THREE KEY *LEGAL REFORMS*


By **James Copland**, Senior Fellow &
Rafael Mangual, Project Manager*

To jump-start economic growth and increase employment, the incoming Trump administration and GOP-led Congress should make reforming America's legal system a priority. In particular, they should move to curb lawsuit abuse, to reduce the regulatory threat placed on innocent businesses and individuals through the federal criminal law, and to fix shareholder voting to prevent special interests from foisting political agendas on companies outside the legislative process. Each of these reforms can be achieved in part without legislation, by reversing Obama-era administrative agency actions, though more lasting change would require congressional action.

1. **Curb Lawsuit Abuse**
2. **Reduce Federal Overcriminalization**
3. **Eliminate Politics in Shareholder Voting**

1.

Curb Lawsuit Abuse

POLICY RECOMMENDATION:
Reverse Obama administration agency actions that threaten private arbitration as a useful alternative dispute-resolution mechanism that lowers litigation costs.

Evidence shows that, after controlling for variations in case characteristics, consumers are more likely to prevail in arbitration than in court and that there is no significant difference in awards between the two avenues. Nevertheless, Democratic Party leaders in Congress have long sought to advance legislation to curb the use of arbitration clauses in contracts, which would impose costs on all Americans but enable trial lawyers to collect substantially more fees.

Although these legislative efforts have been largely unsuccessful, the Obama administration has taken agency action to try to eliminate arbitration clauses in contracts involving nursing-home care,

*A longer version of this paper, with references, is available upon request. Please e-mail **rmangual@manhattan-institute.org**.

financial services, and labor law. The Trump administration can reverse each of these executive-branch actions.

POLICY RECOMMENDATION:
Amend the Federal Rules of Civil Procedure to incorporate "loser pays" principles for civil litigation in federal courts.

In the American legal system, unlike in almost every other country in the developed world, the losers in a lawsuit do not have to reimburse the winners' costs. In combination with open pleading standards and onerous civil-discovery rules, this feature of American law enables nuisance litigation: a defendant in a lawsuit knows that it will incur substantial costs to defend the suit, which gives substantial settlement value even to lawsuits with a low probability of success. Almost every economist who has studied loser pays predicts that it would, if adopted, reduce the number of low-merit lawsuits. A loser-pays rule would also encourage business owners and other potential defendants to try harder to comply with the law, which should produce fewer injuries.

The Federal Rules of Civil Procedure could be amended by Congress to incorporate loser-pays principles in federal courts. Rule 68 in the Federal Rules has an "offer of judgment" provision in which a party to litigation may make an offer to settle the case—and "[i]f the judgment that the offeree finally obtains is not more favorable than the unaccepted offer, the offeree must pay the costs incurred after the offer was made." These costs have not, however, included attorneys' fees. To avoid legal gamesmanship, an offer-of-judgment rule that included attorneys' fees would have to tie the amount of any fee award to the size of the parties' settlement offers, and courts would have to require parties to show capacity to pay fees—including through an insurance policy or assumption of risk by the plaintiffs' attorney—to proceed post-offer.

2.

Reduce Federal Overcriminalization

POLICY RECOMMENDATION:
Enact a default mens rea standard and regulatory-crime reporting requirements under federal law.

There are now more than 300,000 federal crimes on the books, more than 98% of which were never voted on in Congress but were created through regulatory rule-making by administrative agencies. The overwhelming majority of these crimes do not involve conduct that we intuitively view as wrong—crimes like murder, rape, assault, and burglary—but rather are violations of regulatory compliance. For example, walking a dog in a federal park area on a leash longer than six feet is punishable by up to six months in federal prison. Another example: The chief engineer of a military retirement facility diverted a storm drain when a facility that housed sick veterans was flooded by backed-up sewage. The runoff from the diverted drain ran into a creek, and the feds successfully prosecuted the engineer for violating the Clean Water Act.

Traditionally, in American law and in the British law upon which it is based, the government had to show a "guilty mind" to convict someone of a crime, as opposed to levying a civil penalty. Now such protections are often the exception. A study by the Heritage Foundation and the National Association of Criminal Defense Lawyers found that 57% of the 446 nonviolent crimes proposed in the 2005–06 Congress lacked an adequate criminal-intent requirement. Twenty-three percent had no criminal-intent requirement whatsoever.

In November 2015, Democrats and Republicans on a bipartisan task force introduced legislation that would clean up the federal criminal code, require administrative agencies to report to Congress regulations that carried potential criminal penalties, and require the government to show criminal intent to obtain a criminal conviction unless Congress had expressly said otherwise—a requirement paralleling that in at least 15 states, as well as the Model Penal Code upon which most state criminal codes are based. A similar criminal-intent bill was introduced in the Senate the next day.

The Trump administration and GOP leadership in Congress should work to advance this commonsense legislation.

3.

Eliminate Politics in Shareholder Voting

POLICY RECOMMENDATION:
Reinstitute a shareholder-proposal rule that would allow companies to exclude from corporate proxy ballots ideas related to general social, policy, or economic concerns.

In 2016, half of shareholder proposals have related to a social or policy issue that may not be related—or at least has an attenuated relationship—to share value. Common examples include proposals relating to climate change and other environmental concerns, corporate political spending or lobbying, employment diversity, human rights, and animal rights. Multiple proposals last year asked companies to develop a code of conduct for employment practices in areas governed by Israel and the Palestinian Authority.

These kinds of proposals have consistently failed to garner broad shareholder support. Among the companies in the Fortune 250, 1,444 shareholder proposals related to social or policy concerns were presented to shareholders over board opposition from 2006 to 2016, and 1,443 failed to garner majority shareholder support.

The ultimate test of whether shareholder proposals are an effective tool—at least from the standpoint of the average diversified investor—is not whether they win majority shareholder support but whether they enhance share value. Individual investors might, of course, have different priorities, and certain institutional investors, such as "socially responsible" investing funds, are designed to have different priorities. But shareholder value *is* the orienting concern for most equity investors.

Moreover, such concerns are implicit in the fiduciary *duties* that pension funds owe to retirees. And there is some evidence that social-issue shareholder proposals by pension funds may be at the direct expense of the average investor's financial interests.

Before the 1970s, the SEC allowed companies to exclude shareholder proposals from their proxy ballots if the proposals were introduced "primarily for the purpose of promoting general economic, political, racial, religious, social, or similar causes." In 1976, the SEC essentially inverted its long-standing rule: since that time, the agency's position has been that a company may not exclude from its proxy ballot any shareholder proposal that "involve[s] any substantial policy or other considerations."

In light of the evidence that shareholders overwhelmingly reject shareholder proposals focused on social or policy issues and the potential that such proposals may undermine company stock prices, the SEC should revert to the old rule. The commission could take such action without congressional legislation.

POLICY RECOMMENDATION:
Increase the threshold stock-ownership requirements for submitting shareholder proposals, as well as the vote requirements for resubmitting failed proposals on subsequent ballots.

Under the SEC's current rules, shareholders sponsoring a proposal for inclusion on the company's proxy ballot need only own $2,000 of stock for one year to introduce a proposal.

A very small group of individuals and their family members—often referred to as "corporate gadflies"—repeatedly file substantially similar proposals across a broad set of companies. Submission of shareholder proposals is not cost-free to the company and other shareholders—and the direct cost of printing and distributing proposals alone is well above the SEC's threshold for sponsoring a proposal.

Typically, these individuals own very small percentages of a company's stock. For instance, John Chevedden, the most active sponsor of shareholder proposals dating back to 2006, has made substantially the same proposal at Ford Motor Company each of those years, individually or through a family trust. In its 2016 proxy statement, Ford disclosed that Chevedden owned 500 shares of the company's stock—an investment valued at $6,750 at the close of trading on the company's March 16 record date—approximately 0.00001% of the company's market capitalization. All told, Chevedden and four individual gadfly investors and their family members sponsored 29% of all shareholder proposals from 2006 to 2015; six gadfly investors and their family members have sponsored one-third of all shareholder proposals to date in 2016.

The SEC should strongly consider substantially increasing the ownership thresholds for submitting shareholder proposals, as well as substantially increasing the required vote to resubmit failed proposals.