it produces appropriate benefits for the corporation. FRCP 23.1(c); One commentator has recently questioned whether Courts adequately review these settlements allowing some which do not benefit shareholders. Erickson, supra note *, 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.” F.R.C.P. 23, Advisory Committee 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 representative.” Hon. David C. Valasquez, Karen Bravata and Dan Welch, *The Watchdog Role: Determination of Fairness of Proposed Class Action Settlements*, Orange County Lawyer, September, 2007, 33, 37.


\(^{204}\) Mars Steel Corp. v. Continental Illinois National Bank, 834 F. 2d 877, 881 (7th Cir. 1987), opinion by Posner J.
And 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."206

V. The Federal Causes of Action for Securities Fraud

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 claim 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.

2008, the year of the meltdown, was also the seventy-fifth anniversary of the Securities Act of 1933,207 the key piece of legislation enacted to reform our capital markets after the disastrous Crash of 1929 that precipitated the Great Depression. It mandates that before

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205 Seinfeld v. Coker, 847 A.2d at 333.

206 Id. at 135

207 See supra note * and accompanying text.
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.

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

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208 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. U.S. Securities and Exchange Commission, Registration under the Securities Act of 1933, http://www.sec.gov/answers/regis33.htm.

209 Section 5 of the Securities Act; 77 U.S.C. §77e.


For a summary of the process and requirements of securities registration see id at 759-62.

A number of foreign companies, many from China, may now be evading this registration requirement by going public “through the back door.” They accomplish this by purchasing an American shell company which has a stock exchange listing but few assets. They then execute a reverse merger of their firm into that company. “A quick name change and presto, the Chinese company is traded on Nasdaq or the Amex.” James Surowiecki, The Financial Page, Don’t Enter the Dragon, New Yorker, Jan. 31, 2011, at 25.

210 Section 11(a) of the Securities Act, 15 U.S.C. §77k(a). These include not only the issuer, but everyone who signs the registration statement, all the company’s directors, its auditors and underwriters.

211 Section 11(b) of the Securities Act, 15 U.S.C. §77k(b). The classic case interpreting that provision is Escott v. Barchris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968) which allows defendants to avoid liability if they can show they met a specific standard of knowledge or conduct with respect to the material misstatements or omissions.
defendants can show that the investors’ losses were caused by something other than the false statements in the registration statement. 212

Many parallels have been drawn between the Depression era and our current economic difficulties that were brought about by the financial meltdown. 213 Unfortunately the stringent registration requirements and the accompanying 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, 214 credit default swaps were effectively exempted from regulation when that Act provided they were not securities. 215


213 The credit crisis of fall, 2008 sounds like the same situation that was described in a Congressional report supporting the enactment of the Securities Act.

[The Act is]…to protect honest enterprise seeking capital by honest presentation against the competition afforded by dishonest securities offered to the public by crooked promotion; to restore the confidence of a prospective investor in his ability to select 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 restoring buying and consuming power. S. Rep. No. 47, 73d Cong. 1st Sess. 1 (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. Felix Frankfurter, The Federal Securities Act: II, Fortune, Aug. 1933, at 53.

addition credit derivatives and other securitized asset 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.

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Dodd-Frank attempted to address some of those glaring regulatory deficiencies. *See supra* notes ** and accompanying text.

217 Originally this was Section 12(2) but it was amended to 12(a)(2). Marc. I. Steinberg, *Understanding Securities Regulation*, 227 (5th ed. 2007). The earlier cases thus refer to it as 12(2) but this article will uniformly call it 12(a)(2).

The elements of a Section 12(a)(2) action roughly parallel those of Section 11.\(^{219}\)

Causation is satisfied if the offering, including the securities purchased by the plaintiff, is sold by means of a misleading prospectus. Plaintiff need not prove that she relied on the misstatement\(^{220}\) or even received the misleading prospectus.\(^{221}\) And like Section 11, a defendant in a 12(a)(2) action will be liable unless he can establish a “quasi-due diligence”\(^{222}\) defense that “he did not know and in the exercise of reasonable care could not have known, of such untruth or omission.”\(^{223}\)

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”\(^{224}\) until 1995 that Section 12(a)(2) applied to every sale of securities. That was the “overwhelming, if not unanimous” opinion of the lower courts\(^{225}\) and consequently unregistered.

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\(^{219}\) 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 causation of action against a number of individuals connected to a registered offering. See supra note * and accompanying text.


\(^{221}\) Id. at 1226.

\(^{222}\) The apt description is from Steinberg, supra note *, at 228.

\(^{223}\) Id.


\(^{225}\) Steinberg, supra note *, at 374.

While all lower courts had held that Section 12(a)(2) applied to every initial sale of securities, private as well as public, several refused to extend it to cover aftermarket transactions, Bally v. Legg...
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. Alloyed Co.* and interpreted Section 12(a)(2) narrowly, restricting its applicability to securities sold in public offerings. That case 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 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 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

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228 *Id.* at 565-66.

Act which described the document employed in a public stock offering rather than its broader meaning in the definitional section. 230

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 Act’s definitional section the document in question fitted squarely within the meaning of prospectus because it was “a communication…which…confirms the sale of any security.” 231 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.” 232 Another noted authority said, “the reasoning used by the (Gustafson) majority…is so flawed that its full implications will not be known for some time.” 233 And a well-respected former SEC commissioner assailed the decision as “motivated more by politics than any serious examination of the statute.” 234

The Court’s restrictive interpretation of 12(a)(2) all but rendered that cause of action superfluous because it then became almost co-extensive with Section 11. 235 Like Section 11,

230  Id. at 568-70
231  Id. at 585-86
Section 12(a)(2) was 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.\textsuperscript{236}

C. The Shrinking 10b-5 Remedy

With the widening of exemptions to registration that have occurred over the last several decades,\textsuperscript{237} 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\textsuperscript{238} remedy for fraud. The SEC promulgated that rule in 1942 under authority granted it in Section 10(b) of the Exchange Act.\textsuperscript{239} Among other things it prohibits the making of “any untrue statement of material fact or the omission of any material fact necessary in order to make the statement made… not misleading…in connection with the purchase or sale of a security.”\textsuperscript{240}


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, \textit{supra} note *, at 152.

\textsuperscript{236} Legislative history seems to point that way as well. Justice Ginsburg’s dissent, which Justice Breyer joined, contains an extensive discussion of that. Gustafson v. Alloyd Co., 513 U.S. at 599-600. It also notes that Felix Frankfurter, the principle 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. \textit{Id.}, at 601.

\textsuperscript{237} For the author’s discussion of how those exemptions have been improvidently broadened in recent years see Daniel J. Morrissey, \textit{supra} note *, 771-80.

\textsuperscript{238} 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…” Unif. Securities Act, 7B U.L.A. 509 (1956). The impact of that provision is limited however because federal law pre-empts state class actions suits for fraud involving publicly-traded securities. \textit{See supra} note * and accompanying text.

\textsuperscript{239} 15 U.S.C. §78 j(b).
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 shareholders victimized there 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. 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 that 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 meant that a claim for negligent misrepresentation was no longer available under that provision and Congress, in 1995, made

240 17 C.F.R. § 240.10b-5(b).
242 Blue Chip Stamps v. Manor Drug Stores, 421 U. S. 723 (1975), See also supra note *.
245 Blue Chip Stamps, 421 U.S. at 755.
246 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 194 n.11.
the obligatory showing of scienter even more difficult by requiring such state of mind to be plead 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 10-5 with Section 11

Rule 10b-5 actions for fraud in non-registered stock sales are thus unjustifiably more difficult to prosecute than Section 11 claims in at least three key ways. The scienter requirement in 10b-5 now demands that plaintiff 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 there they must show they acted with due diligence to make sure such false statements were not made.

Second 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.

247 See supra note * and accompanying text.
248 Santa Fe Indus., 430 U.S. at 475-76.
249 See supra note * and accompanying text.
250 See supra note * and accompanying text.
251 See supra note * and accompanying text.
In the 2005 case of *Dura Pharmaceuticals 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 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.

Third, 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 High 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

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253 See supra note * and accompanying text.

254 As the Court put it, “Given the tangle of factors affecting price...logic alone permits us to say that the higher purchase price will *sometimes* play a role in bringing about a future loss...[I]n that sense, one might say that the inflated purchase price suggests that the misrepresentation...‘touched up’ 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 (emphasis in the original).


256 511 U.S. 164 (1994)


But see *In re Mutual Funds Investment Litigation* where the Court of Appeals held that an investment advisor to a mutual fund could be held liable for false statements made in the fund’s
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 10-b-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.\textsuperscript{258} 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 \textit{Gustafson} and make it clear that the 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 involving state of mind, participant liability, and causation consistent with the parallel, forceful 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.

\textsuperscript{258} Dodd-Frank H.R. 4173, §929Z(a)

\textsuperscript{258} Dodd-Frank H.R. 4173, §929Z(a)

prospectus, 566 F. 3d 111 (4th Cir. 2009). The U.S. Supreme Court has granted cert. to hear the case on appeal, 130 S. Ct. 3499 (2010).
VI. Conclusion

The massive frauds that led to the meltdown not only cheated large numbers of investors but ultimately also 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]259 than they are about the Securities and Exchange Commission.”260 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

259 The work of Messrs. Lerach and Weiss is well described in a fine current study of shareholder litigation, Dillon, supra note *. Their firm returned more than $45 billion in fraud judgments or settlements to millions of shareholders. 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. As a resulted they served prison terms and forfeited their licenses to practice law.

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 Article 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.