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ANOTHER NAIL IN THE COFFIN OF THE SMALL INVESTOR: THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995[1]

James Cotton[2]

I. INTRODUCTION

How does a small investor[3] in the stock market determine whether or not fraud has been committed by the management of a company where his money is invested? How can he find out if his company is being defrauded by its own management? How can he hold corporate management accountable for fraudulent actions? This article will examine the information and remedies that the small investor has a right to under federal and state laws.

First, an investor is entitled to receive information in the form of an annual corporate report.[4] The annual report, which is certified by the corporation's auditors, gives the investor a financial picture of the company at the very instant the report is

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[1] Pub. L. No. 104-67, 109 Stat. 737 (codified as 15 U.S.C. §§ 77k,77*l*, 77z-1, 77z-2, 78a, 78j-1, 78t, 78u, 78u-4, 78u-5; and a 18 U.S.C. § 1964 (1995)).

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[3] For purposes of this article the definition of small investor shall be anyone who owns securities valued at less than $10,000. Investors with less than $10,000 account for nearly 43.4% of all stockowners. *See* NEW YORK STOCK EXCHANGE, STOCKOWNERSHIP 1995 (1995).

[4] An annual report describing the financial condition of the corporation is required by almost all state statutes. *See* ABA MODEL BUS. CORP. ACT § 16.20(a)(1994), which provides:

> A corporation shall furnish its shareholders annual financial statements, which may be consolidated or combined statements of the corporation and one or more of its subsidiaries, as appropriate, that include a balance sheet as of the end of the fiscal year, an income statement for that year, and a statement of changes in shareholder's equity for the year unless that information appears elsewhere in the financial statements records.

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finished, typically December 31st each year. Thus, the annual report is out of date the day after it is published, and it continues to become outdated as it ages. To keep the annual report updated, the small investor may receive quarterly periodic reports pursuant to the federal securities laws.[5]

The annual report is a document that can be read by most sophisticated investors. However, it is almost impossible to detect fraudulent activity in the company based on reading the annual report. Instead, the annual report is generally a sales document designed to demonstrate to investors how well management is managing the corporation. The annual report that goes to the shareholder typically has all of the required financial information. However, the report will customarily have at least twice as much space devoted to attractive pictures and text to give the appearance of success even if the numbers disprove such sales hype.[6] For the most part, professional investors are the prime users of these reports. The annual corporate report is clearly not a document upon which to base a claim of fraud or deceit.[7] Actionable fraud and/or misrepresentation is more likely to be discovered in the working documents which support these reports. Misrepresentations, such as over or under estimations and unrealistic assumptions, are not easily detected in an annual report. The existence of fraud and the intent in making such exaggerations may only be discerned after substantial litigation discovery proceedings.

In addition to annual reports, a stockholder has a right to review the books and records of his company pursuant to the laws of the state of incorporation provided he does so "in good faith,

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[5] *See* 15 U.S.C. § 78m(a), The Securities Exchange Act of 1934 § 13a. The 13(a) reports consist of the 10-K Annual Report, 10-Q Quarterly Report, and the 8-K Current Report. These reports are filed with the Securities and Exchange Commission and, where appropriate, the securities exchanges.

[6] *See* JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES AND MATERIALS, 701 (1991).

[7] *See* 17 C.F.R. 240.10b-5 (1992). To bring a claim for fraud or deceit under 10b-5, a plaintiff must prove the following five elements: (1) fraud or deceit (2) by any person (3) in connection with (4) the purchase or sale (5) of any security.

and for a proper purpose."[8] The question of what is a "proper purpose" is a matter of law for the court to decide.[9] Examples of a proper purpose might be to ascertain the financial condition of the corporation, the existence of mismanagement, or to attain the names and addresses of other shareholders in order to communicate with them concerning corporate affairs.[10] Typical improper purposes could be to learn business secrets to aid a competitor of the corporation, for the purposes of blackmail and extortion, or to pursue one's own social or political goals.[11] One can imagine the cooperation that can be expected of corporate management if the stated purpose for reviewing the books and records is to determine what fraud and misrepresentation management has engaged in over the last year or so. As one would expect, a request for books and records is not generally welcomed by corporate management.[12]

Another shortcoming of the right to review the books and records is that it does not produce information that will be available at the time the pleadings are drafted. For example, suppose a product is prematurely released with known problems, and destined to become a failure. When the product fails, the information about how and why will most likely be buried in the bowels of the corporation and can only be uncovered with great difficulty. Although a review of the books and records may reveal some fraudulent activity on the part of the company's product assurance department, thereby making the request to review a proper purpose, the information revealed from the examination will not be available at the time the pleadings are drafted. This makes the stockholder susceptible to a motion to dismiss.

The stockholder may also attend the annual meeting of stockholders to learn more about his company and its

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[8] *See, e.g.*, ABA MODEL BUS. CORP. ACT § 16.02(c)(1).

[9] *See* HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS, 536-37 (Student Edition 1983).

[10] *Id.*

[11] *Id.* at 538.

[12] Note, *Security for Expenses in Shareholders' Derivative Suits: 23 Years' Experience*, 4 COLUM. J. OF LAW & SOC. PROBLEMS 50, 64 (1968).

management.[13] However, it is highly unlikely that there will be any evidence of improper business practices or fraudulent activity discussed by the chairman of the board as he conducts the annual meeting of stockholders. Annual meetings are usually conducted in a manner designed to impress investors with the chairman and his team's skill in running the corporation. As the annual meeting is usually carefully scripted, nothing is going to be said or done that will be legally actionable by a stockholder. It goes without saying that the small investor is never invited to financial analysts' intimate briefings, where hard questions may be asked and followed up on to determine the accuracy and the veracity of the corporate management's answers.

Finally, the stockholder may watch the movement of his stock on the stock exchanges, and when there is a significant (10%) fall in the value of the stock, the stockholder may request an explanation. If the explanation provided by the corporation is unsatisfactory, the stockholder will have standing to bring a derivative lawsuit on behalf of the company against management.[14]

Although the above list is the extent of the stockholder's right to information concerning his corporation, one concept has yet to be mentioned: the "Wall Street Rule". The Wall Street Rule states that if you do not like the company or its management, sell. This may seem to be the best form of protection available to all stockholders,[15] but does this work for the small investor or is this an avenue of relief reserved for the more sophisticated or institutional investor? The answer to that question is that the Wall Street Rule is for Wall Street, not for the small investor. The small investor is simply not equipped financially, or information-wise, to buy and sell stock based on information available over the Dow Jones or other stock

[13] Corporations are usually required to hold annual shareholder meetings. *See, e.g.*, CAL. CORP. CODE § 600(b)(West 1990); DEL. CODE ANN. tit. 8, § 211(b)(2001); N.Y. BUS. CORP. LAW § 602(b)(McKinney's 1986 & Supp. 2002); ABA MODEL BUS. CORP. ACT § 7.01.

[14] *See* 17 C.F.R. 240.10b-5.

[15] *See* Scott F. Norberg, *Debtor Incentives, Agency Costs, and Voting Theory in Chapter 11*, 46 U. KAN. L. REV. 507, 516 (1998).

information services. A small investor, almost by definition, does not watch the Dow Jones on a daily basis. Moreover, the small investor is more committed emotionally to his portfolio than the professional investor. The small investor is often not equipped to use the tools he or she does have to hold corporate management accountable. As a result, the Wall Street Rule does not compensate for the deficiencies in the information methods discussed above. To say the least, it is not an effective tool for the small investor.

It is therefore clear that despite all of the disclosure that is available to stockholders today, much of the disclosure will not reveal the existence of a scheme to defraud, particularly where corporate management may be involved in the scheme. Fraud is not easy to discover. By definition, fraud involves deceit,[16] which means it is not going to be self-evident in any SEC filing by a publicly held corporation. Not only is fraud difficult to discover, it becomes more difficult when the allegations are against a corporation of some reputation.[17]

Given the sources of information and methods of verifying the performance of a corporation that are available to the small investor, the only real tools and remedies available for a stockholder to hold management accountable are stockholder derivative lawsuits[18] and stockholder proposals.[19] However, the usefulness of these tools has been diminished by a range of restrictions imposed by assorted regulations, rules, and statutes.

The small investor has been curtailed in his ability to influence management through stockholder proposals by minimum ownership and holding requirements that were established by the SEC.[20] In addition, The derivative suit has been under attack for a long time by corporate management as the

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[16] *See* BLACK'S LAW DICTIONARY 660 (6th ed. 1990)(describing fraud as "[a] false representation . . . which deceives and is intended to deceive another . . . ").

[17] *See* Dirks v. Sec. Exch. Comm'n, 463 U.S. 646 (1983).

[18] *See infra* parts III and IIIA, discussing the derivative lawsuit and the effect of the Security for Expense Statute on the derivative lawsuit.

[19] *See infra* part IV, discussing stockholder proposals.

[20] *See infra* part IV, discussing stockholder proposals.

source of "frivolous lawsuits."[21] As a result, the usefulness of the derivative lawsuit has diminished as the small investor has been curtailed in his ability to require corporate accounting by "security-for-expense" statutes that have been adopted in various jurisdictions.[22] In addition, Rule 11 of the Federal Rules of Civil Procedure has been amended to the point of discouraging the small investor from litigating.[23]

Moreover, the Private Securities Litigation Reform Act of 1995 (PSLRA),[24] which is another effort to stop frivolous lawsuits, has had the effect of further limiting the rights of the small investor.[25] As a result of the PSLRA, the small investor no longer has the right to act as a "private attorney general." Fifty-five years ago, Judge Jerome Frank coined the term "private attorney general" as a means of recognizing the role of private litigation in the enforcement of securities laws.[26] Judge Frank explicitly recognized that Congress can confer standing on private persons, not simply to recover compensation for specific victims, but also "to vindicate the public interest."[27] The United States Supreme Court also recognized the importance of the private attorney general concept.[28] The Court made the assumption that private enforcement would multiply the resources available in preventing fraud in the securities market.[29] The theory of the

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[21] Charles M. Yablon, *The Good, The Bad, and The Frivolous Case: An Essay on Probability and Rule 11*, 44 UCLA L. REV. 65, 66 (1996).

[22] *See infra* part IIIA, discussing the effect of the Security for Expense Statute on the derivative lawsuit.

[23] *See infra* part IIIB, discussing the effect of Federal Rule of Civil Procedure 11 on the derivative lawsuit.

[24] Pub. L. No. 104-67, *see also supra* note 1.

[25] *See infra* part V, discussing the Private Securities Litigation Reform Act of 1995.

[26] *See* Associated Industries of New York State, Inc. v. Ickes, 134 F.2d 694, 704 (2d Cir. 1943), *vacated as moot*, 320 U.S. 707 (1943) (stating that "such persons, so authorized, are, so to speak, private Attorney Generals.")

[27] *Id.*

[28] *See* J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964) (reasoning that "private enforcement . . . provides a necessary supplement" to public law enforcement, and the Court therefore implied private causes of actions under federal securities laws).

[29] *Id.*

private attorney general emphasizes that the rule of private litigation is not merely to secure compensation for victims, but it should also deter fraud, by multiplying the total resources committed to detection and prosecution of crime and fraud.[30]

It is the thesis of this article that the small investor in the American corporation has been the victim of the rule of unintended consequences.[31] The small investor has steadily and regularly been assaulted by corporate management in efforts which have reduced the investor's ability to make management accountable for its performance. Not only does the small investor face the hurdles discussed above in obtaining information relating to potential fraud and misrepresentation by corporate management, the increased perception that derivative lawsuits are frivolous in nature has resulted in further limitations being placed upon the rights of the small investor. Small investors and, quite possibly, all stockholders are steadily losing power to keep the corporate management accountable and liable for questionable actions.

II. CORPORATE DEMOCRACY AND CORPORATE ACCOUNTABILITY

The concept of groups being formed for various purposes with governmental approval goes back to ancient Roman times.[32] There are certain themes that recur in the development of the corporate concept such as group action, approval of the sovereign, and a purpose.[33] It is probable that some form of corporate democracy may have existed at common law because many business associations at that time had both ownership and

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[30] *See* John C. Coffee, Jr., *Rescuing the Private Attorney General: Why the Model of the Bounty Hunter is Not Working*, 42 MD. L. REV. 215 (1983).

[31] The rule of unintended consequences is that well known rule of conventional wisdom that says that things do not always turn out the way we intend them to.

[32] HENN & ALEXANDER, *supra* note 9, at 14, provides a good discussion of the ancient origins of the corporate concept.

[33] *Id.* at 14-15.

control in a very few people.[34] Common principles of today's business corporation, such as limited liability, developed more or less as afterthoughts.[35]

In all of the history and even in current incorporation statutes it is rare to find a comprehensive definition of a business corporation.[36] One of the better definitions is that "the business corporation is a type of a corporation formed to collect a fund of capital and to dedicate such fund to a more or less definite business purpose for profit."[37] Based on this definition, an essential part of the corporate concept is the collection of funds from people and the management of those funds by others.[38] Shareholders are the owners from whom the funds are collected. The directors are the managers of the corporate entity, who work on behalf of the shareholders and manage the funds gathered on behalf of the corporation.[39] This split between ownership and management has given rise to the idea of "corporate democracy."[40]

The term "corporate democracy" has come to mean a method for governing a corporation.[41] In the model for corporate governance, stockholders, because of their investment, "own" the corporation. The shareholders have the duty of electing the board of directors, which, in turn, has the legal obligation to manage the affairs of the corporation. The board then acts through officers and managers to put into effect its policies.[42] The conventional corporation, theoretically, resembles a democratic

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[34] *Id.*

[35] *Id.* at 19.

[36] *Id.* at 2, n.3.

[37] *Id.*

[38] HENN & ALEXANDER, *supra* note 9, at 491.

[39] *Id.*

[40] *See, e.g.*, Mortimer M. Caplin, *Proxies, Annual Meetings and Corporate Democracy: The Lawyer's Role*, 37 VA. L. REV. 653 (1951).

[41] *Id.*

[42] Leila N. Sadat-Keeling, *The 1983 Amendments to Shareholder Proposal Rule 14A-8: A Retreat From Corporate Democracy*, 59 TUL. L. REV. 161, 162.

institution in which decisions are made and leaders chosen according to a democratic one-vote for one-share scheme.[43]

Americans have historically distrusted the corporate form of doing business.[44] Alexis de Tocqueville, in his treatise on Democracy in America, made the following observation in a discussion about "companies:"

> It must be admitted that these collective beings, which are called companies, are stronger and more formidable than a private individual can ever be, and that they have less of the responsibility for their own actions; whence it seems reasonable that they should not be allowed to retain so great an independence of the supreme government as might be conceded to a private individual. The power and duration of these small private bodies in the midst of weakness and instability of the whole community astonish and alarm the people, and the free use which each association makes of its natural powers is almost regarded as a dangerous privilege.[45]

Corporate democracy became a major topic in corporate America in the 1980s in the form of the proposed statutes: the Federal Protection of Shareholders' Rights Act of 1980,[46] and the

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[43] *Id.*

[44] *Id. See also* HENN & ALEXANDER, *supra* note 9, at 16 (discussing how Americans have distrusted corporations as early as 1770, when Adam Smith expressed his views against concentrations of business; and Blackstone provided brief commentaries on corporations).

[45] ALEXIS DE TOCQUEVILLE, DEMOCRACY IN AMERICA 311-12 (Alfred A. Knopf 1960).

[46] *See* HENN & ALEXANDER, *supra* note 9, at 34, n.49. (The proposed Federal Protection of Shareholders' Rights Act of 1980, S.2567, 96th Cong., 2d Sess. (Apr. 16, 1980), would have defined the directors' duty of loyalty and duty of due care, required that a majority of the board of directors be independent, and that there be independent audit and nominating committees. Provision was made for shareholder nominations of directors and cumulative voting. Jurisdiction to enforce the Act would have been concurrent in the federal and state courts, with broad venue and possible allowance of litigation expenses to any prevailing party).

proposed Federal Corporate Democracy Act of 1980.[47] In addition to these statutes, the American Law Institute's ("ALI") Principles of Corporate Governance also fostered the maturation of the corporate democracy concept.[48] The ALI Principles of Corporate Governance recommend that corporations should seek to conduct business in a way that will make maximum profits for shareholders.[49] The Corporate Governance Principles go on to suggest that a corporation, just like a natural person should only act within the law.[50] Thus, in accordance with these principles, and in its most current and modern form, the purpose of the corporation is to lawfully make profits for all of its shareholders, including the small investor in the corporation.

The basic corporate law of most states provides that shareholders elect the directors who manage their corporations[51] and vote to approve fundamental corporate transactions.[52] Thus, (in principle) the stockholders actually control the corporation. Indeed, the management of a modern day corporation would be impossible without the ability to solicit proxies from the shareholders of the corporation.[53] This is particularly true in the case of multi-national corporations, where shareholders are

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[47] *Id.* (The proposed Federal Corporate Democracy Act of 1980 would have required that the majority of the directors be independent, defined the director's duty of loyalty and duty of due care, required independent supervisory and public policy committees. Shareholder nomination of directors and cumulative voting were mandated. Broad disclosure was specified and abusive discharge would have been prohibited).

[48] A.L.I. PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 2.01 (1994).

[49] *Id.*

[50] *Id.*

[51] *See, e.g.*, CAL. CORP CODE § 301 (West 1990); DEL. CODE ANN. tit. 8, § 211(b)(2001); ABA MODEL BUS. CORP. ACT § 7.28.

[52] *See, e.g.*, DEL. CODE ANN. tit. 8, § 251 (2001) (stockholder voting requirements for merger or consolidation of domestic corporations); N.Y. BUS. CORP. LAW § 803 (McKinney 1986 & Supp. 2002)(amendments to articles of incorporation). For a broad discussion of what constitutes fundamental corporate transactions subject to shareholder approval, also see HENN & ALEXANDER, *supra* note 9, at 951-1018.

[53] HENN & ALEXANDER, *supra* note 9, at 951-1018.

located worldwide. Solicitation of proxies is essential in these corporations in order to be able to ratify the actions of directors.[54]

Acting as managers of the corporation, the board of directors will solicit proxies, for various reasons (elections, ratifications, etc.), from shareholders. If the management gets more than 50% of outstanding proxies, the board can then use the proxies to elect themselves and/or to approve any of their previous actions on behalf of the corporation.[55] The importance of proxy solicitation and shareholder voting is much less than may be expected because the process is completely controlled by the directors as managers of the corporation.[56] Directors are working on "behalf" of shareholders to ratify director decisions.[57]

Although proxy solicitations are generally controlled by management, in accordance with the corporate democracy concept, the law allows a stockholder to have some input as to what information can be included in a proxy solicitation. Specifically, in 1942, the Securities and Exchange Commission ("SEC") enacted SEC Rule 14a-8, which required corporate management to include proposals from shareholders in the corporation's proxy solicitation material whenever it was legally necessary for management to solicit proxies from shareholders.[58] The stockholder proposal rule seems to provide stockholders with an avenue for retaining some control over the directors who "technically" work for them.[59] As will be discussed later, however, the stockholder proposal rule, like so many other stockholder tools provided to the small investor, does not fully carry out the intention of the corporate democracy concept.

The idea of corporate democracy and its supposed benefit to the stockholder has received some criticism even though it

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[54] Patrick J. Ryan, Rule 14a-8, *Institutional, Shareholder Proposals, and Corporate Democracy*, 23 GA. L. REV. 97 (1998).

[55] *Id.*

[56] *Id.*

[57] HENN & ALEXANDER, *supra* note 9, at 570.

[58] *See* 17 C.F.R. § 240.14a-8.

[59] *See infra* part IV, discussing stockholder proposals.

seems fair and practical. Since ownership in a large multi-national corporation is so completely dispersed throughout the globe it is almost impossible for any individual shareholder to put together even a significant minority interest.[60] As a result of this geographical condition of the ownership of the corporation the value of the individual vote of a shareholder is practically meaningless.[61] When ownership of the corporation is "sufficiently sub-divided," it is possible that management may become "a self-perpetuating body" even though it has a negligible share in the company's ownership.[62] Thus, the notion of corporate democracy is not really as much of a benefit as it seems to be to most shareholders, and particularly to the small investor. Indeed, in most cases it is management that controls the modern corporation today, not the shareholder, even though he or she is the actual owner of the enterprise. As a result, the opportunities for meaningful participation by a shareholder are negligible at best.[63]

Although the small investor is left to grasp for useless remedies under the corporate democracy concept, not all investors have been as unfortunate in their pursuit to hold corporate management accountable. The relationship between corporate management and the shareholder has been significantly changed by the arrival of the large (if not huge) corporate "institutional investor."[64] The increase of trading by mutual funds, retirement funds, and insurance companies since the early 1960s, has been significant and the pervasiveness of these funds is beyond dispute. The largest holdings in corporate stock are believed to be retirement funds. Moreover, their growing size and influence has made their institutional presence increasingly prevalent in the market. The stock holdings of institutional investors now make up approximately one-third of all outstanding corporate stock. This is an increase from one-quarter in 1977.[65]

[60] Sadat-Keeling, *supra* note 42, at 162.
[61] *Id.*
[62] *Id.* at 163.
[63] *Id.*
[64] Ryan, *supra* note 54, at 149.
[65] *Id.*

Today, the institutional investor has become the dominant voice in the ownership of the American corporation and can, in fact, influence the actions of major corporations. The converse of this is that the small investor has almost disappeared as a factor, although the individual stockholder is regularly courted by the brokerage community.

An important observation concerning the role of the institutional investors as the dominant shareholders of the last quarter-century somewhat discredits observations about management-controlled corporations: although the group in control in a publicly owned corporation may still be able to perpetuate themselves in control, the institutional investors, because of the size of their holdings and because of their sophistication as working investment professionals, can play a significant role in corporate accountability.

In accordance with corporate democracy, stockholders own the corporation; thus stockholders should have the right to hold those directors accountable for actions they take while managing the corporation. Although the size of an investor's ownership should have no influence on his ability to hold corporate management accountable, the corporate democracy concept, like other democratic concepts, favors those individuals with the biggest pocketbooks. In accordance with this general philosophy, the small investor's tools to hold corporate management accountable have been adversely affected by the evolution of the market and also by legislative and regulatory "reforms."

The accountability of corporations for their social actions has been a problem for some time during the last century. In the early 1960s several events, including disclosures involving the collapse of some large corporations, suspicious payments made on behalf of corporations by managers, and serious violations of environmental laws that had been recently passed by Congress helped to point out the problem of corporate social accountability.

The effort to hold corporations accountable for social consequences of their actions has persisted to today.[66]

Every time there is a sustained call for social accountability, there is a reciprocal call to "get off the backs of business."[67] Although the philosophy of the corporate democracy concept is that management is working on behalf of stockholders, the law has provided stockholders with only a few ways to hold the management of a corporation accountable, or to influence corporate management policies - primarily derivative lawsuits and stockholder proposals. Each of these were designed to have some viability for the small investor, but attacks launched by corporate management have resulted in these becoming almost useless to the small investor.

III. THE STEADY EROSION OF THE USEFULNESS OF THE DERIVATIVE LAWSUIT

The derivative lawsuit developed in equity "so that the shareholder could enforce a corporate right or claim (that is one derived from the corporation) and thereby indirectly protect the shareholder's own interest in the corporation."[68] The need for an equitable remedy does not arise until "those in control of the corporation refuse to sue in the corporate name."[69] Typically, before equity will be invoked, a shareholder must demonstrate an inadequate remedy at law by showing that the corporation failed to redress the wrong that was committed against the corporation.[70] Although shareholder derivative suits are procedurally complex, any benefit obtained as a result of the litigation will be in favor of the corporation.[71] In a derivative

[66] Sadat-Keeling, *supra* note 42, at 165. *See also* Staff Report on Corporate Accountability, Division of Corporate Finance, Securities and Exchange Commission, presented to Committee on Banking, Housing & Urban Affairs, U.S. Senate, 96th Cong. 20 Sess. 34-35, 143 (Sept. 4, 1980).

[67] *Id.*

[68] HENN & ALEXANDER, *supra* note 9, at 1036.

[69] *Id.* at 1037.

[70] *Id.*

[71] *Id.*

suit, "the plaintiff-shareholder represents not only the corporation on behalf of whom and on who's benefit the plaintiff-shareholder is suing, but also the other shareholders similarly situated."[72]

"It must be remembered that a [stockholder's derivative suit] is, at present, the only civil remedy that stockholders have for breach of fiduciary duty on the part of those entrusted with management and direction of their corporation."[73] And, "it is clear that the stockholder's derivative suit is an absolutely necessary arm of equity jurisdiction and that, when used with justice and restraint, it has both public and private value."[74] These opinions emphasize the significance of the stockholder's derivative suit as the primary means in the American legal system to hold accountable those entrusted with investments made by small investors and others in corporations. Because of the prominent position that corporations hold in almost all phases of economic life, the value of the stockholder's derivative suit as a way of insuring accountability to small and large investors is almost unquestioned, except by corporate management.[75]

The stockholder derivative suit began to earn the disfavor of corporate managers in the early 1930s when a phenomena developed that was termed the "strike suit." [76] A strike suit is a derivative action that management views as frivolous and brought in bad faith.[77] Although the corporation believes that the lawsuit has no merit, corporate management makes the business judgment to settle the case, because it will cost too much to defend, even

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[72] *Id.* at 1038.

[73] Sergei S. Zlinkoff, *The American Investor and the Constitutionality of Section 61-B of the New York General Corporation Law*, 54 YALE L. J. 352, (1945) (quoting Judge Bernard L. Shientag from Bayer v. Beran, 49 N.Y.S.2d 2 (N.Y. Sup. 1944).

[74] *See* Zlinkoff, *supra* note 73, at 352. (citing Ralph M. Carson, *Current Phases of Derivative Actions Against Directors*, 40 MICH. L. REV 1125, 1127 (1942).

[75] *Id.*

[76] Note, *Extortionate Corporate Litigation: The Strike Suit*, 34 COLUM. L. REV. 1307 (1934).

[77] *Id.*

though it may be without merit.[78] Therefore, the business judgment is that a settlement should be entered into with the stockholder as a means of stopping the costly litigation.

The term "strike suit" may be more descriptive than "frivolous" because the idea is to terrify management into paying off the litigant.[79] A single lawsuit is viewed as a maneuver in a litigation campaign that begins with the first request for information and ends in a negotiated compromise. It may end before the courtroom is reached, because a plaintiff's victory in court is unnecessary for success; where delay or publicity are undesirable, the most non-meritorious of claims may have high nuisance value. In addition, strike suit litigation may also involve the filing of several separate suits, utilizing different causes of action in several jurisdictions and using different defendants.[80]

A. The Effect of the Security for Expense Statute on the Derivative Lawsuit

The first serious legislative effort at dealing with the strike suit while maintaining the rights of the small investor was the infamous Section 61-b of the New York General Corporation Law, which became effective April 9, 1944.[81] Section 61-b, like

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[78] *See* HENN & ALEXANDER, *supra* note 9, at 661 (The "business judgment rule" sustains corporate transactions and immunizes management from liability where the transaction is within the powers of the corporation and the authority of management, and involves the exercise of due care and compliance with applicable fiduciary duties).

[79] Note, *supra* note 76, at 1308.

[80] *Id.* at 1308 note 1.

[81] *See* Zlinkoff, *supra* note 73 at 353 (referring to N.Y. Laws 1944, c. 668). Section 61-b of the New York General Corporation Law read as follows:

> In any action instituted or maintained in the right of any foreign or domestic corporation by the holder or holders of less than five per centum of the outstanding shares of any class of such corporation's stock or voting trust certificates, unless the shares or voting trust certificates held by such holder or holders have a market value in excess of fifty thousand dollars, the corporation in whose right such action is brought shall be entitled at any stage of the proceedings before final judgment to require the plaintiff or plaintiffs to give security for the

other security for expense statutes, requires shareholders owning less than five percent of the outstanding shares of stock to provide the court with a certain dollar amount to cover any attorneys fees or reasonable expenses that are incurred by the corporation in defending the "frivolous" lawsuit. If the shareholder is not successful in his action, the court may award the posted security to the defendnat to pay for expenses, including reasonable attorney's fees.[82] "It would be denying the obvious to deny that the dire effect of the statute - if not the deliberate purpose of it - is to bar many stockholders' actions by making them excessively costly and difficult."[83]

Some twenty years after the enactment of Section 61-B, a small study was conducted to determine the effectiveness of this

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> reasonable expenses, including attorneys fees, which may be incurred by it in connection with such action and by the other parties' defendant in connection therewith . . . .

[82] Zlinkoff, *supra* note 73, at 355.

[83] Shielcrawt v. Moffett, 49 N.Y.S.2d 64 (Sup. Ct. N.Y. County), *aff'd*, 268 A.D. 352, 51 N.Y.S.2d 188 (1944), *rev'd on other grounds*, 294 N.Y. 1801, 61 N.E.2d 435 (1945). Instead of security for expense statutes, the Model Business Corporations Act represents the more acceptable view of how "frivolous" litigation might be discouraged. *See* MODEL BUS. CORP. ACT § 7.46, Payment of Expenses, which provides:

> On termination of the derivative proceeding the court may: (1) order the corporation to pay the plaintiff's reasonable expenses (including counsel fees) incurred in the proceeding if it finds that the proceeding has resulted in a substantial benefit to the corporation; (2) order the plaintiff to pay any defendant's reasonable expenses (including counsel fees) incurred in defending the proceeding if it finds that the proceeding was commenced or maintained without reasonable cause or for an improper purpose; or (3) order a party to pay an opposing party's reasonable expenses (including counsel fees) incurred because of the filing of a pleading, motion or other paper, if it finds that the pleading, motion or other paper was not well grounded in fact, after reasonable inquiry, or warranted by existing law or a good faith argument for the extension, modification or reversal of existing law and was interposed for an improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation.

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statute.[84] The study concluded that, "[s]ecurity-for-expense statutes are a minor factor in the prosecution of stockholders' suits, that plaintiffs' attorneys may avoid the posting of security with relative ease, and that there are many reasons why defendants' attorneys decline to require posting of security, even if circumstances permit them to do so."[85] The study also indicated "that only the smallest minority" of all shareholders could meet the statutory requisites of five percent or $50,000 in order to comply with a motion for security for expenses.[86] Although this study is somewhat dated, the percent of "small investors" who can post security is still quite small.[87]

Strategies have been developed for avoiding security for expense statutes.[88] Creative lawyers have found several standard ways around the security-for-expense statutes. The most frequently used method of avoiding the security requirement is to "plead a federal cause of action."[89] Another common method is to bring suit in a state that does not have a security-for-expense statute.[90] In the event neither of the two methods is acceptable, there is the possibility that the plaintiff may move for a stay of the proceedings, and request an order permitting inspection of the corporation's stockholders list.[91] Corporations are at a disadvantage when a plaintiff seeks to inspect the stockholder lists, as the Courts have freely granted such motions.[92] This potential plaintiff's strategy is one of the main reasons why the security for expense statutes are ineffective. This principle was established in *Baker v. MacFadden Publications, Inc.*,[93] wherein the New York Court of Appeals held that a plaintiff could seek inspection of a corporation's list of shareholders when trying to

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[84] Note, *supra* note 12, at 50.
[85] *Id.*
[86] Zlinkoff, *supra* note 73, at 368.
[87] *Id.*
[88] *J.I. Case Co.*, 377 U.S. at 426.
[89] Note, *supra* note 12, at 59.
[90] *Id.* at 61 (many states do not have security-for expense statutes).
[91] *Id.* at 62.
[92] *Id.*
[93] 300 N.Y. 325 (1950).

overcome the corporation's security-for-expense motion. When shareholders know who their fellow shareholders are, they can discuss the corporation's performance and can bind together and become a real threat to corporate management. As a result of the *Baker* decision, the purpose of the security for expense statutes have been undermined.

Although security-for-expense statutes are fairly ineffective, they still have a chilling effect on the small investor who seeks to hold management accountable through a derivative lawsuit. The idea of filing a lawsuit, and then being required to post security to pay the opposing party's expenses acts as a deterrent to the small investor. Another serious problem with security-for-expense statutes is that there is no consideration of the merits of a dispute, and therefore all shareholders lose, particularly where there is a valid claim against management that is thwarted because of the incapability of posting money under a security-for-expense statute. This underlying problem results in shareholders being deterred from utilizing derivative lawsuits as a means of holding corporate management accountable. The basic fact is that the "loser pays" philosophy has a chilling effect on the small investor's willingness to take justified legal action against corporate management. As a result, the attempt to curb strike suits through the invention of security expense statutes has even further discouraged legitimate small investor derivative lawsuits.

B. The Effect of Federal Rule of Civil Procedure 11 on the Derivative Lawsuit

The security-for-expense statutes were first enacted in 1944 in New York, as a means of curbing "frivolous" strike suits.[94] Although this was the first attempt to curb strike suits, the bar had always appreciated the problem of abuse of the legal system with so-called "frivolous" litigation. Prior to the enactment of security-for-expense statutes, the Federal Rules of

[94] Note, *supra* note 11, at 59.

Civil Procedure attempted to limit frivolous lawsuits through the 1938 version of Rule 11.[95]

The goal of Rule 11 was to insure accuracy and integrity in pleadings filed in Federal Court.[96] In its original form, Rule 11 had requirements for certification of pleadings.[97] The attorney had to swear to the existence of a reasonably adequate basis in facts to support a claim.[98] "Good faith was the standard used to determine whether the rule had been violated: The signature of any attorney constitutes a certificate by him that he has read the pleading; that to the best of his knowledge, information, and belief there is good ground to support it ... "[99] A serious problem with the original version of Rule 11 was that there were no sanctions for a violation.[100] For a court to consider sanctions of any kind, there had to be a finding of bad faith by the attorney filing the pleadings.[101] And, as usual, the judge had discretion with respect to sanctions "even when an attorney had willfully violated the rule." Although the rule established a number of requirements that attorneys were required to comply with, the rule was almost never used by the courts as a means of imposing disciplinary actions upon attorneys. From "1950 to 1976 only nineteen Rule 11 motions were reported."[102]

In 1983, Rule 11 was amended with the goal of providing some clarification as to the provisions regarding sanctioning.[103] The sanctioning provisions were changed so that sanctions were required when the court actually made a finding that there had

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[95] *See* Karen K. Cain, Comment, *Frivolous Litigation, Discretionary Sanctioning and a Safe Harbor: The 1993 revision of Rule 11*, 43 KAN. L. REV. 207, 208 (1994).

[96] *Id.* at 207.

[97] *Id.* at 209.

[98] *Id.*

[99] *Id.*

[100] *Id.*

[101] Cain, *supra* note 95.

[102] *See* D. Michael Risinger, *Honesty in Pleading and Its Enforcement: Some "Striking" Problems with Federal Rule of Civil Procedure 11*, 61 Minn. L. Rev. 1, 34-37 (1976).

[103] FED. R. CIV. P. 11

been a violation of Rule 11.[104] The amendments did not confront the issue of the types of sanctions that should or could be imposed, which was probably a major flaw in the revised rule.[105] As a result, a court had absolute discretion to arbitrarily impose any "appropriate sanction" based on a particular set of facts.[106] By 1990, however, after some experience with the new rule and its lack of direction, the Tenth Circuit, in *White v. General Motors Corp.*,[107] arrived at several factors that a court should consider when determining the value of a monetary sanction. Among the factors the court stated should be considered were: whether the attorney had the ability to pay the sanction; whether the amount requested was reasonable under the circumstances; whether the amount was large enough to deter future conduct; and whether there was a history of Rule 11 violations.[108]

The Advisory Committee said that the purpose of the 1983 Rule was to provide a deterrence to over-zealous and abusive litigation.[109] Enforcement of the 1983 Rule was quite consistent with the principle purposes of creating the rule: (1) punishing any party who offended the rule; (2) deterring attorneys from any future unprofessional or abusive conduct; and (3) compensating injured parties who suffered at the hands of the abuser.[110] The judicial system's consistency in enforcing the underlying purpose of Rule 11 was supported by the fact that attorneys fees were imposed in over ninety percent of the cases where Rule 11 motions were successful.[111] The judiciary's increased utilization of Rule 11 increased attorneys interest in filing Rule 11 motions as a means of shifting the costs of attorneys fees to their adversaries.[112]

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[104] *Id.*
[105] Cain, *supra* note 95, at 211.
[106] *Id.*
[107] 908 F.2d. 675 (10th Cir. 1990).
[108] *Id*; *see also* Cain, *supra* note 95, at 211.
[109] *See* Cain, *supra* note 95 at 214.
[110] *Id.*
[111] *Id.*
[112] *Id.*

The 1993 Rule seems much clearer than prior versions. The 1993 Rule is composed of four subsections: (a) a signature requirement; (b) certification by the attorney as to the legitimacy of the claim; (c) sanctions guidelines; and (d) the limitation that the rule shall not apply to discovery.[113] The significant changes to the Rule, which impacted both interpretation and application, are found in subdivisions (b), which deals with representations to the court, and (c), which deals with sanctions.[114] The 1993 revisions are much more direct and clear than its predecessors.[115] However, its potential for sanctions still may act as a deterrent to the small investor who would like to hold corporate management accountable.

The small investor has two major impediments to his ability to hold corporate management accountable through a derivative lawsuit; security-for-expense statutes and federal Rule of Civil Procedure 11. Considering the financial weakness of small investors, these can present insurmountable obstacles to what might be a legitimate claim of fraud or illegal behavior by corporate management. Of the two, the most unacceptable and draconian is the security-for-expense statute. Rule 11 at least allows for some judicial judgment as to the merits of the proposed litigation.

IV. STOCKHOLDER PROPOSALS

Although the small investor's right to hold corporate management accountable through derivative lawsuits has been affected by security-for-expense statutes and the implementation of Rule 11, the small investor still has the right to hold corporate management accountable through stockholder proposals. The stockholder proposal rule, otherwise known as Rule 14a-8,[116] is the only other significant way that a small investor may be able to influence management. Pursuant to Rule 14a-8, "qualifying"

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[113] FED. R. CIV. P. 11.
[114] *Id.*
[115] Cain, *supra* note 95, at 216.
[116] 17 C.F.R. 240.14a-8.

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shareholders are entitled to include proposals in management's proxy solicitation materials if the subject qualifies as a "proper subject" for action by shareholders.[117] Rule 14a-8 was designed to allow the shareholder to participate in corporate decision-making processes, including those decisions involving matters of public interest and corporate accountability. If management opposes the proposal, which it unfailingly does, the shareholder can include a statement of 100 words supporting his proposal.[118]

There are two issues that SEC Rule 14a-8 has historically highlighted: 1) the need to "hold management of large corporations accountable for their actions which affect society"; and 2) the shareholder's proper role "within the system of corporate governance."[119] The shareholder proposal rule has been used as a tool by shareholders to introduce proposals "on matters of public policy" to management.[120]

The first amendments that were adopted to restrict the shareholder's access to the proxy machinery were adopted in 1948. These amendments were meant to "respond to alleged abuses by a few shareholders of the 'privilege' of having their proposals included in management's proxy statement."[121] These amendments permitted "the exclusion of shareholder proposals that were, in fact, proper subjects for action by shareholders."[122] By 1970, amendments had been adopted by the Commission that "permittted management to exclude proposals on many grounds relating either to a proposal's subject matter or to the procedure followed by its proponent."[123] Perhaps the real purpose, and certainly the effect of the change, was to prevent communication and organization in support of a proposal.[124] Consider that between 1944 and 1971, not one shareholder proposal was able to

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[117] *Id.*

[118] Susan W. Liebeler, *A Proposal to Rescind the Shareholder Proposal Rule*, 18 GA. L. REV. 425, 428 (1984).

[119] Sadat-Keeling, *supra* note 42, at 164.

[120] *Id.*

[121] *Id.* at 168.

[122] *Id.*

[123] *Id.*

[124] *Id.* at note 39.

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muster judicial support for its inclusion.[125] By the late 1960s and 1970s, there was an increase in shareholder proposals,[126] but the law clearly disfavored their proponents.

In 1976, the Commission solicited and received comments on the question of whether eligibility requirements should be imposed upon prospective proponents of proposals. At the time, the SEC concluded that there was "little support" for the imposition of eligibility requirements, finding no evidence that there was abuse or that such requirements would either reduce the number of proposals submitted, or exclude those that were offered in bad faith.[127]

However, in 1982, the SEC found abuse and reversed its previous position.[128] The SEC concluded that abuse of the rule

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[125] Cases during this period rejecting the inclusion of proposals include Peck v. Greyhound Corp., 97 F. Supp. 679 (S.D.N.Y. 1951) (plaintiff shareholder/proponent denied a preliminary injunction which would have enjoined defendant issuer from soliciting proxies unless it included a proposal recommending that management consider the advisability of abolishing the segregated seating system in the South); Dyer v. SEC, 289 F.2d 242 (8th Cir. 1961) (court refused to require inclusion of petitioner's proposal that each director should be disqualified for re-election and censured at a meeting at which proponents were candidates); Brooks v. Standard Oil Co., 108 F. Supp. 810 (S.D.N.Y. 1969) (proposal that issuer continue and intensify its exploration and development of offshore petroleum reserves and encourage creation of a stable international regime having jurisdiction over such resources held excludable as an improper subject for security holder action).

[126] The Commission's annual reports show an increase from 156 proposals in 1966, 32 Sec. Ann. Rep. 52 (1966), to 293 proposals in 1970, and to 370 proposals in 1975, 41 SEC. Ann. Rep. 51 (1975).

[127] *See* SEC Staff Report on Corporate Accountability, Division of Corporate Finance, Securities Exchange Commission, presented to Committee on Banking, Housing, & Urban Affairs, U.S. Senate, 96th Cong. 20 Sess. 34-35, 143 (Sept. 4, 1980).

[128] Sadat-Keeling, *supra* note 42, at 176. "397 Letters were received from 383 commentators: 97 issuers, 7 law firms, 20 bar associations, 31 trade associations and unions, 2 securities industry organizations, 97 religious investors, 19 institutional investors, 104 individual investors and 6 legislators. Securities & Exchange Commission, Division of Corporate Finance, Summary of Comments, Shareholder Proposal Proposed Amendments Release 10 . . . The commission received comments from 207 commentators, 142 of

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would be curtailed by "requiring shareholders who put the company and other shareholders to the expense of including a proposal . . . to have some measured economic stake or investment interest in the corporation."[129] Accordingly, in 1983 the SEC again amended 14a-8 and required a shareholder proposal proponent to hold voting securities of at least one percent of the respective class of shares, or $1,000 in market value.[130] A proponent must have also owned his stocks for at least one year at the time the proposal is submitted.[131] This amendment seems to be aimed squarely at the small investor, and it does not take into consideration those investors abusing the proxy machinery and investors having a legitimate interest in making proposals to management. One percent is absurdly high when dealing with registered companies, considering the fact that nearly one-third of all stockholders have portfolios of less than $5,000.[132]

So at the end of a long line of attacks on 'abuses' of one kind or another, the small investor ends up confronted with security-for-expense statutes, Rule 11, and the imposition of minimum investment and holding requirements that must be met in order to make a proposal to the management of the corporation in which he or she is part owner. Although it seemed that these rules were enough barriers for the small investor, the Private Securities Litigation Reform Act of 1995[133] has further limited the small investor's right to hold corporate management accountable.

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whom supported the minimum investment requirement, the minimum holding period requirement, or both."

[129] Securities Exchange Act Release No. 20091, 48 Fed. Reg. 38, 218 (1983) (released Aug. 16, 1983).

[130] Sadat-Keeling, *supra* note 42, at 176. Pursuant to the rule proponents may aggregate their holding to meet the minimum investment requirements.

[131] *Id.* at 176.

[132] *See supra* note 3.

[133] Pub. L. No. 104-67, *see supra* note 1.

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V. THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

An interesting thing about the Private Securities Litigation Reform Act of 1995 (PSLRA) is that it may well be founded on a false premise. That premise is that there is an explosion of "frivolous" lawsuits being filed and it is costing some corporations and accountants a great deal of money.[134] The Securities and Exchange Commission, however, has denied the existence of any recent litigation "explosion" with respect to securities fraud suits.[135]

The question of whether or not the number of frivolous class actions involving securities fraud has grown substantially over time remains a matter of significant dispute.[136] Some empirical studies have suggested settlements in securities fraud cases may be largely determined by defendant's insurance, rather than by an analysis of the merits of the plaintiff's claims.[137]

In spite of the fact that the empirical evidence on the so-called 'litigation explosion' is suspect, many argue that the reform of the private securities fraud cause of action is justified solely due to the perception of a looming crisis.[138] What is interesting is the absence of any discussion of the substantial

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[134] *See, e.g.*, Jill N. Willis, *The Private Securities Litigation Reform Act of 1995: Friend or Foe of the Investor?*, 47 FLA. L. REV. 841, 842 (1995).

[135] *See* Edward Felsenthal, *Stadium-site Dispute Raises Ethics Issue*, WALL ST. J., June 18, 1993, at B4 (The number of securities cases in federal courts has not increased over the past two decades, and the increase in securities class action suits in the prior three years, while significant, does not constitute an "explosion.").

[136] Edward A. Fallone, *Section 10(B) and the Vagaries of Federal Common Law: The Merits of Codifying the Private Cause of Action Under a Structuralist Approach*, U. ILL. L. REV. 71, 76 (1997).

[137] *See* Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 497; William T. Carleton, et. al., *Securities Class Action Lawsuits: A Descriptive Study*, 38 ARIZ. L. REV. 491 (1996).

[138] *See* John W. Avery, *Securities Litigation Reform: the Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335, 340 (1938).

number of lawsuits that are settled because they are in fact meritorious. It seems that one of the ways one might keep fraud from being discovered is to settle any lawsuit that threatens to expose it. While it may be true that settling a non-meritorious lawsuit saves the company money, it may also prevent the discovery of fraud. To say that a drop in the price of stock is a sufficient reason to test whether or not there is fraud begs the question: What indicators does one look for in determining whether there is fraud in the management of a corporation when great efforts are made to keep it hidden if it exists? All the company has to do is provide a full and accurate description of what is happening in the company.

If the lawsuits are indeed frivolous, fighting them may very well be a better way of handling them than to cut the ability of the small investor to honestly question management. In new and technology driven companies, the only real indicators of what is going on are product announcements and stock prices. When there is a question about either of these in the minds of the small investor, he should have a right to sue.

It has been observed that:

> [t]he major reason for reforming the securities litigation system, however, is one of perception: no matter what the degree of actual dysfunction, many economic actors plainly believe that the system is harmful and counterproductive because of its invitation to frivolous or unnecessary litigation. The perception that we have a fair, controlled system is crucial. I have no doubt that fear of dysfunctional litigation is adversely affecting capital marketplace decisions: whether companies go public, whether foreign companies seek listings on our stock exchanges and NASDAQ, whether voluntary disclosure occurs (and in what form). Moreover, the same fear has produced an unfortunate judicial backlash, eroding otherwise salutary doctrinal standards, evidenced

> most recently by the Supreme Court's *Central Bank* decision.[139]

The SEC should do more to get the facts out about securities litigation rather than fix the system to respond to an inaccurate perception at the expense of corporate democracy and the small investor. All of the arguments of the proponents of the "litigation explosion" theory were challenged by Professor Joel Seligman in 1994, with an article based on the thesis that, "[w]ith limited exceptions, there is yet insufficient evidence to justify significant rule or legislative changes that would further burden private federal securities litigation. While there may be a few peripheral questions that deserve further investigation, the basic case for new legislation restricting private rights of action has not been made."[140] He lays down the argument that securities litigation has gotten out of hand and is destroying the very capital formation policy it seeks to promote and then explains how securities registration filings had steadily increased from 500 billion dollars to 868 billion dollars from 1991 to 1993.[141] He also counters the argument that an explosion in litigation results because companies "are sued whenever their stock drops," with data showing only 123.5 consolidated cases filed per year compared to 17,400 companies that file annually with the SEC.[142]

Professor Seligman's comments were not well received as the Republican Congress drove through the PSLRA over then President Clinton's veto in an effort to fulfill its 'Contract with America.'

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[139] *Id.* at 340.

[140] Joel Seligman, *Merits do Matter: A Comment on Professor Grundfaest's "Disimplying Private Rights Under the Federal Securities Laws: The Commission's Authority"*, 108 HARV. L. REV. 438 (1994) (In this article Professor Seligman states the fundamental arguments for the proponents of a change in the securities laws to contain the litigation explosion, and then destroys them.).

[141] *Id* at 439.

[142] *Id.* at 442.

A. Stricter Pleading Requirements Under the Act

To date, the PSLRA's stricter pleading requirements are the most litigated section of the Reform Act. There have been many cases that deal with the issue of clarifying the new pleading standards and whether or not the pleadings have met those standards.[143] The Act makes the standards for pleading significantly more specific for complaints filed pursuant to the Securities Exchange Act by requiring plaintiff to plead as to the defendant's state of mind. The purpose of the Act is to "establish uniform and more stringent pleading requirements to curtail the filing of meritless lawsuits."[144] Because liability is conditioned upon the defendant acting with a particular state of mind, the complaint must contain specific facts that give rise to a "strong inference" that the defendant possessed the requisite mental state;[145] a pleading standard that is difficult to meet in cases of fraud.

The increased pleading standards further require that the plaintiff plead and prove proximate causation as an element of the claim. These two increased pleading standard requirements, combined with the small investor's limited resources for investigation limit, even further, the small investor's right to hold corporate management accountable.

B. Reforming Class Action Lawsuits Under the Act

The second way that the PSLRA of 1995 has limited the rights of the small investor is through the PSLRA's reforms relating to class action lawsuits. As a means of curbing the ability of plaintiffs' attorneys to serve as the person initiating a

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[143] *See, e.g.*, Williams v. WMX Technologies, Inc., 112 F.3d 175 (5th Cir. 1997); In re Silicon Graphics, Inc. Securities Litigation, 970 F. Supp. 746 (N.D. Cal. 1997); In re Baesa Securities Litigation v. Buenos Aires Embotelladora, 969 F. Supp. 238 (S.D.N.Y. 1997); Krear v. Malek, 961 F. Supp. 1065 (E.D. Mich. 1997); Marksman Partners, L.P. v. Chantal Pharmaceutical Corporation, 927 F. Supp. 1297 (C.D. Cal. 1996).

[144] H.R. CONF. REP. No. 104-369, at 740.

[145] 15 U.S.C. § 78u-4(b)(2).

class action lawsuit, the PSLRA placed limitations on who could act as the class representative. The Act requires plaintiffs, who want to serve as class representatives, file sworn statements that they have reviewed the complaints, did not purchase stock at the direction of counsel as a means of qualifying as class representative, and do not intend to accept any payment for serving as class representatives.[146] The Act's provisions further provide that a court should presume the plaintiff with the "largest financial stake in the relief sought"[147] is the most appropriate lead plaintiff of the class.[148]

The presumption that the individual with the "largest financial stake in the relief sought" is the most appropriate lead plaintiff is fatally flawed. The assumption is the lead plaintiff will be an institutional investor, because in today's securities exchange market, an institutional investor will likely be the entity with the largest financial stake in the relief sought.[149] The

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[146] 15 U.S.C. § 78u-4(a)(2)).

[147] In M. Greebel et al. v. FTP Software, Inc., 939 F. Supp. 57 (1996). The plaintiff brought an action on behalf of himself and other similarly situated, and then moved to be appointed lead plaintiff. In granting the motion, the court stated:

> In making this determination, the statute erects a rebuttable presumption that the most capable plaintiff is the person with the largest financial interest in the relief sought by the class, and 'otherwise satisfies the requirements of Rule 23 of the Federal Rules of Civil Procedure.' The presumption may be rebutted only 'upon proof by a member of the purported plaintiff class that the presumptively most capable plaintiff 'will not fairly and adequately protect the interests of the class' or is 'subject to unique defenses.'

Id. at 58 (quoting 15 U.S.C. § 78u-4(a)(3)(B)(iii)(II)).

[148] 15 U.S.C. § 78u-4(a)(3).

[149] Scholars predict that increasing the role of institutional investors will benefit both injured shareholders and courts:

> Institutions with large stakes in class actions have much the same interests as the plaintiff class generally; thus, courts could be more confident settlements negotiated under the supervision of institutional plaintiffs were 'fair and reasonable' than is the case with settlements negotiated by unsupervised plaintiffs' attorneys.

Greebel, 939 F. Supp. at 64.

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problem with this presumption is that most institutional investors are "fiduciaries" that are responsible for managing other people's money. As such, they have an obligation to maximize profits on all investments in which they participate. As a result of this fiduciary relationship, it appears that an institutional investor, who serves as a fiduciary and is appointed lead plaintiff, may find himself or herself faced with a conflict of interest. The conflict is as follows.

Assume an institutional investor (pension fund A) holds a substantial amount of stock in company ABC. ABC is sued for violating Rule 10b-5 for fraud. Assuming the PSLRA's stricter pleading standards are met, and there is a "strong inference" that some fraud has occurred, the institutional investor must, under his fiduciary duty to his investors, consider whether to hold or sell its stock in ABC. If discovery procedures uncover serious fraud, the institutional investor most likely has a duty to unload all, or substantially all, of his stock in ABC. This runs full circle back to a plaintiff with a relatively small investment in ABC. If the institutional investor does not dispose of ABC, the institutional investor may face problems when responding to inquiries about why he or she held onto stock in a company where fraud had occurred. This results in the investor losing money due to plummeting stock prices. There does not appear to be an acceptable answer to this problem.

A better approach would require the lead plainitiff have a minimum investment. The minimum investment will lessen the above-mentioned conflict, and also enable the small investor to preserve his rights.

C. Delaying Discovery and Proportionate Liability Under the Act

In addition to "reforming" the pleading and class action procedures, the Act has also attempted to reform discovery in private securities litigation cases. The Act has provisions requiring that discovery be delayed until the defendant has the

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opportunity to file a motion to dismiss, which can postpone the running of litigation costs to the corporate defendant.[150]

The Act also institutes a new scheme of proportionate liability, where a defendant may be held liable only for that portion of the judgment that he is responsible for. "In many cases, this amounts to a reduced recovery for innocent investors and small investors."[151] The Act's proportionate liability rule applies whether the defendant has been found liable for unintentional (i.e., reckless) violation of the Securities Exchange Act, and neither of the following scenarios exist: (a) the plaintiff has a net worth of less than $200,000 and is entitled to damages in excess of ten percent of his net worth, or (b) a co-defendant is insolvent and cannot pay his share of damages.[152]

D. Strengthening Rule 11 Under the Act

Additionally, the PSLRA limits the rights of the small investor by making Rule 11 of the Federal Rules of Civil Procedure much stronger in its application to private securities actions. The Act specifically requires a court enter findings relating to an attorney's compliance with his or her obligations under Rule 11.[153] Where the court determines that Rule 11 has been violated, the imposition of sanctions is mandatory. There is a rebuttable presumption that sanctions will take the form of attorneys' fees and costs.[154] In a class action, the court has the authority to require an undertaking from the attorney for the class to provide for the payment of fees and expenses ultimately awarded under Rule 11.[155] Once again, this provision further deters the small investor from holding corporate management accountable.

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[150] *See* H.R. CONF. REP. No. 104-369, at 736 (1995).

[151] *See* Alan S. Ritchie, *The Proposed "Securities Private Enforcement Reform Act": The Introduction of Proportionate Liability into Rule 10b-5 Litigation*, 42 CLEV. ST. L. REV. 339 (1994).

[152] *See* 15 U.S.C. § 78u-4(f).

[153] 15 U.S.C. § 78u-4(c)(1).

[154] *Id.*

[155] 15 U.S.C. § 78u-4(a)(8).

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E. New Safe Harbor for Forward-Looking Information

Another significant reform coming from the PSLRA is the creation of a safe harbor for the disclosure of forward-looking information.[156] Congress' concern that frivolous litigation has discouraged corporate management from disclosing internal projections and similar forecasts was the impetus for creating the new safe harbor provision.[157]

Any public statement that satisfies the requirements for the safe harbor cannot be the basis for private liability if either of two tests is satisfied. First, no private liability may be imposed for forward-looking statements made without actual knowledge that the statements were false or misleading.[158] Rule 3b-6 states that forward-looking statements in documents filed with the SEC shall not be deemed fraudulent unless made without a reasonable basis or in bad faith.[159]

Second, no private liability is possible if the forward-looking statement is identified as such when made and is accompanied by meaningful cautionary language identifying significant factors that might prevent the statement from

[156] *See* 15 U.S.C. § 78u-5. Securities Act Release No. 7101, 59 Fed. Reg. 52,723 (Oct. 19, 1994) provides:

> The term 'forward-looking statement' is defined in current Rule 175 as limited to the following: (1) A statement containing a projection of revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure or other financial items; (2) A statement of management's plans and objectives for future operations; (3) A statement of future economic performance contained in management's discussion and analysis of financial condition and results of operations included pursuant to Item 303 of Regulation S-K or Item 9 of Form 20-F; or (4) Disclosed statements of the assumptions underlying or relating to any of the statements described in (1), (2), or (3) above. 17 C.F.R. 230.175.

[157] *See* H.R. CONF. REP. NO. 104-369, at 741-42 (1995).

[158] *Id.*

[159] 17 C.F.R. § 240-3b-6 (1995).

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becoming accurate.[160] The "bespeaks caution" doctrine holds that forward-looking statements are not actionable if accompanied by cautionary language because (a) such statements may be immaterial as a matter of law, and (b) plaintiffs are not entitled to justifiably rely upon such statements.[161]

This safe harbor provision is unfavorable to both the small and large investors. The management can be protected even though misleading statements are released as long as the statements are based on past financial performance or estimated future performance. Whether it is reasonable or wishful thinking is almost impossible to determine, and it is focused on having the ability to accurately predict the future. "The [Private Securities Litigation Reform Act] which has gone too far . . . have changed the safe harbor provisions to the point where actual lying is permitted . . . ."[162]

VI. CONCLUSION

The Private Securities Litigation Reform Act has serious unintended consequences. When Congress is pressured by a group of lobbyist to enact this type of legislation, which is beneficial only to the group represented by the lobbyist, the consequences are evident to the group adversely affected. However, the group of "small investors" continue to have the availability of the unsatisfactory "Wall Street" rule for their ultimate protection.

Perhaps corporations should not have the ability to quickly settle what they consider frivolous lawsuits. Corporations and plaintiffs should be held accountable for their actions. Eventually lawyers and their clients, who abuse the legal process, will understand it is not advantageous to pursue frivolous litigation. This scenario will resemble other investments where the return will be realized within a few years with a significant decrease in "frivolous litigation." In addition, stockholders should

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[160] *Id.*

[161] Avery, *supra* note 138, at 344.

[162] 141 Cong. Rec. H15214-06, H15217.

understand this position benefits the long-term interest of the company. Fraud and misrepresentation are present in the market place, and the ability of a "small investor" to act as a private attorney general should not be limited, particularly in view of the financial constraints that can be imposed on the Justice Department, the Securities and Exchange Commission, and the Federal Trade Commission.

The "small investor" has an informational disadvantage in terms of detecting fraud and misrepresentation, and is severely limited in his ability to get information that is not published by corporate management. This statute promotes as well as permits misrepresentation and fraud, which may be less likely to be discovered. It will be virtually impossible to determine whether there is a factual basis for any forward-looking statement. Furthermore, the pleading requirements will prevent the meritorious and the non-meritorious cases.

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