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Let shareholders decide how to resolve disputes

By Hal Scott

Securities class actions are a strange breed of litigation. One group of shareholders (usually both present and former) sues the company (and thus all current shareholders) to recover damages for alleged management wrongdoing. Most often, shareholders recover pennies in the dollar and management misconduct is not deterred.

The real winners are plaintiff lawyers. An obscure 1990 legal opinion by a US Securities and Exchange Commission assistant general counsel asserts that shareholders cannot waive the right to file securities lawsuits. This in effect prevents shareholders from forgoing costly lawsuits, even though the Supreme Court found in two prior cases that customers could waive their rights to sue broker-dealers and agree instead to arbitration.

The Committee on Capital Markets Regulation, of which I am director, believes shareholders should have the same choice and recommended last year that shareholders be given the right to choose how they want to resolve disputes with their companies by amending their corporate charters, including the possibility of arbitration without class actions or the waiver of jury trials.

Class actions weigh heavily on the markets. Both the committee and the Bloomberg-Schumer report found that the prospect of class action litigation is an important factor in the loss of competitiveness of US public capital markets. Although new class action filings decreased from 211 in 2005 to 135 in 2006, probably because of the strong bull market, total settlements reached a record high of more than $17bn. Companies that cannot risk litigating huge dollar suits are under pressure to settle them, whatever their merits.

Do these actions compensate shareholders for losses? Success in these cases may be a mirage. NERA Economic Consulting has found that the ratio of settlements to investor losses since 2002 has averaged less than 3 per cent while 25-30 per cent of recoveries go to class action lawyers. Furthermore, securities class actions suffer from a circularity problem, in which the current shareholders pay damages to the shareholders in the plaintiff class. In the case of institutions, these present (paying) and former (plaintiff) shareholders often are the same. On the other hand, some shareholders do recover part of their losses and courts avoid the costs of a multiplicity of individual actions.

Defenders of class actions point to their role in deterring corporate fraud, but we do not think the prospect of corporate liability significantly deters individuals from committing fraud. Did Bernie Ebbers care that WorldCom would pay billions in class action settlements if his fraud were discovered?

To the extent deterrence works, the prospect of civil actions by the SEC, National Association of Securities Dealers and the New York Stock Exchange, which resulted in sanctions of more than $3.8bn in 2006, together with prosecutions by the Department of Justice and civil and criminal actions by the states, should be more than sufficient. Besides, the biggest deterrent is imposed by the market - the prospect of sharp stock drops following revelations of fraud. On average, companies lose 41 per cent of their market value when news of misconduct is reported.

In a recent hearing of the House Financial Services Committee, Christopher Cox, SEC chairman, told committee chairman Barney Frank that the SEC was not considering allowing public companies to "mandate" arbitration for shareholder disputes. We would urge the SEC not to do so. The committee rejected the idea of companies mandating arbitration, insisting that it be adopted by a shareholder vote on a charter amendment. That vote would bind present and future shareholders. Future shareholders would be free to reject arbitration through a subsequent charter amendment. The shareholders, not the company, would be mandating arbitration. Furthermore, the committee has not suggested that the SEC endorse particular alternative rem-edies, or exempt such remedies from court challenges by use of its exemptive power under Section 36 of the Securities and Exchange Act.

The reform that the committee urges strengthens shareholder rights by broadening choice beyond the route of class action litigation. The SEC should not feel constrained to block or endorse alternatives to class actions. Indeed, after full and fair public discussion, the SEC should leave resolution of disputes between shareholders and their companies where it belongs, in the hands of shareholders and the courts.

The writer, Nomura professor and director of the programme on international financial systems at Harvard Law School, is director of the Committee on Capital Markets Regulation

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