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SETTLEMENTS IN SECURITIES FRAUD CLASS ACTIONS: IMPROVING INVESTOR PROTECTION

by
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INTRODUCTION

In 1941, Harry Kalven, Jr. and Maurice Rosenfield suggested a new use for class action lawsuits based on the emerging marketplace for publicly traded securities.[1] Kalven and Rosenfield argued that the securities markets had become so complex that investors had little incentive to seek remedies under the Securities Act because the cost of prosecuting a claim far surpassed the expected recovery.[2] To remedy this problem, the authors proposed using civil class actions to police abuses in the securities markets – a theory that would later be dubbed the "private attorney general."[3] The

[1]*See* Harry Kalven, Jr. & Maurice Rosenfield, *The Contemporary Function of the Class Suit*, 8 U. CHI. L. REV. 684 (1941).

[2]*See id.*; *see also* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 569 (1992).

[3]The term was coined by Judge Jerome Frank of the United States Court of Appeals for the Second Circuit. *See Associated Indus. of New York State, Inc. v. Ickes*, 134 F.2d 694, 704 (2d Cir. 1943) ("[T]here is nothing constitutionally prohibiting Congress from empowering any person, official or not, to institute a proceeding involving such a controversy, even if the sole purpose is to vindicate the public interest. Such persons, so authorized, are, so to speak, private Attorney Generals."). For a discussion of the rise of private enforcement actions under federal regulatory

current class action provision codified in Federal Rule of Civil Procedure 23 embodies Kalven's and Rosenfield's idea that civil class action suits could empower individual consumer redress while simultaneously ensuring enforcement of the federal securities laws.[4]

While securities class actions have offered some of the social benefits Kalven and Rosenfield envisioned, experience has shown that, like many other well-intended social experiments, they are not exempt from the law of unintended consequences, having brought with them vast social costs never imagined by their early promoters. Today, economic incentives unique to securities litigation encourage class action lawyers to bring meritless claims and prompt corporate defendants to pay dearly to settle such claims. These same incentives operate to encourage significant attorneys' fee awards even in cases where class members receive little meaningful compensation. And the problem is widespread. Recent studies conclude that, over a five-year period, the average public corporation faces a 9% probability of facing *at*

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laws, *see generally* John C. Coffee, Jr., *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working*, 42 MD. L. REV. 215 (1983). For criticism of the private attorney general model, *see generally* Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiff's Attorneys' Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1 (1991) (proposing private rights of action be auctioned to attorneys seeking to bring the class claim).

[4]Although there is little documentation of the discussion of Kalven's and Rosenfield's theory during the advisory committee sessions, their arguments proved important to the final proposed rule. *See* Note, *Developments in the Law — Class Actions*, 89 HARV. L. REV. 1318, 1321-23 (1976).

least one securities class action lawsuit.[5] As Congresswoman Anna Eshoo (D-Cal.) has put it, "Businesses in my region place themselves in one of two categories: those who have been sued for securities fraud and those that will be."[6] In the last four years alone, securities class action settlements have exceeded two billion dollars *per year*.[7]

What are the sources of the problems confronting securities class litigation? And how might we address them in a way that ensures we protect the valuable function securities class action litigation was originally intended to serve? This article seeks to offer a preliminary step toward answering these questions.

I. CERTAIN STRUCTURAL PROBLEMS OF SECURITIES FRAUD CLASS ACTIONS

A. The Incentive to Bring – and the Pressure to Settle – Meritless Suits

Because the amount of damages demanded in securities class actions is frequently so great, corporations often face the choice of "stak[ing] their companies on the outcome of a single jury trial, or be forced by fear of the

[5]*See* Elaine Buckberg et al., NERA, *Recent Trends in Securities Class Action Litigation: 2003 Early Update* 4 (Feb. 2004) ("*2003 Early Update*").

[6]Conference Report on H.R. 1058, Private Securities Litigation Reform Act of 1995, 141 Cong. Rec. H14039, H14051 (Dec. 6, 1995).

[7]*See Laura E. Simmons & Ellen M. Ryan*, Cornerstone Research, *Post-Reform Act Securities Settlements Reported Through December 2004* at 1 (Mar. 2005), *available at* http://securities.cornerstone.com. Settlements in 2001 were estimated at $2.1 billion, rising to $2.537 billion in 2002, holding at $2.016 billion in 2003, and rising to a record high 2.8 billion in 2004. *Id.*

risk of bankruptcy [into settling] even if they have no legal liability."[8] Unsurprisingly, executives faced with the potential destruction of their companies in a single trial typically opt to settle – even if it means paying out on meritless claims. They are, as Congress has recognized, "confronted with [an] implacable arithmetic . . . even a meritless case with only a 5% chance of success at trial must be settled if the complaint claims hundreds of millions of dollars in damages."[9] Illustrating just how powerful the incentive to settle can be, Bristol-Myers Squibb recently agreed to settle a pending class action for $300 million *even after the suit was dismissed with prejudice* at the trial court level.[10]

With such pressure to settle meritless suits comes, unsurprisingly, a concomitant incentive to bring them. As one academic commentator has candidly recognized, there is simply "*no appreciable risk* of non-recovery" in securities class actions; merely "*[g]etting the claim into the legal system*,

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[8]*In re Rhone-Poulenc Rorer, Inc.*, 51 F.3d 1293, 1299 (7th Cir. 1995); *see also* Victor E. Schwartz, *Federal Courts Should Decide Interstate Class Actions: A Call for Federal Class Action Diversity Jurisdiction Reform*, 37 HARV. J. ON LEGIS. 483, 490 (2000) ("For defendants, the risk of participating in a single trial [of all claims], and facing a once-and-for-all verdict is ordinarily intolerable.") (internal quotation marks omitted); Elliot J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2064 (1995); Woodruff-Sawyer & Co., *A Study of Shareholder Class Action Litigation* 25 (2002) (83% of securities fraud cases are resolved through settlement).

[9]H.R. Rep. No. 106-320, at 8 (1999). *See also West v. Prudential Sec., Inc.*, 282 F.3d 935, 937 (7th Cir. 2002) (noting scholarly concerns that "settlements in securities cases reflect high risk of catastrophic loss, which together with imperfect alignment of managers' and investors' interests leads defendants to pay substantial sums even when the plaintiffs have weak positions"); Schwartz, *supra* note 8, at 490.

[10]Jonathan Weil, *Win Lawsuit – and Pay $300 Million*, WALL ST. J., Aug. 2, 2004, at C3.

without more, sets in motion forces that ultimately compel a multi-million dollar payment."[11] And the Second Circuit concurs: "[a]necdotal evidence tends to confirm this conclusion. Indeed, [Melvyn I.] Weiss and his partner William S. Lerach of the Milberg firm have stated that losses in these cases are 'few and far between,' and they achieve a 'significant settlement although not always a big legal fee, in 90% of the cases [they] file.'"[12] Even the Supreme Court has acknowledged that, as a result of this phenomenon, securities class action litigation poses "a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general."[13] Illustrating how tempting these cases are for plaintiffs' lawyers, one court found it "peculiar that four of the lawsuits consolidated in this action were filed around 10:00 a.m. on the first business day following [the defendant's] announcement" of business problems and that "[m]ost of the complaints are virtually identical (including typographical errors)."[14] At the hearing on the

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[11]Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 578, 569 (1991) (emphasis added). *Accord Hevesi v. Citigroup Inc.*, 366 F.3d 70, 80 (2d Cir. 2004) (noting "numerous courts and scholars have warned that settlements in large [securities] class actions can be divorced from the parties' underlying legal positions"); *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 164 (3d Cir. 2001) (discussing the "inordinate or hydraulic pressure on [securities fraud] defendants to settle, avoiding the risk, however small, of potentially ruinous liability").

[12]*Goldberger v. Integrated Res., Inc.*, 209 F.3d 43, 52 (2d Cir. 2000) (quoting *In re Quantum Health Res., Inc. Sec. Litig.*, 962 F. Supp. 1254, 1258 (C.D. Cal. 1997)). The Milberg Weiss Bershad Hynes & Lerach firm has now divided into two separate partnerships known as Milberg Weiss Bershad & Schulman, and Lerach Coughlin Stoia Geller Rudman & Robbins.

[13]*Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975).

[14]*Ferber v. Travelers Corp.*, 785 F. Supp. 1101, 1106 n.8 (D. Conn. 1991).

defendant's motion to dismiss, the judge inquired:

> [H]ow did you get to be so smart and to acquire all this knowledge about fraud from Friday to Tuesday? On Friday afternoon, did your client suddenly appear at your doorstep and say 'My God, I just read in the Wall Street Journal about Travelers. They defrauded me,' and you agreed with them and you interviewed them and you determined that there was fraud and therefore you had a good lawsuit, so you filed it Tuesday morning, is that what happened?[15]

The court tellingly noted that "[c]ounsel for the plaintiffs was not responsive to this line of inquiry."[16]

B. The Incentive to Reward Class Counsel But Not Necessarily Class Members

While plaintiffs' attorneys have a strong financial incentive to bring meritless suits, and defendants have a strong incentive to settle them, neither has a particularly strong incentive to protect class members. Once the scope of the settlement fund is determined, defendants usually have no particular concern how that fund is allocated between class members and plaintiffs' counsel. And with the threat of adversarial scrutiny from the defendant largely abated, plaintiffs' counsel has free reign to seek (and little reason not to try to grab) as large a slice of the settlement fund as possible. Thus, settlement hearings frequently devolve into what the Third Circuit has called "jointly orchestrated . . . pep rallies," in which no party questions the

[15] *Id.*

[16] *Id.*

fairness of the settlement or attorneys' fee request and "judges no longer have the full benefit of the adversarial process."[17] This arrangement has led one prominent securities fraud attorney to boast that "I have the greatest practice in the world because I have no clients. I bring the case. I hire the plaintiff. I do not have some client telling me what to do. I decide what to do."[18]

Just how true that is can be illustrated by a 2002 settlement involving AT&T and Lucent regarding allegedly improper billing practices. A settlement fund for class members and counsel was established and valued at $300 million in settlement hearing proceedings. Soon after, the lawyers for the class collected some $80 million in fees, or more than 26% of the $300 million fund. Class members, meanwhile, "didn't collect as easily."[19] Two years later, in 2004, the parties revealed that class members found the settlement terms so unattractive that they had bothered to redeem a mere $8 million from the settlement fund – meaning that the plaintiffs' lawyers earned *ten times* the amount of the injured consumers.[20]

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[17]*Id.* at 1310. *See also Cohen v. Young*, 127 F.2d 721, 725 (6th Cir. 1942); *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 532 n.7 (1984).

[18]*In re Network Assocs. Inc. Sec. Litig.*, 76 F. Supp. 2d 1017, 1032 (N.D. Cal. 1999).

[19]Editorial, *Fees Line Lawyers' Pockets*, USA TODAY, Apr. 6, 2004.

[20]*Id.*

In re PeopleSoft Securities Litigation exemplifies the same problem.[21] Immediately following a decline in the common stock of PeopleSoft, Inc., 19 complaints were filed alleging that top company executives had made materially false and misleading statements to inflate the stock price. At the onset of the action, counsel represented that the case was worth hundreds of millions of dollars in damages. Yet, one year later, the plaintiffs sought approval for a settlement of $15 million. In reviewing the proposed settlement, the district court concluded that counsel had engaged in "minimal" discovery, "on the borderline of acceptability" given the purported scope of the case. Although the district court concluded that "a substantial part of the allegations that led the court to sustain the complaint in the first place are untrue, were never true, and had, at most, razor-thin support," plaintiffs' counsel pocketed $2.5 million in fees and expenses all taken from the common settlement fund.[22]

C. The Transfer Effect

Yet another unique structural issue affects securities class action settlements. Because settlement payments often come largely out of corporate coffers (directors' and officers' insurance policies also contribute),

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[21] *See* Order Certifying Settlement Class, Approving Class Settlement, and Awarding Fees and Expenses, *In re PeopleSoft, Inc. Sec. Litig.*, No. C 99-00472 WHA, at 9-10 (N.D. Cal. Aug. 24, 2001).

[22] *Id.*

securities class actions frequently involve only "a transfer of wealth from current shareholders to former shareholders."[23] That is, to the extent the corporation pays out, it is only transferring a portion of that wealth to existing shareholders' bank accounts (essentially an economic wash) in addition to sums paid to former shareholders who sold at some point during the class period and, of course, class counsel. Thus, to the extent that class members still own shares in the company at the time of the suit (as they often do), "payments by the corporation to settle a class action amount to transferring money from one pocket to the other, with about half of it dropping on the floor for lawyers to pick up."[24] All this led Judge Friendly to observe that securities fraud litigation carries the risk of "large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers."[25]

II. WHERE TO GO FROM HERE?

A. Recent Efforts at Reform

To be sure, Congress has recognized and sought to address some of

[23]Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1503 (1996). *See also* Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 638-39 (1985); Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 698-700; Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 650 & n.48 (1996); Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. ILL. L. REV. 913, 921-22.

[24]Alexander, *supra* note 23, at 1503.

[25]*SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 867 (2d Cir. 1968).

the negative side-effects of securities class action litigation.[26] In 1995, Congress enacted the Private Securities Litigation Reform Act[27] ("PSLRA").[28] It followed up in 1998 with the Securities Litigation Uniform Standards Act ("SLUSA").[29] Together, these bills sought to toughen pleading standards for securities class action suits,[30] encourage the appointment of pension funds as lead plaintiffs in the hope that they might better oversee class counsel,[31] and ensure that cases are tried in federal courts rather than in state courts.[32]

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[26]H.R. Conf. Rep. No. 104-369, at 31 (1995), *reprinted in* 1996 U.S.C.C.A.N. 730, 731. Congress explained that:

> The House and Senate Committees heard evidence that abusive practices committed in private securities litigation include: (1) the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action; (2) the targeting of deep pocket defendants, including accountants, underwriters, and individuals who may be covered by insurance, without regard to their actual culpability.

Id.

[27]15 U.S.C. § 78u-4.

[28]Pub. L. No. 104-67, 109 Stat. 737, 15 U.S.C. §§ 77k *et seq*. (1995).

[29]Pub. L. No. 105-353, 112 Stat. 3227, 15 U.S.C. §§ 77b *et seq*. (1998).

[30]*See* S. Rep. No. 104-98, at 15 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 694 (noting the PSLRA imposes a "strong pleading requirement" on the filing of any securities fraud action); H.R. Conf. Rep. No. 104-369, at 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 740 (the PSLRA "requires the plaintiff to plead and then to prove that the misstatement or omission alleged in the complaint actually caused the loss incurred by the plaintiff"); s*ee also Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc*., 532 U.S. 588, 597 (2001) (noting the "stricter pleading requirements" imposed in the PSLRA).

[31]H.R. Conf. Rep. No. 104-369, at 34, *reprinted in* 1995 U.S.C.C.A.N. at 733.

[32]*See* H.R Conf. Rep. No. 105-803 (Oct. 9, 1998) (explaining Congress's intent that SLUSA would "prevent plaintiffs from seeking to evade the protections that Federal law provides against abusive litigation by filing suit in State, rather than in Federal, court").

Congress's reforms, however, did little to address the underlying incentives that encourage plaintiffs' lawyers to bring – and defendants' lawyers to settle – meritless suits, or the incentives the parties have to benefit class counsel more than class members.[33] In fact, there has been a 32% nationwide increase in the mean number of securities fraud suits filed in the six years since the enactment of the PSLRA.[34] According to one published report, public companies now face a nearly 60% greater chance of being sued by shareholders.[35] And virtually all of these suits continue to be settled. One recent opinion quoted a statistic showing the dismissal rate in the Ninth Circuit as *only 6%*.[36] Studies show, too, that six years after the passage of the PSLRA, shareholders in class action suits collected, on average, just six cents for every dollar of claimed loss while their counsel continue to reap enormous fees.[37] As a result, despite congressional efforts at reform securities class action settlements reached an all-time high in

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[33]*See* Laura E. Simmons & Ellen M. Ryan, Cornerstone Research, *Post-Reform Act Securities Lawsuits: Settlements Reported Through December 2003* (May 2004) ("*Post-Reform Study*"), *available at* http://www.cornerstone.com.

[34]Perino, *supra* note 23, at 930.

[35]*See* Todd S. Foster et al., National Economic Research Associates, *Trends in Securities Litigation and the Impact of PSLRA* 4 (2003).

[36]*In re Infospace, Inc. Secs. Litig.*, No. C01-931Z, 2004 WL 1879013, at *4 (W.D. Wash. Aug. 5, 2004).

[37]Cornerstone Research, *Securities Class Action Case Filings 2002: Year in Review* (2003).

2004 of $2.9 billion.[38]

More recently, Congress passed the Class Action Fairness Act of 2005.[39] That law imposes several new hurdles for class action litigants. First, the Act expands the original jurisdiction of the federal courts to include suits where the aggregate amount of controversy exceeds $5 million and the class includes at least 100 potential members, only one of whom must be a citizen of a different state than the defendant.[40] Second, the Act eliminates restrictions on removal, including the one-year time limitation otherwise applicable to civil suits, the need for all defendants to consent to removal, and the inability for defendants to remove from state courts where they are citizens.[41] Third, the Act closes the so-called "joinder loophole" that allowed massive actions on behalf of numerous plaintiffs to proceed without seeking class action certification by extending federal jurisdiction over most all civil actions seeking monetary damages on behalf of 100 or more persons.[42] The Class Action Fairness Act also places new controls on the

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[38]*See Laura E. Simmons & Ellen M. Ryan*, Cornerstone Research, *Post-Reform Act Securities Settlements Reported Through December 2004* (Mar. 2005) at 1, *available at* http://securities.cornerstone.com. Notably, the $2.9 billion total was adjusted for the effects of inflation and did not include the $2.6 billion partial settlement in the WorldCom, Inc. litigation. *Id.*

[39]Class Action Fairness Act of 2005, Pub. L. 109-2, § 2 (outlining Congress's findings of class action abuses that have "harmed class members with legitimate claims and defendants that have acted responsibly").

[40]*Id.* § 4.

[41]*Id.* § 5.

settlement of class actions, particularly certain settlements awarding coupons in lieu of damages.[43]

For better or for worse, however, the Class Action Fairness Act will have little impact on securities class action litigation. By its terms, the Act does not apply to claims that could not already be removed under SLUSA, suits relating to "internal affairs or governance of a corporation," and suits relating to breaches of fiduciary duties in the sale of a security.[44] As a result, securities fraud class actions remain susceptible to the very problems that Congress sought to redress in other forms of class action litigation.

Beyond Congress, some have promoted recent changes to the Federal Rules of Civil Procedure as ways to improve the class action mechanism. Like Congress's reforms, however, these recent rule changes simply do not address the fundamental problematic incentives and structures unique to securities litigation.

First, until its recent amendment, the decision whether to opt out of a Rule 23 class action frequently had to be made early in the case – often before the nature and scope of liability and damages could be fully understood. As amended, Rule 23(e)(3) now permits courts to refuse to

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[42] *Id.* § 4.

[43] *Id.* § 3. The Act also authorizes the Court to receive expert testimony on the valuation of a class settlement.

[44] *Id.* § 4.

approve a settlement unless it affords a new opportunity to request exclusion at a time when class members can make an informed decision based on the proposed settlement terms. Early experience, however, shows that few courts have permitted additional opt-out periods following settlement approval.[45] Critically, too, a second opt-out offers no protection where settlement occurs before a class is certified – yet such early settlements are the norm in securities class action litigation given the scope of damages they involve, and the fact that securities class actions are so frequently certified.[46]

Second, Rule 23(f) has been amended to encourage interlocutory appeals from district court class certification orders. Early reports indicate, however, that Rule 23(f) has been used modestly, resulting in approximately nine published opinions per year since the rule was adopted in 1998.[47] The discretionary nature of Rule 23(f), moreover, has led to a patchwork of standards and guidelines in the circuit courts, thus raising the possibility of

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[45]*See In re Auto. Refinishing Paint Antitrust Litig.*, MDL No. 1426, 2004 WL 1068807, at *3 (E.D. Pa. May 11, 2004) (finding "no significant developments since the original opt-out that would require . . . a second opt-out period"); *In re Visa Check/Mastermoney Antitrust Litig.*, 297 F. Supp. 2d 503, 518 (E.D.N.Y. 2003) (declining to offer the class a second opt-out opportunity "in light of the infinitesimal number of objections" by class members).

[46]*See* Lawrence J. Zweifach & Samuel L. Barkin, *Recent Developments in the Settlement of Securities Class Actions*, 1279 PLI/Corp. 1329, 1339 (2001).

[47]Brian Anderson & Patrick McLain, *A Progress Report on Rule 23(f): Five Years of Immediate Class Certification Appeals*, Washington Legal Foundation LEGAL BACKGROUNDER (Mar. 19, 2004).

inconsistent remedies depending on the forum.[48] And, once again, Rule 23(f) provides little assistance in cases where settlement occurs *before* class certification – and that is, again, the dominant practice in securities class actions.[49]

B. Toward Meaningful Reform in Securities Class Action Settlements

While the procedural fixes and patches enacted by Congress and in the federal rules may help, it seems clear that they have proven insufficient to the task of preventing unmeritorious securities fraud cases or deterring settlements that benefit lawyers more than their clients. Future reform efforts may be more effective if focused less on procedures and more directly on the underlying economic incentives. What does this mean? Here are some possibilities.

1. Enforce the PSLRA's Loss Causation Requirement

A majority of circuit courts have held that a securities fraud plaintiff must demonstrate that the price of the security at issue declined as the result of disclosure of previously concealed information, and have limited

[48]*See* Aimee G. Mackay, Comment, *Appealability of Class Certification Orders under Federal Rule of Civil Procedure 23(f): Toward a Principled Approach*, 96 NW. U. L. REV. 755 (2002) (collecting the various standards of the circuit courts).

[49]*See* Zweifach & Barkin, *supra* note 46, at 1339.

the plaintiff's damages to the amount of that decline.[50] As recently explained by the Second Circuit in an opinion affirming the decision of the late Judge Milton Pollack in *Lentell v. Merrill Lynch*, "to establish loss causation, a plaintiff must allege . . . that the *subject* of the fraudulent statement or omission was the cause of the actual loss suffered."[51] There, a class of investors in once high-flying Internet startups brought suit for losses suffered after the now-famous "irrational exuberance" that fueled investments in the late 1990s diminished and the Internet stock price bubble burst. Eager to find someone to blame for their losses, the plaintiffs filed suit against Merrill Lynch claiming the company issued false recommendations in its analyst reports – this despite the fact that the plaintiffs were not clients of Merrill Lynch and had not relied on, read, or even seen a copy of any of Merrill's reports. The Second Circuit rejected the plaintiffs' construction of the loss causation requirement and held that they failed "to account for the price-volatility risk inherent in the stocks they chose to buy" or plead any other facts showing that "it was defendant's fraud – rather than other salient factors – that proximately caused [their] loss."[52]

In contrast, the Ninth Circuit has held that a securities fraud plaintiff

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[50]*See Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189 (2d Cir. 2003); *Semerenko v. Cendant Corp.*, 223 F.3d 165 (3d Cir. 2000); *Robbins v. Koger Props., Inc.*, 116 F.3d 1441 (11th Cir. 1997); *Bastian v. Petren Res. Corp.*, 892 F.2d 680 (7th Cir. 1990).

[51]*Lentell v. Merrill Lynch*, 396 F.3d 161, 173 (2d Cir. 2005).

[52]*Id.* at 177.

need only argue that the price of a security was "inflated" when he or she bought shares.[53] Rather than holding companies liable for the damage they inflict, as reflected by actual market events, the Ninth Circuit's rule thus permits liability to be found and damages to be awarded even when the plaintiff can point to *no actual market price reaction to a corrective disclosure at all*. Under this regime, a plaintiff can bring a class action simply on the allegation that a company's share price was once "inflated" because of the undisclosed accounting issue – and do so without ever having to establish a causal link between any price decline and the alleged misrepresentation. The Ninth Circuit's approach thus allows recovery where investors are *never hurt* by the alleged fraud, including in cases where the plaintiff sold before the alleged misrepresentation was exposed; where the misrepresentation was never exposed at all; or where the misrepresentation was exposed but the market did not respond negatively.

The facts of the Ninth Circuit case are illustrative. On February 24, 1998, Dura Pharmaceuticals announced a revenue shortfall for the following year, unrelated to any alleged fraud. By the next day, shares in Dura dropped from $39.125 to $20.75 for a one-day loss of 47%. Some *nine months later*, on November 3, 1998, Dura announced for the first time that the Food and Drug Administration had declined to approve its Albuterol

[53] *Broudo v. Dura Pharms, Inc.*, 339 F.3d 933 (9th Cir. 2003); *see also Gebhardt* v. *ConAgra Foods, Inc.*, 335 F.3d 824, 831 (8th Cir. 2003).

Spiros product – an announcement that plaintiffs themselves contend constitutes the first public disclosure of the alleged fraud in this case. Following this announcement, however, Dura shares fell only slightly and briefly. Share prices initially dropped from $12.375 to $9.75, but, within 12 trading days, they recovered to $12.438, ultimately climbing to $14.00 within 90 days of the announcement. A claim of fraud on behalf of Dura investors followed.

But seeking to boost their recovery, the class plaintiffs never alleged damages based on the brief and shallow $2.625 stock price dip after the November 3 disclosure of the supposed fraud. Rather, they demanded recovery based on the much more significant February 24 stock price decline of $19. In other words, the plaintiffs sought damages based on a decline in share value that occurred nine months *before* the disclosure of the alleged fraud. The facts were as simple, and seemingly insufficient, as if Mrs. Palsgraf had filed suit for a headache she developed before ever leaving for the train station. The district court agreed and dismissed the action. The Ninth Circuit saw things differently, finding loss causation satisfied where the plaintiffs "have shown that the price *on the date of purchase* was inflated because of the misrepresentation."[54]

The economic implications of the Ninth Circuit's holding are

[54]*Broudo*, 339 F.3d at 938.

staggering. Rather than holding companies liable for the damage they inflict, as reflected by actual market events, the Ninth Circuit's rule permits liability to be found and damages to be awarded even when the plaintiff can point to no actual market price reaction to a disclosure of the supposed fraud. Denying courts any means for weeding out at the pleading stage suits where the alleged fraud had no empirical effect on share price, and thus imposed no demonstrable harm on class members, the Ninth Circuit's rule adds fuel to a fire in which virtually every case is settled, wealth is transferred away from current shareholders to former shareholders.

Recently, however, the Ninth Circuit's treatment of the loss causation requirement received a cool response when the Supreme Court granted certiorari and heard arguments in the *Dura* case – a case that gives the High Court its first chance to explain the loss causation doctrine.[55] The questions posed by the Justices at oral argument suggest a fundamental disagreement with the Ninth Circuit's logic, exemplified by Justice Ruth Bader Ginsburg's observation: "How could you possibly hook up your loss to the news that comes out later? There is no loss until somehow the bad news comes out."[56]

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[55]The Solicitor General had urged the Supreme Court to review the decision concluding that the Ninth Circuit's reasoning was "difficult to reconcile with the well-established principle that transaction causation and loss causation are distinct elements of a Rule 10b-5 cause of action." *See* Brief for the United States as Amicus Curiae at 12, *Dura Pharms., Inc. v. Broudo*, No. 03-932 (U.S. filed May 28, 2004).

[56]Hope Yen, *High Court Hears Securities Fraud Case*, SEATTLE POST-INTELLIGENCER, Jan. 12. 2005.

Justice Sandra Day O'Connor also summed up the problem: "The reason why loss-causation is used is because a 'loss' experienced by the plaintiff is 'caused' by the misrepresentation. You have to put pleadings that are clear, which you didn't do."[57]

The Court's skepticism is well-founded. The Ninth Circuit's holding introduces a new legal rule that only further encourages plaintiffs to file and companies to settle meritless claims by removing a key safeguard against such suits. Worse still, the Ninth Circuit's rule encourages risky investment behavior, effectively forcing issuers to insure against speculative losses having nothing to do with their own conduct. Under the Ninth Circuit's rule, an investor can file a claim and obtain recovery even when the disclosure of an allegedly fraudulent statement has absolutely *no effect* on the stock price. To estimate damages in the absence of any contemporaneous real world stock price movement, moreover, the Ninth Circuit's rule encourages, and in fact depends upon, a return to the use of "junk science" by allowing recovery where disclosures do *not* prompt any stock price decline – *i.e.*, any actual harm. Under this standard, the parties and courts are, by necessity, forced to rely on a grab-bag of speculative theories to estimate damages since no empirically verifiable proof of injury exists. Like *Daubert v. Merrell Dow Pharmaceuticals* and its progeny, the

[57] *Id.*

loss causation requirement arms courts with a tool to ensure that the legal system compensates fully for empirically confirmable losses, but not for "phantom losses" based on "cause-and-effect relationships whose very existence is unproven and perhaps unprovable."[58]

By contrast, the alternative loss causation rule endorsed by the Government, petitioners, and four other courts of appeals would avoid all of these problems while ensuring full recovery of real losses. Requiring plaintiffs to plead facts showing loss causation enables judges to separate investor losses stemming from actual fraud from those caused by mere market downturns. Allowing the theory of "fraud-on-the-market" to satisfy the plaintiffs' entire burden on causation risks overcompensating investors for stock losses unrelated to any specific action by a defendant. Where an alternative cause (such as the marketwide drop in Internet, technology, and telecommunications securities in early 2000) results in comparable losses across similarly situated investors, plaintiffs must logically allege some facts that tend to show that their particular losses were caused by the defendants' alleged wrongdoings. Only by requiring a specific causal nexus can courts achieve optimal deterrence against fraud without transforming the federal securities laws into a system of national investor insurance.

[58]Kenneth R. Foster *et al.*, *Phantom Risk: Scientific Inference and the Law* 1 (1993).

2. Mandate Separate Fee Funds

The practice of paying plaintiffs' attorneys' fees from the settlement fund creates a powerful incentive to "structure a settlement such that the plaintiffs' attorneys' fees are disproportionate to any relief obtained for the corporation,"[59] and insulates the fee request from adversarial scrutiny. Paying fees out of the common settlement fund reduces the recovery available to consumers, and shifts the burden of paying the class counsels' fees to class members. In contrast, a regime that requires fee requests to be made separately from, and outside of, the class settlement fraud would help reintroduce the possibility that defendants might have some incentive to scrutinize fee requests and more closely monitor a regime that currently doles out 25% to 30% of every settlement to securities class action attorneys – many of whom do little or nothing to prosecute their cases and simply "free ride" on SEC or Justice Department investigations.

3. Revive the Lodestar Method for Calculating Fees

While the trend in federal courts has been toward using percentage of recovery methodology to determine fee awards, the lodestar method can provide a useful cross-check. The purpose behind any fee award from a

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[59]*Bell Atlantic v. Bolger*, 2 F.3d 1304, 1308-09 (3d Cir. 1993) (citing RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 21.9, at 570 (4th ed. 1992) (plaintiffs' attorney "will be tempted to offer to settle with defendant for a small judgment and a large legal fee, and such an offer will be attractive to the defendant provided the sum of the two figures is less than the defendant's net expected loss from going to trial")).

common fund settlement is to compensate attorneys for the fair market value of their time in successfully prosecuting the class claims. While the lodestar method has been criticized as burdensome and fact intensive (it is both), strict adherence to the percent of recovery standard can also overlook inequitable fee awards. For instance, when Bank of America paid $490 million to settle a securities fraud class action in 2002, plaintiffs' lawyers pocketed $28.1 million dollars in fees. Although at first glance the fee award appears reasonable as a percentage of recovery, the plaintiffs' lawyers actually earned $2,007 per hour.[60] In such cases, the lodestar method can provide an important safeguard against attorney over-billing through a closer review of counsels' hours, rates, and other charges.

4. Employ Competitive Bidding to Select Class Counsel

A bidding process to determine class counsel would employ market forces to constrain the supra-competitive prices often charged by plaintiffs' attorneys. This concept was first employed by Judge Vaughn R. Walker of the Northern District of California.[61] There, the district court solicited sealed bids from law firms seeking to represent the lead plaintiff,

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[60]Peter Shinkle, *Deal Was Just the Beginning in Class-Action Suit*, ST. LOUIS POST DISPATCH, Jan. 16, 2005.

[61]*See* District Judge Vaughn R. Walker, Remarks at the ABA National Securities Litigation Institute 7-8 (June 5, 1998) ("[I]nstances of institutional investors actively leading a [securities class] litigation effort remain relatively rare. . . . This is no surprise. . . . [I]nstitutional investors have disincentives to becoming [parties]. . . . Lawsuits are costly in time, money and other resources.").

accompanied by a description of the firm's experience and qualifications in such actions. The court then selected the lead plaintiffs' lawyer from these submissions, and determined the attorneys' fees based on the firm's own bid.[62] In another approach to competitive bidding, the district court might interview each of the prospective class attorneys, and select the lead plaintiffs' counsel based on the judge's independent analysis of the attorneys' ability to monitor and represent the interests of the class. Although Judge Walker's innovative approach was initially rejected by the Ninth Circuit,[63] recent amendments to Rule 23 appear to have vindicated Judge Walker's experiment, allowing judges to conduct competitive auctions based in part on the fees class counsel will receive.[64]

5. *Encourage Meaningful Oversight*

Participation by the appropriate state and federal agencies in

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[62]*In re Oracle Sec. Litig.*, 131 F.R.D. 688, 697 (N.D. Cal. 1990). Auctions for lead counsel have also been used in *In re Comdisco Sec. Litig.*, 141 F. Supp. 2d 951 (N.D. Ill. 2001); *In re Commtouch Software Sec. Litig.*, No. C 01-00719, 2001 WL 34131835 (N.D. Cal. June 27, 2001); *In re Quintus Sec. Litig.*, 148 F. Supp. 2d 967 (N.D. Cal. 2001); *In re Auction Houses Antitrust Litig.*, 197 F.R.D. 71 (S.D.N.Y. 2000); *In re Bank One Holders Class Actions*, 96 F. Supp. 2d 780 (N.D. Ill. 2000); *In re Lucent Techs., Inc., Sec. Litig.*, 194 F.R.D. 137 (D.N.J. 2000); *Sherleigh Assocs., LLC v. Windmere-Durable Holdings, Inc.*, 184 F.R.D. 668 (S.D. Fl. 1999); *Wenderhold v. Cylink Corp.*, 188 F.R.D. 577 (N.D. Cal. 1999); *In re Network Assoc., Inc., Sec. Litig.*, 76 F. Supp. 2d 1017; *In re Cendant Corp. Litig.*, 182 F.R.D. 144 (D.N.J. 1998); and *In re California Micro Devices Sec. Litig.*, 168 F.R.D. 257 (N.D. Cal. 1996); *see also* John F. Grady, *Reasonable Fees: A Suggested Value-Based Approach Analysis for Judges*, 184 F.R.D. 131, 142 (1999).

[63]*See In re Quintus Sec. Litig.*, 201 F.R.D. 475 (N.D. Cal. 2001), *rev'd sub nom. In re Cavanaugh*, 306 F.3d 726 (9th Cir. 2002).

[64]FED. R. CIV. P. 23(g)(1)(C)(iii) permits district courts to direct class counsel "to propose terms for attorney fees and nontaxable costs." *See In re Copper Mountain Sec. Litig.*, 305 F. Supp. 2d 1124, 1129 (N.D. Cal. 2004) (Walker, J.) (noting changes to federal class action rule cast doubt on Ninth Circuit's rejection of competitive bidding).

reviewing and commenting on proposed settlements could also help expose and prevent collusive deals. In recent years, the FTC has launched an aggressive and admirable effort in this area.[65] For example, in *In re First Databank* the FTC successfully challenged the fees sought in a consumer class suit that largely relied on an earlier enforcement action brought by the Commission.[66] In *Databank*, the FTC obtained agreement on $16 million in consumer redress as part of an antitrust enforcement action. Soon after, a private class action settlement added $8 million to the consumer fund, for a total of $24 million. Despite this marginal increase, class counsel sought fees of 30% of the *entire* $24 million fund, or more than 90% of the additional value added by the private action. Based largely on the FTC's objection, the district court reduced the fee award to 30% of the $8 million dollar additional recovery noting that the settlement was reached after the FTC "had already expended substantial efforts to establish" liability.[67]

Other agencies – including the Justice Department, the SEC, and the state attorneys' general – should be encouraged to follow the instructive example of the FTC and begin their own oversight of class action settlements purporting to piggy-back on their own investigations. Indeed, the Class

[65]*See* Thomas B. Leary, *The FTC and Class Action*, June 26, 2003, *available at* http://www.ftc.gov/speeches/leary/classactionsummit.htm; Remarks of R. Ted Cruz Before the Antitrust Section of the American Bar Association, Dec. 12, 2002, *available at* http://www.ftc.gov/speeches/other/tcamicus.

[66]209 F. Supp. 2d 96 (D.D.C. 2002).

[67]*Id.* at 101.

Action Fairness Act of 2005 imposes just such a reporting requirement for class action settlements *not* involving securities fraud. Under the Act, each settling defendant must notify both the Attorney General of the United States and the appropriate state officials no later than 10 days after any proposed class action settlement.[68] The Act further states that final approval of a settlement may not issue earlier than 90 days after notice to the governmental officials. It is unclear why securities class actions should be exempted from these requirements — especially given the federal government's strong and historic interest in the regulation of the securities industry.

The FTC previously sought to address the notice problem in 2002 in a way that would have helped in the securities context when it proposed an amendment to Rule 23 under which parties to any class action would be required to notify the court of any related actions by government agencies, and to notify the government agencies involved in those actions of the related private class action.[69] The advisory committee, however, somewhat astonishingly declined to adopt these suggestions. Until the committee or Congress recognizes the value of a hard, independent look at securities class action settlements and reverses course, no procedure exists to ensure the

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[68]Class Action Fairness Act of 2005, Pub. L. 109-2, § 3.

[69]Federal Trade Commission, *Comments on Proposed Amendments to Rule 23 of the Federal Rules of Civil Procedure* (Feb. 15, 2002).

timely participation of interested governmental enforcement agencies.

6. Don't Duplicate Governmental Efforts

While agency oversight may help prevent collusive settlements, one well-intentioned feature of the Sarbanes-Oxley bill actually risks double recoveries. It is well known that actions by a federal regulatory agency frequently trigger parallel private class actions. Indeed, since the passage of the PSLRA in 1995, over 20% of all securities fraud actions have followed an SEC litigation release or administrative proceeding.[70] And more than half of recent SEC enforcement actions have produced parallel private civil actions.[71] The prevalence of these follow-on private actions is significant because Congress has recently granted the SEC the power to redress consumer harms directly. Section 308 of the Sarbanes-Oxley Act[72] allows the SEC to reimburse investors by depositing civil penalties for securities or accounting violations into a victim's compensation fund. And in the last couple years the SEC has exercised this authority with zeal, collecting hundreds of millions of dollars in compensation for affected shareholders.[73]

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[70] *See* Simmons & Ryan, *Post-Reform Study*, *supra* note 33.

[71] James D. Cox et al., *SEC Enforcement Heuristics: An Empirical Study* 53 DUKE L.J. 737, 777 n.113 (2003).

[72] 15 U.S.C. § 7246.

[73] *See* Paul F. Roye, Director, Division of Investment Management, U.S. Securities and Exchange Commission, Keynote Address at the 22nd Annual Advanced ALI-ABA Conference on Life Insurance Company Products (Nov. 4, 2004), *available at* http:// www.securitiesmosaic.com

Where the SEC exercises this authority, therefore, a parallel shareholder class action may be simply unnecessary to deter the alleged wrongdoing and adequately compensate the investors.

To date, however, the SEC, Congress, and the courts have not given this question the attention it deserves and parallel class actions continue even in cases where the SEC has already acted to compensate victims. Permitting plaintiffs to receive damages through private civil suits in addition to disgorgement awards risks overcompensating both class investors and plaintiffs' attorneys who fail to account for the government's efforts in their fee requests. At a minimum, courts should insist that disgorgement awards be treated separately from any class action settlement to prevent plaintiffs' lawyers from "free riding" on the good will achieved by the government's enforcement actions.

7. Encourage Meaningful Oversight by Litigants

In the PSLRA, Congress sought to reign in non-meritorious suits by expressing a strong preference for having institutional investors appointed as class representatives.[74] Congress, not unreasonably, believed that

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(noting that as of 2004 the SEC had "brought 51 enforcement cases related to the mutual fund scandals and levied $900 million in disgorgement penalties").

[74]The PSLRA requires courts to appoint as "lead plaintiff" the class member "that the court determines to be most capable of adequately representing the interests of class members." 15 U.S.C. § 78u-4(a)(3)(B)(i), and creates a rebuttable presumption that the most adequate plaintiff is the party with the "largest financial interest in the relief sought by the class." *Id.* § 78u-4(a)(3)(B)(iii)(I)(bb).

"increasing the role of institutional investors in class actions will ultimately benefit shareholders and assist courts by improving the quality of representation in securities class actions," rather than leaving the responsibility to small individual holders, many of which were often repeat players closely aligned with specific plaintiff law firms.[75] Congress may have failed, however, to consider the magnitude of the task it asked institutional investors to assume. Although some are suitable candidates to lead class action litigation, many lack the staff, resources, funding, and experience to monitor independently the suits brought on their behalf.

For example, the trustees of the Louisiana Teachers' Retirement System recently brought a derivative suit against the majority shareholders of Regal Entertainment to stop the issuance of a $750 million dividend, despite holding only a $30,000 investment in the company. The court denied the Louisiana Teachers' application for a preliminary injunction, finding "'not a shred of evidence' that minority shareholder would be hurt," and the Teachers subsequently dropped their claims.[76] Notably, the court found the claims so doubtful, that it asked plaintiffs' counsel "[t]o what extent has the plaintiff thought about the claims they're asserting and have

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[75]H.R. Conf. Rep. No. 104-369, at 34, *reprinted in* 1995 U.S.C.C.A.N. at 733.

[76]Editorial, *Pension Fund Shenanigans*, WALL ST. J., Aug. 20, 2004, at A12 ("[W]hat we have here is a public fund whose risky practices have cost the taxpayer billions throwing mud at a profitable company's management . . . a company . . . that was one of the fund's better-returning investments."). By way of full disclosure, the authors represented Regal in this suit.

they really studied them?"[77] As it turned out, the Louisiana Teachers' Retirement System has been involved in 60 class action lawsuits in the last eight years.[78] Citing this substantial docket, one district court judge in the Eastern District of Tennessee declined to allow the Teachers to serve as a lead plaintiff in one of these class actions, concluding that "the Court cannot help but conclude the Louisiana Funds' resources are being spread too thin."[79]

To help institutional investors from becoming spread too thin, and the concomitant loss of meaningful oversight promised by the PSLRA, courts might consider greater enforcement of the PSLRA's "professional plaintiff" rule to bar actions repeating allegations already considered and rejected in a prior suit. The PSLRA prohibits a party from serving as lead plaintiff in more than five securities class actions brought during a three-year period.[80] Some courts have disregarded this rule with respect to institutional investors, relying on commentary contained in the Conference Report accompanying the PSLRA.[81] As other courts have properly noted, however,

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[77]Transcript of Oral Argument Before the Hon. William B. Chandler, *Teachers' Retirement Sys. of La. v. Regal Entm't Group*, No. 444-N, at 156 (Del. Ch. June 1, 2004).

[78]*Pension Fund Shenanigans*, *supra* note 76.

[79]*In re Unumprovident Corp. Secs. Litig.*, MDL Case No. 03-1552, No. 03-CV-049 (E.D. Tenn. Nov. 6, 2003).

[80]15 U.S.C. § 78u-4(a)(3)(B)(vi).

[81]*See* H.R. Conf. Rep. No. 104-369, at 35 (stating that "[i]nstitutional investors . . . may need to exceed this limitation and do not represent the type of professional plaintiff this legislation

the PSLRA's plain language "contains no express blanket exception for institutional investors" and automatically excusing institutional investors from the rule would undermine rather than further the PSLRA's purposes.[82] Institutional investors themselves might also consider the creation of neutral litigation oversight committees to help them review solicitations made by plaintiffs' lawyers to ensure that the cases brought are meritorious, that fee agreements are fair and reasonable, and that any settlement benefits shareholders overall and does not, for example, simply result in a transfer of assets from current shareholders (very often including institutional investors themselves) to former shareholders.

CONCLUSION

Congress intended the PSLRA to reform the abuses that dominated securities fraud litigation in the early 1990s. Despite the best of legislative intentions, virtually all securities fraud claims that survive initial motions practice will be settled. With little prospect that their claims will be fully tested by the adversarial process, plaintiffs' attorneys have a strong economic incentive to bring ever-more securities fraud class actions without regard to the underlying merit of the suit, or the ultimate recovery to the

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seeks to restrict").

[82] *In re Enron Corp. Sec. Litig.*, 206 F.R.D. 427, 443-44 (S.D. Tex. 2002); *see also In re Telxon Corp. Sec. Litig.*, 67 F. Supp. 2d 803, 821 (N.D. Ohio 1999).

class. Faced with such daunting prospects, businesses are frequently forced to comply with all but the most outrageous of settlement demands. As a result, new corporate investments are deterred, the efficiency of the capital markets is reduced, and the competitiveness of the American economy declines. And class members, who often have absolutely no interest in the suit from filing to final judgment, literally wind up paying the bills.

The reforms attempted so far are steps in the right direction. But none directly addresses the underlying economic incentives that drive the filing of frivolous securities fraud class actions in the first instance. Meaningful reforms must move beyond procedure to address these incentives directly. Enforcing the PSLRA's loss causation requirement will empower judges to dismiss securities fraud suits stemming from mere market downturns. Utilizing a competitive bidding process for the selection of class counsel will help address the de facto cartel responsible for the vast majority of securities class suits. Requiring attorneys' fees to be paid from a separate fee fund will increase adversarial challenges to exorbitant requests, and reviving the loadstar method will provide a tool to guard against overbilling. And no fees should be awarded for suits that do not provide meaningful benefits to investors after an opportunity for review by the appropriate regulatory agency. While no single reform can guarantee that securities fraud class action settlements will always be fair and reasonable, these proposals are just a few possible steps in the direction of helping to secure the full promise of the securities class action mechanism as the vehicle for consumer protection envisioned by Kalven and Rosenfield nearly six decades ago.