Proposition 211: A Random Tax on Investors

Susan E. Woodward

In 1995 Congress passed the Private Securities Litigation Reform Act. On December 22, 1995, the Senate joined the House in overriding President Clinton's veto of the bill. The act applies to all cases filed in the federal courts since its enactment.

The battle for securities litigation reform, however, is not over. The companies that fought for the reform, especially the high technology firms (computers, electronics, and pharmaceuticals) are enraged over the president's veto. Despite having contributed to Clinton's 1992 election campaign, they are now giving to other candidates, or not giving at all. Their concern is well placed.

The trial lawyers who fought against the reforms have not given up. In California they have sponsored an initiative on the November ballot, Proposition 211, which would effectively allow Californians to circumvent the Private Securities Litigation Reform Act and make it even easier to sue for securities fraud than it was under prereform federal law. And President Clinton, in another Olympic-class back flip, recently declared his opposition to Proposition 211 in a speech in Silicon Valley. A substantial amount is at stake in this election. From 1990-93, settlements of class action securities suits in California, most against high technology firms, amounted to more than $500 million. More costly to the economy is the chilling effect of these suits in discouraging investors, company officers and directors, accountants, stockbrokers, and pension fund managers from involvement with any firms that are especially vulnerable.

Who will win and who will lose if Proposition 211 passes? One group of winners is very clear: the lawyers in California who make a living suing for securities fraud. If Proposition 211 passes, it will be easier for lawyers to sue than it is now and they will be able to maintain control over suits without taking direction from their clients. Best of all for those California lawyers, any company with a shareholder in California could be sued. And it is a rare public company that does not have at least one shareholder in California.

The losers' circle is equally clear: It includes anyone with an interest in the vitality of U.S. equity markets, particularly long-term holders of diversified equity portfolios. As this article will show, Proposition 211 is effectively a random tax on investors with relatively large, adverse effects on high technology firms.

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The Logic of Securities Law

Let us first examine the logic of securities law. Securities fraud suits nearly always are filed after a sharp decline in the price of a company's stock. The suits claim that an earlier disclosure made by the company was either inaccurate or failed to contain important information, usually bad news. The suits claim that the investors who purchased stock between the time when accurate disclosure should have been made and the time when accurate disclosure actually was made were harmed because they paid too much for their stock. The suits seek recovery for these buyers. Of course anyone who sold during this time gained from the delayed disclosure, but these suits ignore the sellers; instead, they pit the defrauded buyers against the long-term stockholders.

Now let us suppose that upon disclosure, the stock price fell fifteen cents per share, net of all the influences outside the company itself. And let us further suppose that the total number of shares purchased (net inside and outside) was 100 million. Then the total "damages" would be $.15 x 100 million, or $15 million. This money then is collected from the company—implicitly from everyone who is a shareholder at the time of the settlement—and paid to those who bought during the damages period, and their lawyers. The lawyers typically get one-third of the settlement damages, in this example $5 million, presumably because they worked hard and took the risk that they would be paid only if the case succeeded.

So here is what actually happened: The stock price fell fifteen cents due to some bad news; those who paid too high a price were compensated ten cents per share, and two sets of lawyers were each paid five cents per share. In a narrow sense, the "damaged" buyers who paid too high a price are better off having sued because at least they got back ten of their fifteen cents. But whether they are better off in the long run with more of these suits depends on whether this purchase is an isolated event in their lives, or part of a continuing diversified investment program.

Long-term, diversified investors are made worse off, not better off, by frequent suits of this type. They hold stock in many different companies over long periods of time. Once in a while they will find themselves among the "damaged" buyers and will receive compensation. But far more often they will be on the paying side. Suppose they were on both sides in equal proportion. Then, if there were no leakage they would not care whether or not these suits happened; payments and receipts would net zero. But there is leakage: for every dollar of compensation to an investor, another dollar is paid to legal counsel. Among the three parties—buyers, long-term stockholders, and lawyers, the game is zero sum. But among past and future shareholders, it is a losing game.

And here is the real fraud in Proposition 211: It is hailed as the "Retirement Savings and Consumer Protection Act." Retirement savers are exactly the people who are made worse off, not better off, when suits are frequent. A large proportion of total savings in the country is retirement savings that go into big, defined benefit pension plans, usually company or government pension plans that hold diversified long-term portfolios. Or the savings are placed in mutual funds via individual retirement savings plans such as the 401K. Mutual funds also are large, diversified portfolios. Thus, we are talking not about individuals who put all of their money into one company's stock, but about investors, including small investors, whose portfolios contain thousands of different securities.

The bottom line consequence of Proposition 211 would be a random tax on investors who would pay half to the current security buyers and half to lawyers. Clearly this does not make long-term investors better off.

Why "Fraud on the Market" Suits Rattle High Tech Firms

The high technology firms, which are twice as likely to be sued for securities fraud as firms from other industries (and more likely to be located in California), feel especially victimized by the way securities fraud suits work. What precipitates most suits is a company announcement followed by an immediate, sharp drop in the stock price. Plaintiff lawyers follow the stock market closely, alert for an opportunity to sue. The lawyers claim that the announcement corrected some earlier inaccuracy or omission. Just by filing the suit, plaintiffs force the defendant firm to spend considerable resources preparing a legal defense. To avoid further expenditures, it is often in the interest of the defendants to settle the case. Virtually all class action securities suits settle before trial. Given the nature of the fraud suits, technology firms whose stocks are more volatile than average are vulnerable to being held up by plaintiff lawyers whenever their stock prices suddenly drop.

Economists partly are responsible for the shape these suits take. Beginning in the 1960s, securities fraud suits began to reflect the growing body of evidence supporting the theory of efficient markets. This theory holds that at any given time, securities prices reflect all information that is available publicly. If this theory is right, investors should not be able to devise market-beating investment strategies by using information that is already available to the public. Many studies now support this theory. On average all securities are correctly priced—that is, they are priced competitively and efficiently. Investors can presume market prices reflect all available information.

Class action securities suits almost never are brought by investors; they are brought by lawyers.

Market efficiency has several important implications for securities fraud litigation. First, prices reflect all publicly available information regardless of whether all investors are aware of the information. The evidence that markets incorporate information swiftly and accurately is so strong that reasonable investors should find it wasteful to spend time trying to determine whether individual securities are overpriced or underpriced. This means that if the price of a security is inflated due to inaccurate or incomplete disclosure, not only those who read and relied on the disclosures but also those who simply bought at the price resulting from the disclosure paid too much. This is the essence of the fraud-on-the-market theory behind virtually all class action securities fraud litigation today.

Moreover, the market price that prevails when a company releases inaccurate information reflects the market consensus as to the value based on that wrong information. Another implication of efficient markets is that when the fraud is resolved—that is, when inaccuracies or omissions are corrected, the resulting price reflects the true value. The change in price resulting from the correction offers a measure of the impact of the fraud, and thus a measure of the amount by which investors were misled. Thus, investors who bought while the inaccurate news prevailed paid too much, and those who sold received too much.

The Supreme Court examined the fraud-on-the-market approach in *Basic v. Levinson* (1986). The Court upheld the notion that individual investors need not demonstrate that they relied on particular inaccuracies in order to establish that they were harmed thereby. The Court also blessed the change in market price upon correction as a measure of the amount by which investors were misled. After *Levinson*, the volume of private, class action securities suits doubled. The volume of similar cases brought by the Securities Exchange Commission, however, remained unchanged.

Class action securities suits almost never are brought by investors; they are brought by lawyers. The only involvement of actual investors prior to settlement is that the lawyers must rustle up a nominal investor as a class representative in order to bring an action, and must give notice to members of the class once it has been certified by the court. Given the nature of the evidence in these suits, it is easy for these actions to be lawyer driven. The evidence—the reaction of prices to various announcements—is entirely in the public domain. No investors need be deposed. In fact, most investors, even institutional investors, are usually unaware of any proceeding until a settlement is at hand, despite the requirement for notifying class members.

Who are the class members? Fraud-on-the-market suits identify a damages period—the period between a disclosure containing inaccuracies or omissions and a subsequent disclosure or event that corrected the inaccuracies or omissions. Because the inaccuracies caused the price to be too high, all who bought during the damages period and held at least until the inaccuracies were corrected were net losers. Those who sold during the damages period and held at least until the inaccuracies were corrected received too much, and were net winners. Those who both bought and sold during the damages period, in the simplest cases, were unharmed.

Who is sued and why? The suits are driven by the size of potential damages. The earliest suspicions were that companies with more volatile stocks are more likely to be sued—they are, but this is not the end of the story. The stock market factors that are most strongly associated with the likelihood of a suit are the turnover, or volume of trading in the stock, and firm size (measured as the dollar value of the company's outstanding stock). The higher the turnover, the more investors who bought during any particular period, and thus the larger the number of investors who were potentially harmed. And the larger the company, the larger the investment affected by any announcement. Other important factors are performance over the previous year (worse than average performance invites a suit), and recent return volatility (higher volatility is associated with suits). But even after accounting for these stock market factors, high technology firms still are more likely to be sued than companies in other industries with the same turnover, capitalization, volatility, and performance.

The factors that high technology firms have in common, even in very different lines of business, give some clues about why they are so vulnerable. The three industries usually identified among the high technology are computers, electronics, and pharmaceuticals. These industries are special in important aspects of finance and organization. First, they have very little debt because they are financed almost entirely with equity. Even pharmaceutical firms, many of which are large, old, established firms, have virtually no debt. In addition, they are typically closely held, meaning that a small group of individuals, often a family, owns a significant, controlling fraction of the stock. Newly listed companies nearly always have more than half of the stock held by insiders who have a role in managing the company. Again the pharmaceuticals are notable because they are still closely held, even after many decades of being public companies and even after having grown enormously.

All of these features—low debt, close ownership, and control—call for explanation because debt has big tax advantages for corporations and diversification has big benefits for every portfolio. So here we have companies that take little advantage of the tax benefits of debt and whose owners take less advantage of diversification than they could. What is special about these lines of business? They are complex, and their assets are very plastic. The assets of these businesses mainly are ideas. The ideas are difficult to pin down, changing easily and often. Computer programs, even commercially successful ones, are updated continuously. The research that pharmaceutical firms do produces results that often modify their future progress. It is thus more difficult for parties outside these companies, for example bondholders and outside equity holders, to know what is going on inside the company in the way that the shareholders of a steel manufacturing plant could know what is going on in their company. In addition, it seems that the interests of owners and managers must be closely aligned in high technology firms. Owners cannot just give managers instructions to maximize profits, go about their own business, and expect good results. The managers must be owners.

These factors that cause high technology firms to be closely held and debt free can be thought of as difficult, or high cost communication. When communication is difficult, disagreements result. This is consistent with the high turnover in the stock of these companies. If everyone agreed on the significance of all news for these companies, news would change stock prices but would not generate a lot of trading. Trading occurs when people change their minds and have differing opinions. Sometimes these disagreements degenerate into disputes and litigation results. Thus, it is not so surprising that companies whose finances and ownership structures are shaped by high cost communication with securities holders would also be prey to more securities litigation.

The Securities Litigation Reform Act vs. *Proposition 211*

The Private Securities Litigation Reform Act of 1995 contained several important provisions that Proposition 211 seeks to overturn. The overall impact of the reform act will be to reduce the frequency of civil, class action securities fraud suits. Proposition 211 would more than reverse several provisions of the reform act.

Safe Harbor

The most eagerly sought provision is a "safe harbor" for forward-looking statements in company disclosures. A significant proportion of securities fraud suits is based on forecasts and other forward-looking statements that were not met. Under the reformed law, most forecasts are not actionable if they are "accompanied by meaningful cautionary statements identifying factors that could cause actual results to differ materially from those projected." (The new safe harbor does not apply to forecasts included in financial statements, to roll ups, private transactions, tender offers, or initial public offerings.) Of course, establishing that appropriate cautionary statements were made still will be harder for high technology companies than for those in other industries; but even for them, the safe harbor should preclude some suits. Proposition 211 would eliminate the safe harbor created by last year's reform act.

Damage Estimates

Another provision that limits suits under the reform act concerns how damages should be computed. The bill requires that damages cannot exceed the difference between the purchase or sale price paid by the plaintiff and the average trading price of the security during the ninety days following the date of the correction (or the sale price, if the investor sells during the ninety days). The approach to damages that had been typical in fraud-on-the-market cases, based on efficient markets, took the difference between the value precorrection and the value postcorrection. The new law requires that one look, not just at the price immediately following the correction, but at the average price for the ninety days following the announcement.

The economists who have contributed to the research on efficient markets would say that this ninety-day window does not make much sense because the price movements after the first day or so have nothing to do with either the fraud or its correction. But neither the defendant firms nor their lawyers were ever so confident as the economists that this was the right approach. Evidently, neither were the legislators.

However, the research on patterns of change in stock prices gives a clear prediction of the impact of the new damage-calculation rule. The research indicates that day-to-day stock prices are as likely to go up as down. This implies that over any ninety-day window, stock prices on average will rise for half of all companies and fall for the other half. For some substantial fraction, but less than half, stock prices will rise enough to make the difference between the precorrection price and the ninety-day average price positive rather than negative, precluding any recovery at all. And, because high technology companies have higher than average stock price volatility, a larger fraction will escape liability due to rising stock prices postcorrection. Proposition 211 would eliminate this alteration of damages calculation in the reform act.

Officers and Directors

Most companies now protect the personal assets of officers and directors against claims involving company-related activities by insurance and indemnification. Proposition 211 not only authorizes punitive damages, it also bars any indemnification of these damages, and current California law does not permit insurance of punitive damages. This would fully expose company officers and directors to any punitive damages awarded by a court and further strengthen a defendant company's incentive to settle claims out of court.

Liable Parties

Proposition 211 substantially expands the scope of potential liability beyond that authorized by the 1995 reform act or current California law. The standard for "aiding and abetting" claims is weakened but full joint and several liability is retained; this exposes even marginal defendants to potentially catastrophic liability. The initiative also creates a new class of liability for managers of pension funds.

Lead Plaintiff

Perhaps the most interesting and provocative requirement of the reform act is its requirement to select a lead plaintiff. The act prohibits professional plaintiffs by limiting individuals to no more than five class actions in any three-year period and prohibiting payments to class representatives or referrals to brokers who find a class representative. Within twenty days of filing a securities class action, the filing plaintiff must publish a notice of the suit describing the claims and inviting class members to be named lead plaintiff. From those who express interest, the court must appoint a lead plaintiff to represent the class. The lead plaintiff has the power to select counsel for the class. This means that the lawyers who file the original suit may not end up as counsel to the class. Trial lawyers evidently found this provision of the reform act very distasteful as Proposition 211 eliminates all mention of clients as lead decision-makers for the litigation.

The class member with the largest stake in fraud-on-the-market suits nearly always will be a financial institution—a mutual fund or pension fund. On average, the largest claimant in class action suits accounts for 14 percent of the dollar value of claims. The second largest claimant accounts for 7 percent, the largest ten account for 41 percent, and the largest fifty account for 57 percent.

Most such institutions hold diversified portfolios. They may still own the stock whose purchase made them members of the class. In addition, they may have stock in the same company purchased at other times. Members of the class who bought during the damages period and held until after the correction paid "too much" for that stock. On any stock still held and any stock purchased at other times, members also bear part of the cost of the suit. What are the costs? Plaintiff lawyers typically receive about one-third of the total recovery. As noted earlier, it is conservative to estimate the defendant's legal costs as equal to the plaintiff's legal costs. This means that total cost to the defendant is 4:3 of damages, and the plaintiff's recovery is 2:3 of damages, thus making the total cost about double the plaintiff's recovery.

The cost calculations can give us an indication of the interests of different class members. Those who bought during the damages period and sold after the damages period, and no longer hold any stock in the company, would certainly want the suit to proceed and would be indifferent to additional legal costs. Those who still hold stock bought during the damages period, but no other stock in that company, would want the suit to proceed, because for each dollar of recovery the suit costs this plaintiff some fraction of a dollar smaller than one-half, but the plaintiff still would have some interest in containing legal costs. But for those who own additional stock bought at other times, the interest can turn around. Since the legal costs are borne equally by all holders of the stock postcorrection, a class member's proportionate holdings need only to exceed his proportionate claim on damages by double (given the prevailing legal fee structure) in order for the plaintiff to wish to drop the suit entirely. For example, if a plaintiff held 5 percent of the dollar value of potential plaintiff claims, but overall held 10 percent of the company stock, the plaintiff's legal costs would cancel its recovery. Putting this plaintiff in charge of the proceeding could kill the suit, or if the judge is very alert, result in failure to certify the class as all who purchased (and did not sell) during the damages period.

Potential conflicts of interest among those who purchased during the damages period, of course, are not a product of the reform act. The conflicts have always been present but were only recently acknowledged in Judge Walker's decision in *Seagate Technologies II*. But the reform act, in its requirement to identify and appoint a lead plaintiff—who may also be a large stockholder—will force courts to focus on the issue, and will be a step toward putting members of the class, rather than lawyers, in the position of leadership.

Active recruiting of institutional investors to play a larger role in fraud-on-the-market suits could have an even larger impact in the long run as institutions are forced to consider their long-run interests in these suits. These institutions are the vehicles for retirement savings discussed earlier, which mainly lose rather than gain from a higher volume of securities fraud litigation. A holder of a large diversified portfolio will find himself a member of the class in many class action securities suits. In some suits, his recovery will exceed his costs. When he is not a plaintiff, he will have costs but no recovery. But on average, these suits will generate net losses for securities' holders because of the leakage to lawyers. The reform act pushes in the direction of allowing institutions to pursue investors' best interests in minimizing legal costs. Proposition 211 would raise the legal costs, and raise them beyond what they were before the 1995 reform act.

Disclosure and the Market for Capital

The success of a market economy depends on the integrity of the system. This requires a culture that encourages people who make deals to deliver on their promises and a legal system that can resolve honest disputes without great expense. For corporations with stock held by the public, part of the honesty lies in regular and complete disclosure. What is the role of fraud-on-the-market suits in promoting regular, full disclosure and honest markets?

In the simplest analysis, the types of suits discussed here involve pure transfers—some investors bought at too high a price, some sold at too high a price. Moreover, the issue is not "no disclosure" but "late disclosure." If a disclosure is never corrected, there is never a stock price reaction to the correction, and hence no suit. On net and on average the social loss is zero, gross of legal costs. From a portfolio point of view, and most investors are portfolio holders, the suits simply represent a form of leakage that reduces returns on their investments.

The more subtle social costs and benefits of more timely disclosure are difficult to assess. Perhaps when one stock is incorrectly priced, it causes others to be mispriced too. In these cases, real new investments are made resulting in a net social loss. If so, plaintiff lawyers are missing an opportunity. If not, the social cost of late disclosure is all the more elusive. But it does seem that a random tax on long-term investors, half of which is paid to legal counsel, is not the appropriate remedy.

In any case, it is clear that California's Proposition 211 will not help the investors it purports to help. It is a bald attempt to restore and extend the tax that lawyers impose on investors through securities litigation. If we are not sure what steps to take to promote timely and full disclosure without high legal costs and disruption of business activities, we at least can be sure that the right way to lean is toward the 1995 reform act, *not* toward Proposition 211.