



# Shareholder Rights and the Ever-Growing Need for Shareholder Activism



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# I. Shareholders as Owners of Corporations and Shareholder Rights

# Shareholders as Owners

- ▶ You own the corporation.

“The principle that shareholders own the companies in which they invest – and are the ultimate bosses of those running them – is central to modern capitalism.”

Arthur Levitt Jr. (former SEC Chairman), *How to Boost Shareholder Democracy*, Wall St. J., July 1, 2008, at A17.



# Rights as Owners

- ▶ As owners, shareholders have the right to:
  - Freely transfer their interest in the corporation;
  - Vote to elect directors to serve on the corporation's board;
  - Vote on shareholder proposals and other major organic events;
  - Bring derivative suits on the corporation's behalf;
  - Obtain information from the corporation;
  - Receive quarterly or yearly dividends; and



# Shareholders as Owners

- ▶ **Management works for you.**

“A corporate executive is an employee of the owners of the business,” with “direct responsibility to his employers” – notably, a “responsibility . . . to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society.”

Milton Friedman (Nobel Prize recipient in Economics), *A Friedman Doctrine - The Social Responsibility of Business is to Increase Profits*, N.Y. TIMES MAG., Sept. 13, 1970, at 33.



# Shareholders as Owners

- ▶ **You elect directors to promote shareholder interests.**
  - Board decisions should protect and further shareholder value.
- ▶ **Directors are accountable to you.**
  - The board owes fiduciary duties to the corporation and its shareholders.



# Fiduciary Duties Owed to Shareholders

- ▶ The **duty of care** requires decisions to be informed, well reasoned, and to serve a rational business purpose.

*Smith v. Van Gorkom*, 488 A.2d 858, 871 (Del. 1985).

- ▶ The **duty of loyalty** requires the “best interest[s]” of the corporation and its shareholders to be placed above management’s interests.

*Guth v. Loft, Inc.*, 5 A.s2d 503, 510 (Del. 1939).

- ▶ The **duty of good faith**, part of the duty of loyalty, disallows acts, which do harm or consciously disregard one’s duties.

*In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 63 (Del. 2006).





## II. The Challenges Faced by Shareholders

# The Battle of David Versus Goliath

- ▶ “You are not able to go out against this Philistine and fight him; you are only a young man, and he has been a warrior from his youth.”

*1 Samuel 17:33*

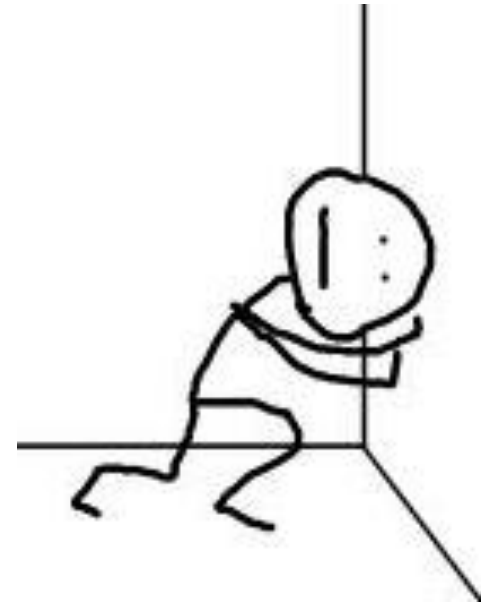


# Why David and Goliath?

- ▶ Shareholders face a challenging regulatory environment.
- ▶ Shareholders' ability to bring private securities litigation is under assault.
- ▶ The SEC and other government agencies are not adequately protecting shareholders.

# Challenges Faced by Shareholders

- ▶ Board decisions are protected by the business judgment rule.
- ▶ Proving loss causation in securities fraud cases is increasingly difficult.
- ▶ Third-party liability is extremely limited.
- ▶ The SEC and other government agencies are not protecting shareholder interests.
- ▶ Private securities litigation is under assault.
- ▶ Shareholders are “kept in the dark” by the board.
- ▶ Proposals for governance reforms are non-binding.



# Limiting Third-Party Liability: *Refco*

- ▶ **Facts:** Refco, with Mayer Brown, orchestrated sham transactions to “pay” down hundreds of millions of dollars in uncollectible receivables owed to Refco.
- ▶ **Holding:** “Although the Complaint alleges facts that, if true, would make the Mayer Brown defendants guilty of aiding and abetting the securities fraud ... the Supreme Court and Congress have declined to provide a private right of action for victims of securities fraud against those who merely - if otherwise substantially and culpably - aid a fraud that is executed by others.”

*Judge Gerard E. Lynch*



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# The Inequity of Refco



- ▶ “[I]n the criminal context when the Godfather orders a hit, he is only an accomplice to murder ... but he is nonetheless liable as a principal for the commission of the crime ... Likewise, some civil accomplices are deeply and indispensably implicated in wrongful conduct.”

*Judge Gerard E. Lynch*

- ▶ Mayer Brown partner Joseph Collins was criminally convicted for his role in the Refco fraud.



# The SEC Is Not Protecting Shareholders

- ▶ In *amicus* briefs, the SEC has argued against investors' rights:
  - ***Dura***: Argued for strict interpretation of loss causation.
  - ***Tellabs***: Argued that judges, before trial, should dismiss cases if negative inferences of scienter outweigh positive inferences.
  - ***Stoneridge***: Argued that secondary actors could not be primary violators unless plaintiffs relied on their statements.



# The SEC Is Not Protecting Shareholders



- ▶ Failed to uncover Madoff’s ponzi scheme despite “more than ample information ... over the years to warrant a thorough and comprehensive examination.” *SEC OIG Report*
- ▶ Inadequately settled claims against BoA for its purchase of Merrill, which Judge Rakoff described as “half-baked justice.”
- ▶ Turned a blind eye to questionable practices in the allocation of IPOs for nearly a decade until *The Wall Street Journal* uncovered 'spinning' disclosures in 2000.
- ▶ Enforcement director Khuzami is being investigated for going easy on Citigroup executives in connection with the bank’s non-disclosure of \$50 billion in subprime securities.



# The SEC Is Not Protecting Shareholders

- ▶ Failed to intervene in Lehman's collapse.
  - “I saw nothing in my investigation to suggest that the S.E.C. asked even the most fundamental questions that might have uncovered this practice [of hiding debt] early on, before Lehman escalated it to a \$50 billion issue.”

Anton R. Valukas, examiner for Lehman bankruptcy



LEHMAN BROTHERS

# The SEC Is Not Protecting Shareholders

- ▶ The SEC is cash-strapped, which has led to cut backs in enforcement and market oversight efforts, including:
  - Postponing depositions
  - Limiting travel for on-site investigations
  - Capping the number of expert witnesses used
  - Hindering the process of implementing financial reforms



# Other Government Agencies Are Not Protecting Shareholders

- ▶ The FDIC has limited resources to pursue claims against “bad” bank officials for wrongful conduct
  - About **325** banks have failed since January 1, 2008, but only **four** lawsuits have been filed by the FDIC against former bank officials
  - The FDIC has authorized claims against approximately 119 other former bank officials, with damages worth about \$2.5 billion



# Private Litigation Is Under Assault



- ▶ The Chamber of Commerce has stated that “[p]rivate securities class action lawsuits present a serious threat to the health of U.S. businesses, the prosperity of American families and the strength of our nation’s global competitiveness.”
- ▶ The Chamber of Commerce has for years sought to end private securities litigation by pressing Congress to implement stiff reforms.

# Private Litigation Is Under Assault

- ▶ The Supreme Court has recently issued a wave of bad decisions for shareholders:
  - **Central Bank:** Private lawsuits cannot be filed against “secondary actors.”
  - **Stoneridge:** A secondary actor that does not make a misstatement cannot be held liable.
  - **Tellabs:** A complaint must establish a strong inference of guilty intent.
  - **Dura:** An inflated purchase price does not by itself demonstrate loss causation.



# Private Litigation Is Under Assault

- ▶ **Morrison** : The court severely limited foreign investors' access to U.S. courts. The holding has been broadly interpreted as preventing fraud claims in U.S. courts by any investor – either from the U.S. (“F-squared”) or abroad (“F-cubed”) – who purchased shares on a foreign exchange.

- *\*BP Securities Litigation*
- *Toyota Securities Litigation*
- *Porsche Securities Litigation*
- *Vivendi Securities Litigation*
- *\*RBS Securities Litigation*



# Private Litigation Is Under Assault

- ▶ The Supreme Court is currently reviewing three securities cases with serious implications to investors:
  - **Janus:** Whether a legally distinct investment advisor to a group of mutual funds may be subject to primary liability for “participating” in preparing false or misleading prospectuses.
  - **Matrixx:** Whether a drug company can be liable for failure to disclose adverse-event reports if the undisclosed reports do not constitute statistically significant evidence of adverse events.
  - **Halliburton:** To what extent “loss causation” should be considered at the class certification stage.





**As a Result, there is...**

# Fraud: The BoA Securities Litigation



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Bank of America®



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- ▶ **Facts:** BoA did not disclose Merrill's tens of billions of dollars in 4Q losses and a secret agreement for Merrill to pay \$5.8 billion in bonuses.
- ▶ **Opinion:** "Despite the Bank's somewhat coy refusal to concede the *materiality* of these nondisclosures, it seems *obvious* that a prudent Bank shareholder, if informed of the aforementioned facts, would have thought twice about approving the merger or might have sought its renegotiation."

*Judge Jed S. Rakoff*

# Other Facts Kept from BoA Shareholders

- ▶ BoA felt Merrill's \$15.3 billion in 4Q losses represented a "material adverse change" and wanted to walk away from the merger.
- ▶ BoA could not absorb Merrill's losses without a \$138 billion taxpayer bailout.



# Fraud: Mortgage Backed Securities



- ▶ “Let’s hope we are all wealthy and retired by the time this house of cards falters.”
  - CDO group analytical manager at S&P rating services cited in the SEC’s July 2008 report on rating agencies
  
- ▶ “In January 2008, there were 12 triple A rated companies in the world. At the same time, there were 64,000 structured finance instruments, like CDO tranches, rated triple A. It is easy to blame the rating agencies for their credit judgments. But the blame is not theirs alone. Every financial institution that participated in the process has to accept part of the responsibility”
  - Remarks by Lloyd C. Blankfein to the Council of Institutional Investors

# Fraud: Everywhere...

- ▶ The Subprime Crisis
- ▶ The Gulf Oil Spill
- ▶ The Toyota Recalls
- ▶ Various Drug Recalls
- ▶ The Massey Mining Tragedy





## III. The Need for Shareholder Vigilance

# Shareholders Must Be Vigilant

- ▶ Congress empowered investors by passing the PSLRA, which:
  - Encourages institutions to seek appointment as lead plaintiff.
  - Establishes a framework for appointing institutional leadership.
    - Favors the movant with the largest financial interest.
    - Allows the “most adequate” movant to select counsel.



# Options When Confronted by Fraud

- ▶ Always consider your options:
  - File a Class Action.
  - File an individual (or “opt-out”) action.
  - File a Derivative Action.
  - Hope that someone else protects your rights.



# Objectives in Pursuing Private Litigation

- ▶ Recover investment losses caused by fraud and corporate misconduct.
- ▶ Deter manufactured/manipulated financial results.
- ▶ Achieve corporate governance reforms.
- ▶ Improve business ethics and practices.



# Institutions Are Effective Lead Plaintiffs

- ▶ Institutions serving as lead plaintiff lend credibility to a case, which impacts the judge, the defendants, and the jury (where applicable).
- ▶ “The presence of an institutional investor as lead plaintiff is [also] associated with a statistically significant increase in settlement size.”

*Cornerstone Research*



# Institutions Achieve Top Recoveries

Enron	• \$7.1 Billion
WorldCom	• \$6.15 Billion
Cendant*	• \$3.3 Billion
Tyco International, Ltd.	• \$3.2 Billion
AOL Time Warner	• \$2.5 Billion
Nortel Networks*	• \$2.4 Billion
Royal Ahold	• \$1.1 Billion
McKesson HBOC*	• \$1.04 Billion
UnitedHealth Group**	• \$920 Million
Xerox Corp.	• \$750 Million
Lucent Technologies*	• \$673.4 Million

\*Cases prosecuted by BLB&G

\*\*A derivative lawsuit prosecuted by BLB&G; Such a suit is brought by a shareholder on behalf of a corporation against a third party – frequently that company's management or board of directors.

# Institutions Are Effective Lead Plaintiffs

- ▶ Private litigation is far more effective than regulatory actions. Since 1995, only 5% of monetary recoveries came from SEC settlements.

Company	Securities Class Action Recovery	SEC Recovery
Enron	\$7,242,000,000	\$450,000,000
WorldCom, Inc.*	\$6,156,100,670	\$750,000,000
Tyco International Ltd.	\$3,200,000,000	\$50,000,001
AOL Time Warner	\$ 2,500,000,000	\$308,000,000
Nortel Networks Corp. I & II*	\$1,142,775,308 (I) \$1,074,265,298 (II)	\$35,000,000
HealthSouth Corp.*	\$804,500,000	\$100,000,000
Xerox Corp.	\$750,000,000	\$44,000,000
Lucent Technologies, Inc.*	\$667,000,000	\$25,000,001
Cardinal Health, Inc.	\$600,000,000	\$35,000,000
Raytheon Company	\$460,000,000	\$14,700,000

\* Cases prosecuted by BLB&G

Source: RiskMetrics Group, Securities Class Action Services

# Institutions Are Effective Lead Plaintiffs



- ▶ Institutions serving as lead plaintiffs also achieve significant corporate governance reforms:
  - Requiring greater board independence
  - Increasing the accountability of directors
  - Imposing shorter terms for directors
  - Requiring shareholder votes for revaluing stock options
  - Creating corporate governance committees





# Questions