

# SHAREHOLDER REMEDIES UNDER U.S. LAW

Charles M. Yablon

Benjamin N. Cardozo School of Law

March 7, 2011

Hong Kong Corporate Counsel Association

# SHAREHOLDER REMEDIES UNDER U.S. LAW

- In the United States shareholders may bring private civil lawsuits to enforce obligations owed to them under American corporate and securities law, or to obtain monetary damages for violations of such legal duties.
- Such claims are generally brought against the corporation's officers, directors and, where applicable, its controlling shareholders.

# THE DUAL NATURE OF THE CORPORATION

## ENTITY

The corporation is a legal person.

It has rights and duties, may own property and sue and be sued.

## AGGREGATE

The corporation is a “nexus of contracts.”

It represents an implied consensual agreement between management, labor, and capital.

Corporate law contains mandatory and default terms of that implied contract.

# DUAL NATURE OF SHAREHOLDER LITIGATION

## **Shareholder Derivative Suits**

Lawsuits brought on behalf of the corporate entity to compensate the firm for breach of fiduciary duties owed to it by its officers, directors and sometimes, controlling shareholders.

May be brought by any shareholder (with some limitations) on behalf of the corporation. Damages, if recovered, are paid to the corporate entity (minus attorneys fees).

Usually brought in state courts (primarily Delaware) raising issues of state (primarily Delaware) law.

Threshold motions may be made challenging the merits of the underlying claims.

# DUAL NATURE OF SHAREHOLDER LITIGATION

## **Shareholder Class Actions**

Lawsuits brought directly by shareholders against the corporation and its officers, directors and sometimes, controlling shareholders for violation of legal duties owed directly to shareholders (usually disclosure obligations under federal securities law.)

Aggregate litigation brought on behalf of a class of similarly situated shareholders (who bought or sold shares within a particular time frame). Recovery is to the shareholders directly (minus attorneys fees).

Usually brought in federal court. Broad venue provisions apply.

# FREE RIDER PROBLEM

- In the United States, most companies do not have a controlling shareholder. Most shareholders, even large institutional investors, are highly diversified and do not own more than 1 or 2% of the shares of any single company.
- Shareholder derivative or class action litigation is risky and expensive, and even if successful, provides benefits to all shareholders equally on a pro rata basis.
- Why would any rational shareholder seek to initiate such an action?

# WHO REALLY BRINGS THESE LAWSUITS?

Professional Plaintiffs Securities Litigation Law  
Firms

# ATTORNEYS' FEES UNDER AMERICAN LAW

## **Litigation Costs**

English (and pretty much everywhere else in the world) Rule:

Loser pays attorneys fees of the winner of the lawsuit.

American Rule:

Each side pays its own attorneys fees (unless the court orders otherwise.)

Accordingly, no out-of-pocket costs for losing class action or derivative plaintiffs

# ATTORNEYS' FEES UNDER AMERICAN LAW

## **Contingency Fees**

In most types of American tort cases, plaintiffs lawyers can agree with their clients to work on a contingent fee basis. Lawyers' compensation is defined as a percentage of the recovery obtained for the plaintiff in the litigation (either through judgment or settlement.) If there is no recovery, no fee is owed or paid.

# ATTORNEYS' FEES IN SHAREHOLDER LITIGATION

- Nominal shareholder plaintiffs have little or no financial costs or risks
- In derivative suits, plaintiffs' law firm gets a percentage (usually 15-25%) of total corporate recovery
- In securities class actions, plaintiffs' law firms get a similar percentage of class recovery (although fees are sometimes awarded based on lawyer hours worked)
- In both derivative and class actions, plaintiffs attorneys' fees are subject to judicial oversight and approval.
- In essence, this is lawyer-generated litigation.

WHAT ARE THE COSTS AND  
BENEFITS OF THE U.S.  
SYSTEM OF SHAREHOLDER  
LITIGATION?

(My personal and somewhat idiosyncratic  
opinions)

# Major Problems

- Not very good method of uncovering corporate wrongdoing.
- Enron scandal uncovered by whistleblowers and business journalists. Options back dating discovered by *academics!*
- Huge transfer payments from corporations to law firms-both plaintiffs and defendants firms.
- Significant danger of “sweetheart settlements.”

# THE THREAT IS FRIVOLOUS LITIGATION IS SOMEWHAT OVERSTATED

Studies indicate that a publicly traded U.S. company has a 2% likelihood of being subject to a securities class action in any given year.

Lawsuits are typically triggered by

- a) Corporate scandal (accounting or otherwise)
- b) Unexplained stock price drop
- c) Corporate transactions substantially affecting shareholder rights

# Most Companies Have Little to Fear

- The law is relatively favorable to defendants
- Plaintiffs must overcome various threshold motions
- The “business judgment rule” protects most exercises of managerial discretion.
- The judges are usually financially sophisticated.

# SETTLEMENT IS ALWAYS AVAILABLE

- Plaintiffs law firms have strong financial incentives to settle.
- Directors and officers liability insurance is available.
- 96% of cases settle within policy limits.
- Even without insurance, corporate funds can usually be used to indemnify officers and directors.

# POTENTIAL BENEFITS OF THE U.S. SYSTEM OF SHAREHOLDER LITIGATION

## **Reduced Regulatory Costs**

- Less need for complex regulatory restrictions or prohibitions on transactions that may be harmful to shareholders in some circumstances and beneficial in others. E.g. partial takeovers
- Less need for government enforcement, particularly of private, intracorporate disputes.

# POTENTIAL BENEFITS OF THE U.S. SYSTEM OF SHAREHOLDER LITIGATION

- Perceived fairness and legitimacy
- Trial and judicial determination provide a thorough, impartial and authoritative method for investigating and allocating responsibility for corporate wrongdoing.

# POTENTIAL BENEFITS OF THE U.S. SYSTEM OF SHAREHOLDER LITIGATION

## **Prevention of Corporate Wrongdoing**

The most important benefit of any system of corporate and securities regulation is the corporate wrongdoing that does not take place because of it.

Most prevention of corporate wrongdoing takes place in the office of corporate legal counsel.

Threats of shareholder litigation give corporate counsel powerful arguments and incentives to detect and deter questionable practices by corporate officers and directors.