



SECURITIES CLASS ACTION LITIGATION

The problem, its impact, and the path to reform



Executive Summary: Private securities class actions present a serious threat to the health of the U.S. economy. The costs of securities litigation are enormous, but the benefits are miniscule. The culture of abusive class actions, driven by a multibillion dollar plaintiffs' lawyer industry, is eroding the competitiveness of U.S. capital markets at a time when they face perhaps their greatest threat from foreign competition. The system is broken, and Congress must enact the reforms needed to fix it.

The costs of securities class actions—already in the billions annually—are rising rapidly. The number and size of these cases are growing. New lawsuits increased 58% in 2007 over 2006, and the number of new filings during the first half of 2008 has increased nearly 60% from the same time last year. However, the number of filings only tells part of the story given the alarming rise in the size of these actions: 2007 witnessed a near doubling over 2006 in terms of the average estimated losses in these lawsuits, whether measured in terms

of Disclosure Dollar Loss (the decline in market capitalization of a defendant company from the day before a class period ends to the day after disclosure) or average Maximum Disclosure Loss (the decline in market capitalization of a defendant company from the maximum price point during the class period to the day after disclosure), an increase driven by the large number of “mega-filings” (Disclosure Dollar Loss of \$5 billion or more or Maximum Disclosure Loss of \$10 billion or more).

These class actions virtually always exert an inexorable pressure to settle, as target companies must decide whether to settle for millions (or billions) or to fight, diverting the attention of management for years, incurring considerable legal bills, and risking catastrophic liability. This incentive to mitigate potential damages unsurprisingly has generated massive settlements, with approximately \$51.8 billion paid out in the past decade. The total value of securities class action settlements in 2007 was nearly 15 times the total in 1998; in 2006 alone, settlements amounted to an unprecedented \$17.6 billion. Excluding billion-dollar plus settlements, the average settlement in 2007 increased approximately 43% from the previous year. The consequences to the U.S. economy are alarming: no less than three independent reports have identified excessive securities class action litigation as weakening the competitive position of the U.S. capital markets in comparison to its foreign competitors.

These high costs do not produce benefits for average shareholders. Between 1995 and 2005, securities class action litigation caused the destruction of nearly \$25 billion of shareholder wealth. Securities class actions pointlessly transfer money from one innocent investor to another. In almost every class action, it is the current shareholders of a company that foot the bill for the settlement amount, along with the costs of defending the action and the corporation's increased insurance premium. Yet, the other group of shareholders—supposedly represented by the lead plaintiff—recover only pennies on the dollar. Indeed, the median ratio of settlements compared to investor losses has ranged between 2% and 3% over the past five years, dropping to 2.4% in 2007. Much of the settlement value is siphoned off to plaintiffs' lawyers, who have earned nearly \$17 billion, in securities cases, in the last decade alone, along with other middlemen. Finally,

small shareholders are the least likely to receive substantial compensation; their recovery is dwarfed by large, institutional investors who are as likely to derive benefit from selling stocks at fraud-inflated prices as they are to suffer harm from buying stocks at such prices.

This flawed system is not needed to monitor and punish securities fraud: the ample regulatory, civil, and criminal enforcement powers of the Securities and Exchange Commission, the Department of Justice, their state counterparts, and financial services self-regulatory organizations more effectively deter wrongdoers and compensate shareholders without the inefficiencies of the class action litigation system. Over the past two fiscal years, the SEC alone has initiated a total of 1676 investigations, brought 480 suits and 750 administrative proceedings, and obtained orders for almost \$5 billion in disgorgement and penalties from securities law vio-

lators—contributing to a total of \$13.8 billion dollars in disgorgement and penalties from FY 2003 to FY 2007. The Justice Department’s Corporate Fraud Task Force, moreover, has obtained nearly 1300 guilty pleas and convictions (including those of over 200 CEOs), levied billions in fines, and ordered hundreds of millions to be paid in restitution between July 2002 and April 2008.

The systemic failures of private class action litigation are exacerbated by trial lawyers who have hijacked the class action mechanism and abused it for profit. Illegal payments to plaintiffs produced the downfall of Milberg Weiss LLP and several of its partners, in connection with a scheme of paying “bounties” to repeat plaintiffs that has produced multimillion dollar fines and lengthy prison terms. This criminal behavior may also be just the tip of the iceberg; Bill Lerach, a former Milberg Weiss partner, recently explained that his illegal conduct was “industry practice.” The integrity of the

class action system is further undermined by a *legal* “pay to play” culture whereby plaintiffs’ law firms ensure their status as lead counsel through contributions to the political campaigns of officials who control the large public pension funds that often serve as lead plaintiffs.

Reform is urgently needed. This report highlights several areas of potential legislative change:

- Enact the Securities Litigation Attorney Accountability and Transparency Act to address abusive payment practices and excessive fees and to enhance transparency in the selection of lead counsel by requiring disclosure of payments, fee arrangements, and political contributions by attorneys. This act would also serve to harness market forces to discipline attorneys’ fees by authorizing an auction process for the selection of lead counsel and by studying fee amounts over time.
- Require detailed documentation and verification of clients’ alleged losses to prevent plaintiffs’ attorneys from inflating such numbers to obtain appointment as lead counsel.
- Curb abuse of civil discovery, the costs of which fall disproportionately on defendant companies and create enormous pressure to settle, by modifying existing rules to permit the costs of discovery to be shifted from defendants to plaintiffs when plaintiffs’ requests for information are only loosely related to the claims and defenses being litigated.
- Provide defendants with equal access to interlocutory appeals from denials of motions to dismiss and motions for summary judgment in order to reduce the intense pressure to settle meritless suits following the denial of such dispositive motions.

- Close loopholes that the plaintiffs' bar has exploited in the Private Securities Litigation Reform Act and the Securities Litigation Uniform Standards Act in order to permit realization of Congress's purposes in enacting those measures.

- Refine the measure of damages in securities class actions by moving away from a compensate-the-plaintiff standard and towards a system that focuses on the defendant's gain. Calculate damages on a per share basis to prevent artificial inflation of damages awards. Give priority to small, retail

investors in the distribution of settlement funds.

- Increase transparency in the settlement process by requiring a public report accounting for the distribution of settlement proceeds.

- Preserve and encourage the present widespread use of effective and efficient arbitration procedures in the securities industry that reduce costs and shorten resolution timelines.

- Coordinate the SEC's Fair Funds authority with settlement recoveries in private class actions so that private damages awards are offset by any Fair Funds collected by the SEC to compensate shareholders.

Introduction: Private securities class action lawsuits pose an immediate and alarming threat to the health of the U.S. economy. Massive and abusive securities litigation is eroding the competitiveness of U.S. capital markets at the same time those markets face increased challenges from foreign competitors. Moreover, these lawsuits betray their intended purpose, generally harming, rather than benefiting, the investors they purport to protect. In short, securities class actions are costly and burdensome, do not serve the goals of compensating injured investors or deterring wrongful conduct, and enrich lawyers at the expense of the average shareholder.

Securities class action suits today impose a large—and rapidly growing—cost on American businesses, investors, and employees. To begin with, the pressure to settle these lawsuits is typically overwhelming because of the burden imposed on management, the cost of going to trial, and the risk of a massive adverse verdict. As a consequence, settlement values are skyrocketing to record highs irrespective of the mer-

its of the actual claims. And even if a claim is legitimate, it simply results in one group of innocent shareholders (those who own shares at the time of the settlement) paying another group of innocent shareholders; guilty individuals rarely make a significant contribution. Recoveries usually amount to just pennies on the dollar of alleged loss, while lawyers and other middlemen extract significant fees and various transaction costs,

amounting to millions—and sometimes billions—of dollars. Indeed, those whom the securities class action system is supposed to protect—small, individual retail investors—are the ones who, in fact, benefit the least.

Even worse, the system is plagued by abuse. A cascade of indictments, guilty pleas, and lengthy prison sentences lodged against what had been the country's preeminent plaintiffs' law firm, several of its former partners, and other plaintiffs' attorneys shines a bright spotlight on the scope of the problem. And such brazen criminal activity is unfortunately just the tip of the iceberg. The integrity of the securities class action system is further undermined by a *legal* "pay-to-play" culture of corruption in which lawyers make political contributions to the politicians charged with deciding who will represent large public pension funds as lead plaintiffs in these suits—and thus who will collect the largest share of attorneys' fees from the inevitable settlements.

According to the Honorable Joseph A. Grundfest, former SEC Commissioner and current professor at Stanford Law School, "The conclusion is clear. The class action securities fraud litigation system is broken. It fails efficiently to deter fraud and fails rationally to compensate those harmed by fraud. Its greatest proponents seem to be the class action counsel and others who profit as a consequence of the irrationally large damage exposures generated by the current regime."¹

The exorbitant costs and damaging economic impact of this broken system should make securities class action reform an issue of major concern to all investors. Fixing the broken securities class action regime is particularly important for average individual shareholders who ultimately bear the burden of the existing system but reap little, if any, of the benefit.

Common sense reform must be a priority; it is necessary to ensure that

¹ Statement of the Honorable Joseph A. Grundfest, Stanford Law School, to the Meeting of the Advisory Committee on the Auditing Profession 4 (Feb. 4, 2008), *available at* <http://www.ustreas.gov/offices/domestic-finance/acap/submissions/02042008/Grundfest02042008.pdf> [hereinafter "Grundfest Statement"].

securities class actions enhance investor protection, our capital markets, and the overall U.S. economy.

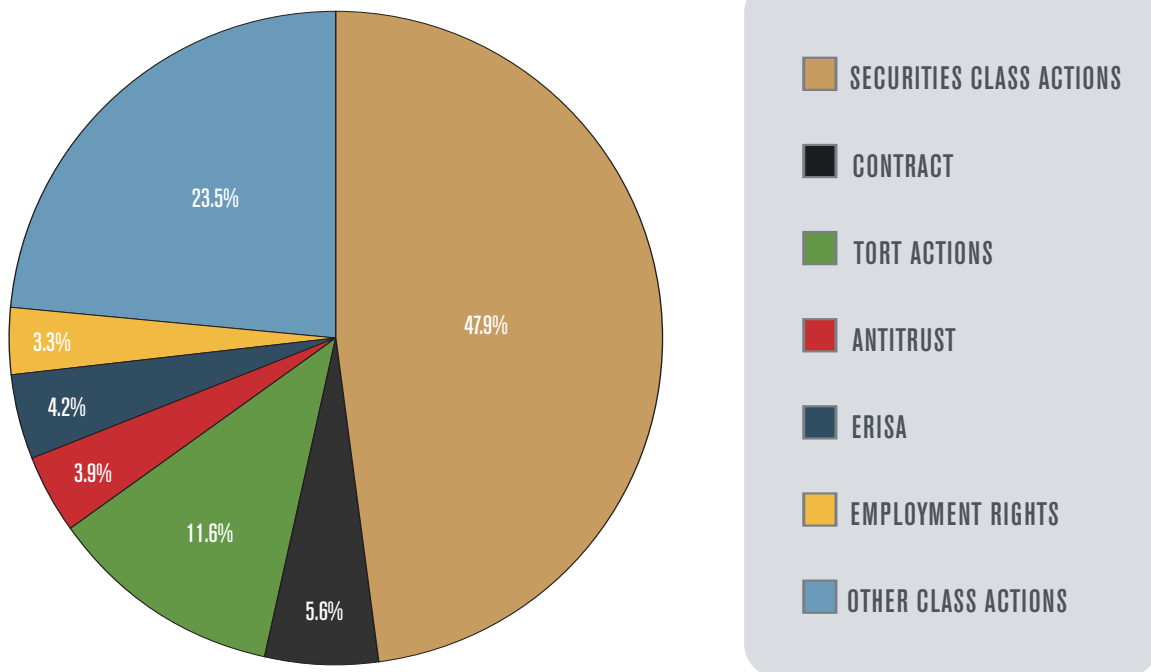
The Rising Cost of Securities Class Actions

The class action mechanism was intended to allow individual plaintiffs to combine relatively small claims together

into a single action that would be prosecuted by class representatives and their attorneys for the benefit of the entire class. Unfortunately, securities class actions have devolved into a burdensome means of extracting ever-increasing settlements from public companies, regardless of the merits of the underlying claims. Several recent inde-

► Categories of Federal Class Actions (2004)

Figure 1



Source: Interim Report of the Committee on Capital Markets Regulation 74 (Nov. 2006).

pendent studies have documented the significant—and increasing—toll these suits are taking on our capital markets and our overall economic future.

Securities Class Actions

Dominate Federal Court Litigation

Securities class actions are the equivalent of legal skyscrapers that dominate the litigation landscape, and they show no signs of receding. Although private plaintiffs bring class actions in a number of areas of law—tort, contract, employee benefits, and employment rights—the sheer quantity of federal securities class actions swamps these other categories. Indeed, in 2004, securities class actions accounted for almost half of all federal class actions in the United States, and were represented four times more often than any other single category of federal class action. (See Figure 1). “[B]ecause securities class actions disproportionately claim

judicial time and attention”—they generally take longer to resolve, they require selection of a lead plaintiff, and they often feature multiple “repleadings” and motions to dismiss—the relatively high administrative costs of these lawsuits falls squarely on the shoulders of the American taxpayer.²

An average of 261 federal securities class action lawsuits were filed annually between 1998 and 2007.³ The number of suits is extraordinary when compared to the number of companies that issue stock and, as a result, can even be sued under the federal securities laws. Since 1996, at least 2,758 public companies—or 41% of the roughly 6,000 companies currently listed on the three major stock exchanges—have been named as defendants in at least one federal securities class action. In 2007 alone, more than 2% of all listed companies were defendants in a

² John C. Coffee, *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 Colum. L. Rev. 1534, 1540 (Nov. 2006).

³ Stephanie Planchich et al., NERA Econ. Consulting, *Recent Trends in Shareholder Class Action Litigation: Filings Return to 2005 Levels as Subprime Cases Take Off; Average Settlements Hit New High 2* (Dec. 2007) [hereinafter “Recent Trends”].

newly filed class action.⁴ This phenomenon is not limited to U.S. companies; there was a 73% increase in filings against non-U.S. companies (*i.e.*, those not domiciled in the U.S.) in 2007 from the previous year.⁵

The most recent data shows that securities class action filings are on the rise: as compared with 2006, new lawsuits increased 58% in 2007.⁶ This data confirms that the decline in new filings in 2006 likely was the temporary result of a strong stock market with relatively low volatility (the filing of securities class actions is often precipitated by the decline in a company's stock price).⁷ As one experienced analyst has speculated, "[i]f the market goes

south, I would not be surprised to see the level of filings move back to the 200 per year level."⁸

And early indicators suggest that is precisely what is occurring. The number of new filings in the first half of 2008 (108) increased nearly 60% from the first half of 2007; at this rate, the number of new suits will top 200 by year's end. The 204 new lawsuits filed between July 2007 and June 2008 represent a 65% increase compared to the same 12-month period in 2006-2007, and is the highest total since 2004-2005.⁹

The number of filings only tells part of the story. These are not ordinary cases; rather, they are often massive claims whose size is increasing sig-

⁴ Stanford Securities Class Action Clearinghouse Statistics, available at <http://securities.stanford.edu/index.html>; Commission on the Regulation of the U.S. Capital Markets in the 21st Century, Independent Bipartisan Commission Established by the U.S. Chamber of Commerce, *Report and Recommendations* 30 (Mar. 2007), available at <http://www.uschamber.com/publications/reports/0703capmarketscomm.htm> [hereinafter *Chamber Commission Report*].

⁵ *Recent Trends*, *supra* note 3, at 6 & n.4.

⁶ *Id.* at 2; Stanford Securities Class Action Clearinghouse Statistics, *supra* note 4.

⁷ Research suggests that increased stock market volatility correlates to a rise in the number of securities class actions. Cornerstone Research, *Securities Class Action Case Filings, 2007: A Year in Review* 6 (2008) [hereinafter "*Class Action Filings*"].

⁸ Statement of John Gould, Cornerstone Research & Stanford Class Action Clearinghouse, Press Release, *Stanford Law School and Cornerstone Research Release Mid-Year Securities Fraud Class Action Filings Report* (July 9, 2007), available at <http://securities.cornerstone.com/pdfs/CSR%20Release%20MYIR%202007.pdf>.

⁹ Stanford Class Action Clearinghouse Statistics, *supra* note 4; The D&O Diary, *Mid-Year 2008: Securities Lawsuit Filings Remain Up* (Jun. 30, 2008), available at <http://www.dandodiary.com/2008/06/articles/securities-litigation/midyear-2008-securities-lawsuit-filings-remain-up/>.

nificantly. Independent analysts of these cases measure claim size by reference to the decline in market capitalization from the day before the class period ends to the day after disclosure (Disclosure Dollar Loss) or the decline in market capitalization from the maximum price point during the class period to the day after disclosure (Maximum Dollar Loss).¹⁰ (Although recoverable damages typically are smaller than these measures, they provide a means of assessing changes in claim size.)

Either measure reveals an alarming increase in the size of newly filed securities class actions. The total Disclosure Dollar Loss in 2007 of \$151 billion represents a 188% increase from 2006 and an 18% increase relative to the ten-year average from 1997-2006.¹¹ The Maximum Dollar Loss is even more staggering: the total in 2007 was \$669 billion, a 128% increase from 2006.¹² The

2007 averages of both measures nearly doubled relative to 2006, an increase driven by the large number of “mega-filings”: in 2007, plaintiffs filed 9 suits with a Disclosure Dollar Loss of \$5 billion or more and 16 suits with a Maximum Dollar Loss of \$10 billion or more.¹³ Unfortunately, these “mega-filings” appear on an upward trend as the majority were filed in the second half of 2007.

The Pressure to Settle is Overwhelming and Creates a Tax on U.S. Business

Even when the allegations made in a securities class action lawsuit lack merit, the target company faces a stark choice: settle the case for millions, or even billions, of dollars; or fight, diverting both the time and attention of management, incurring massive legal bills, and running the risk that an unpredictable jury will impose potentially catastrophic liability. As the Supreme Court recently recognized in the landmark

¹⁰ *Class Action Filings*, *supra* note 7, at 8.

¹¹ *Id.* at 9.

¹² *Id.* at 10.

¹³ *Id.* at 12.

Stoneridge case, “extensive discovery and the potential for uncertainty and disruption in a lawsuit allow plaintiffs with weak claims to extort settlements from innocent companies.”¹⁴ It should therefore come as no surprise that most defendants settle such suits regardless of the merits of the underlying claims. Indeed, only a small handful of class actions have been tried to verdict in the past decade.¹⁵

As a consequence, the existing system is premised less on fairness and merit and more on exploitation of the costs and risks of defending against even baseless lawsuits. According to Dick Thornburgh, former Attorney General to Presidents Ronald Reagan and George H.W. Bush, “Outcomes [of securities class actions] are often less a matter of justice than of negotiation, as many

defendants decide it is better to settle than to incur the enormous costs, inconvenience and risks associated with what may become virtually endless litigation.”¹⁶ As former Clinton Administration official Robert E. Litan similarly observed, “some defendants can feel financially pressured to settle even if they have done nothing wrong, believing it not to be worth betting their companies on a subsequent mistaken jury verdict that can be difficult to overturn on an appeal.”¹⁷ These observations have long been supported by scholarly research, which has shown that class action settlements often bear little relationship to the merits of the underlying claims.¹⁸

The unfortunate result is that securities class actions are a regular and burdensome tax on doing business—a tax incurred by many companies that

¹⁴ *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 772 (2008).

¹⁵ It is estimated that since 1996 (following the enactment of the PSLRA), only 13 actions have proceeded to a verdict, and only 3 led to a finding in favor of a plaintiff. See Adam T. Slavett, RiskMetrics Group, *Securities Class Action Trials in the Post-PSLRA Era* (Feb. 2008), available at <http://slw.riskmetrics.com/SCAS%20Trials.pdf>.

¹⁶ Dick Thornburgh, Commentary, *Class Action Gamesmanship*, Wash. Times, Jun. 15, 2007.

¹⁷ Robert E. Litan, U.S. Chamber Institute for Legal Reform, *Through Their Eyes: How Foreign Investors View and React to the U.S. Legal System* 13 (Aug. 2007).

¹⁸ See, e.g., Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 497, 528-34 (1991).

may have done nothing wrong. Even more unfortunate is that this tax falls particularly heavily on smaller companies—key drivers of America’s economic growth and innovation. Such companies suffer because they generally lack the resources and expertise necessary to contest complex litigation, and because they are particularly vulnerable to the risk of being put out of business permanently by a large adverse judgment.¹⁹

Private Class Action Settlements Have Skyrocketed to a Record High

In light of the overwhelming pressure on companies to settle these suits, it is not surprising that settlement costs have increased dramatically over the past decade. The total value of securities class action settlements in 2007

was nearly *15 times* the total in 1998. In 2006, settlements amounted to an unprecedented \$17.6 billion, and 2007 featured the highest median settlement amount ever.²⁰ Nine of the ten largest securities class action settlements of all time occurred in the past three years, and nine of those top ten exceed \$1 billion.²¹ The first six months of 2008 alone have produced two mega-settlements that together equal more than \$1.5 billion.²² Even companies settling litigation at the lower end of the spectrum are paying more: the minimum settlement amount increased threefold in 2007.²³ All together, the total value of class action settlements between 1998 and 2008 equaled an astronomical \$51.8 billion. (See Figure 2).

More alarming is the exponential growth trend in average settlement val-

¹⁹ Anjan Thakor, *The Unintended Consequences of Securities Litigation* 9-10 (Oct. 2005) (U.S. Chamber Inst. For Legal Reform) [hereinafter Thakor, *Unintended Consequences*].

²⁰ Laura E. Simmons & Ellen M. Ryan, Cornerstone Research, *Securities Class Action Settlements: 2007 Review and Analysis* 2 (2008) [hereinafter “*Class Action Settlements*”]; see also *Recent Trends*, *supra* note 3, at 9-10.

²¹ The top ten (\$MM) are: (1) Enron Corp. (2007): \$7,231; (2) WorldCom, Inc. (2005): \$6,156; (3) Cendant Corp. (2000): \$3,561; (4) Tyco International, Ltd. (2007): \$2,975; (5) AOL Time Warner Inc. (2006): \$2,650; (6) Nortel Networks (I) (2006): \$1,143; (7) Royal Ahold, NV (2006): \$1,100; (8) Nortel Networks (II) (2006): \$1,074; (9) McKesson HBOC Inc. (2007): \$1,033; (10) UnitedHealth Group (2008): \$895. *Recent Trends*, *supra* note 3, at 8.

²² In July 2008, United Health Group announced an \$895 million settlement of an options-backdating suit, one of largest settlements ever, and in March 2008 Xerox announced a \$750 million settlement of a securities class action suit lodged against it. *The D&O Diary, Headline News: Settlements, Lawsuits, Dismissals* (July 3, 2008), available at <http://www.dandodiary.com/2008/07/articles/options-backdating/headline-news-settlements-lawsuits-dismissals/>.

²³ *Class Action Settlements*, *supra* note 20, at 2.

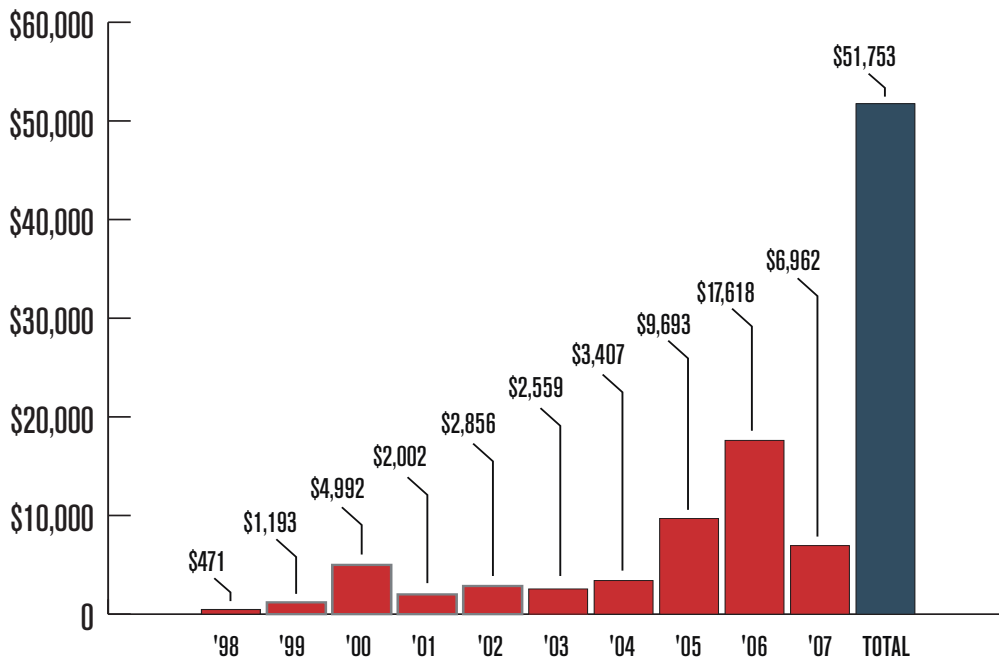
ues. (See Figure 3). The average settlement amount from 2002 to 2007 rose to \$40.5 million, about two and a half times the average settlement amount of \$16.3 million from 1996 to 2001. Excluding billion-dollar-plus settlements, the average settlement in 2007 increased approximately 43% from the previous year.²⁴

The Threat Posed to U.S. Capital Markets and the U.S. Economy is Real

The costs and uncertainties associated with securities class action litigation pose a serious threat to U.S. capital markets and the overall economy. Three recent independent reports specifically identified such litigation as an issue of major concern deserving

► Total Value of Securities Class Action Settlements (in millions)

Figure 2



Source: Laura E. Simmons & Ellen M. Ryan, Cornerstone Research, *Securities Class Action Settlements: 2007 Review and Analysis 5* (2008)

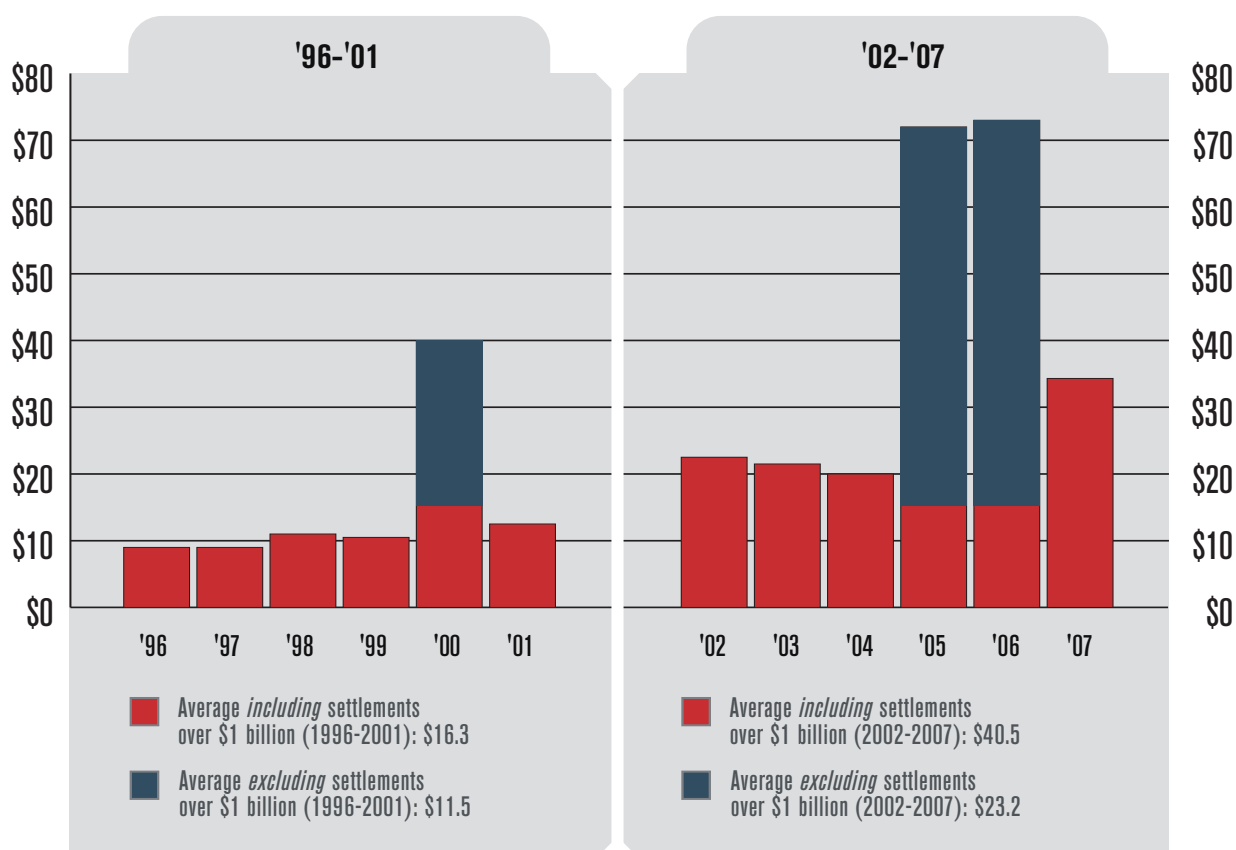
²⁴ *Id.* at 12.

of immediate attention from lawmakers.²⁵ They suggest that the legal unknowns associated with investing

and operating in the United States likely have dissuaded foreign companies from entering the U.S. market.

► Average Settlement Value (\$MM)

Figure 3



Source: Stephanie Planchich et al., NERA Econ. Consulting, *Recent Trends in Shareholder Class Action Litigation: Filings Return to 2005 Levels as Subprime Cases Take Off; Average Settlements Hit New High 2* (Dec. 2007)

²⁵ Committee on Capital Markets Regulation, *Interim Report* 74 (Nov. 2006), available at http://www.capmktreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf [hereinafter *Interim Report*]; *Chamber Commission Report*, *supra* note 4; McKinsey & Company, Report Commissioned by Mayor Michael R. Bloomberg and Senator Charles E. Schumer, *Sustaining New York's and the U.S.' Global Financial Services Leadership* (2007), available at http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf. [hereinafter *Bloomberg/Schumer Commission Report*]. The Financial Services Roundtable also prepared a comprehensive report that addresses this issue. Richard M. Kovacevich et al., The Financial Services Roundtable, *The Blueprint For U.S. Financial Competitiveness* (Nov. 2007) [hereinafter *Blueprint*].

One recent survey conducted by The Financial Services Forum, which polled 334 senior executives of companies based in the U.S., U.K., Germany, France, India, China, and Japan, provides strong evidence of this phenomenon. “One out of three companies in the survey that considered going public in the United States rated litigation as an ‘extremely important’ factor in their decision,” and “nine out of 10 companies who de-listed from a U.S. exchange in the last four years said the litigation environment played some role in that decision.”²⁶ This survey pointed out that “U.S.-listed companies face the potential of extraordinary litigation costs that companies listed abroad do not.”²⁷ These results are confirmed by a report commissioned by Senator Charles E. Schumer and New York City Mayor Michael R. Bloomberg, which found that “the

high legal cost of doing business in the US financial services industry is of real concern to corporate executives. When asked which aspect of the legal system most significantly affected the business environment, senior executives surveyed indicated that propensity toward legal action was the predominant problem.”²⁸ Indeed, 85 percent of CEOs indicated that London was preferable to New York in this regard.²⁹

The considerable increase in the number of federal class actions directed at *foreign* filers in 2007 reinforces the impression that the U.S. legal system is hostile to foreign businesses.³⁰ There has been an upsurge in the filing of securities class actions on behalf of *foreign* plaintiffs against *foreign* companies for trading on *foreign* exchanges—the “f-cubed” cases. Professor John

²⁶ The Financial Services Forum, 2007 *Capital Markets Survey* 6-8 (2007), available at <http://www.financialservicesforum.org/att/cf/%7B95f7c378-e3f0-4073-ab67-ed043f25dbb7%7D/FINAL%202007%20FORUM%20IPO%20STUDY.PDF>.

²⁷ *Id.* at 7.

²⁸ Bloomberg/Schumer Commission Report, *supra* note 25, at 75.

²⁹ *Id.*

³⁰ PriceWaterhouse Coopers, 2007 *Securities Litigation Study* 6, 56 (Apr. 8, 2008).

Coffee has stated that this new phenomenon produces “the fear that listing on a U.S. exchange exposes the foreign issuer to potentially bankrupting securities liabilities if its stock price were to decline sharply. This liability would be owed not simply to U.S. investors, but, more importantly, to a much larger worldwide class of foreign shareholders who acquired their shares outside the United States.”³¹ The danger is real: for instance, in June 2008, a class action lawsuit was filed in New York on behalf of U.S. investors who purchased shares in a foreign corporation that trades *only* on a foreign exchange.³² Moreover, foreign issuers have been the targets of enormous settlements: in 2006, 13 foreign issuers settled securities class actions for a total of \$2.4 billion, and two of the top ten largest settle-

ments of all time (Nortel, Royal Ahold) involved foreign issuers.³³

Whether jurisdiction in the U.S. is even appropriate is unclear and has been the subject of some dispute in the federal courts.³⁴ However, the negative effect on the willingness of companies to list their shares on the U.S. capital markets is clear.

Such litigation abuse is not without dire consequences. According to the Bloomberg/Schumer Commission Report, “the prevalence of meritless securities lawsuits and settlements in the U.S. has driven up the apparent and actual cost of doing business—and driven away potential investors.”³⁵ In 2006, for example, U.S. exchanges attracted only about one-third the share of global IPO volume as in 2001, and there is growing concern that the U.S. may soon

³¹ John C. Coffee, Jr., *Foreign Issuers Fear Global Class Actions*, Nat'l L. J. (Jun. 14, 2007); see also George T. Conway III, *The Rise and (Coming) Fall of “F-Cubed” Securities Litigation*, 9 Engage 33 (Mar. 2008).

³² Complaint, *Bristol County Retirement Sys. v. EADS*, No. 08-civ-5389 (S.D.N.Y., filed Jun. 12, 2008).

³³ PriceWaterhouse Coopers, *2007 Securities Litigation Study*, *supra* note 30, at 67-69; see also *In re Vivendi Universal S.A., Sec. Litig.*, 241 F.R.D. 213 (S.D.N.Y. 2007); *In re Royal Dutch/Shell Transp. Sec. Litig.*, 380 F. Supp. 2d 509 (D.N.J. 2005); *In re Royal Ahold N.V. Sec. & ERISA Litig.*, 351 F. Supp. 2d 334 (D. Md. 2004).

³⁴ See, e.g., *Bersch v. Drexel Firestone Inc.*, 519 F.2d 974 (2d Cir. 1975), *SEC v. Kasser*, 548 F.2d 109, 116 (3d Cir. 1977); *In re Nat'l Australia Bank Sec. Litig.*, 2006 U.S. Dist. Lexis 94162 (S.D.N.Y. Oct. 25, 2006); *Bleckner v. Daimler-Benz A.G.*, 410 F. Supp. 2d 266 (D. Del. 2006).

³⁵ *Bloomberg/Schumer Commission Report*, *supra* note 25, at ii.

► Recent Capital Markets Studies Note The Burden of Securities Class Actions

- *Sustaining New York's and the U.S.'s Global Financial Services Leadership*
(commissioned by Mayor Bloomberg and Senator Schumer)

"[T]he prevalence of meritless securities lawsuits and settlements in the U.S. has driven up the apparent and actual cost of doing business – and driven away potential investors."

- *Interim Report of the Committee on Capital Markets Regulation*

"The modern securities class action lawsuit creates a heavy burden for public companies; without a substantial social benefit, this burden cannot be justified...[H]owever, the public value of the securities class action litigation is questionable."

- *Commission on the Regulation of the U.S. Capital Markets in the 21st Century* (Independent Commission Established by U.S. Chamber of Commerce)

"[I]nternational observers increasingly cite the U.S. legal and regulatory environment as a critical factor discouraging companies and other market participants from accessing the U.S. markets."

- *The Blueprint For U.S. Financial Competitiveness* (Financial Services Roundtable)

"Excessive litigation and the threat of litigation are the most significant impediments to the competitiveness of U.S. businesses" and the growth in "securities class-action cases...presents a major competitive challenge to U.S. financial services firms in comparison to foreign firms that are not subject to a similar risk."

become marginalized in the global derivatives markets.³⁶ This trend is only worsening: through the end of 2007, the U.S.'s share of global IPO proceeds dropped to 20%.³⁷

These worrying trends will continue to accelerate if the securities class action system is not repaired. As recent studies have concluded, the enormous financial burden of securities class actions has contributed to a negative perception among global executives and investors regarding the predictability of the U.S. legal system, and the belief that it is particularly ineffective at discouraging abusive litigation. According to the Commission on the Regulation of the U.S. Capital Markets in the 21st Century, “international observers increasingly cite the U.S. legal and regulatory environment as a critical factor discouraging companies and other market participants from accessing the U.S. markets.”³⁸

Average Shareholders Benefit Little From These Suits

It is difficult to justify the burden imposed by securities class actions given their impact on U.S. companies and the overall economy; it is even more difficult given that average shareholders too are burdened by the current system without receiving much benefit. One recent study estimated that litigation over corporate disclosures, of which securities class actions are the key component, wipes out, at a minimum, an average of approximately 3.5% of the equity value of each company subjected to such litigation. These figures imply that between 1995 and 2005, securities class action litigation caused the destruction of nearly \$25 billion of shareholder wealth.³⁹ The Interim Report of the Committee on Capital Markets Regulation recognized that “[t]he modern securities class action

³⁶ *Id.* at 43, 54-56.

³⁷ PriceWaterhouse Coopers, *After a record year of U.S. IPO activity in 2007, 2008 is off to a sluggish start*, available at <http://www.pwc.com/extweb/ncpressrelease.nsf/docid/595A78775ABD5DCB852574320071A8CA>.

³⁸ *Chamber Commission Report*, *supra* note 4, at 30.

³⁹ Thakor, *Unintended Consequences*, *supra* note 19, at 1, citing Anjan Thakor et al., U.S. Chamber Institute for Legal Reform, *The Economic Reality of Securities Class Action Litigation* 8 (Oct. 2005) [hereinafter Thakor, “Economic Reality”].

lawsuit creates a heavy burden for public companies; without a substantial social benefit, this burden cannot be justified. ...[H]owever, the public value of...securities class action litigation is questionable.”⁴⁰

There are several reasons securities class actions do not in fact protect the average shareholder. First, settlement payments in such suits are not financed by wrongdoers but rather flow in a circular fashion from some innocent investors to others. Second, after attorneys’ fees and other costs are deducted, actual compensation for injured investors generally amounts only to pennies on the dollar of alleged investor loss.⁴¹ Third, average retail investors—the category of plaintiff who was the primary intended beneficiary of a class action system premised on the aggregation of small, individual claims—are per-versely the least able to take advantage of the class action mechanism.

With lawyers reaping millions and investors essentially left out, the unavoidable conclusion is that private securities class actions do not serve the goals of compensation or deterrence as effectively as enforcement by public authorities.

The Existing Securities Class Action System is Pointlessly Circular and has the Perverse Effect of “Punishing the Victims”

The most fundamental flaw in the current system is that the transfer of settlement payments from defendants to plaintiffs is inherently circular: securities class actions do little more than shift money from one innocent investor to another, even when the underlying claims may be legitimate. (See Figure 4). Widely shared concerns about this “immense amount of pocket-shifting” were in fact the core issue raised in a letter submitted by a prominent group of academics to the SEC last year.⁴²

⁴⁰ *Interim Report*, supra note 25, at 78.

⁴¹ Thakor, *Economic Reality*, supra note 39, at 8.

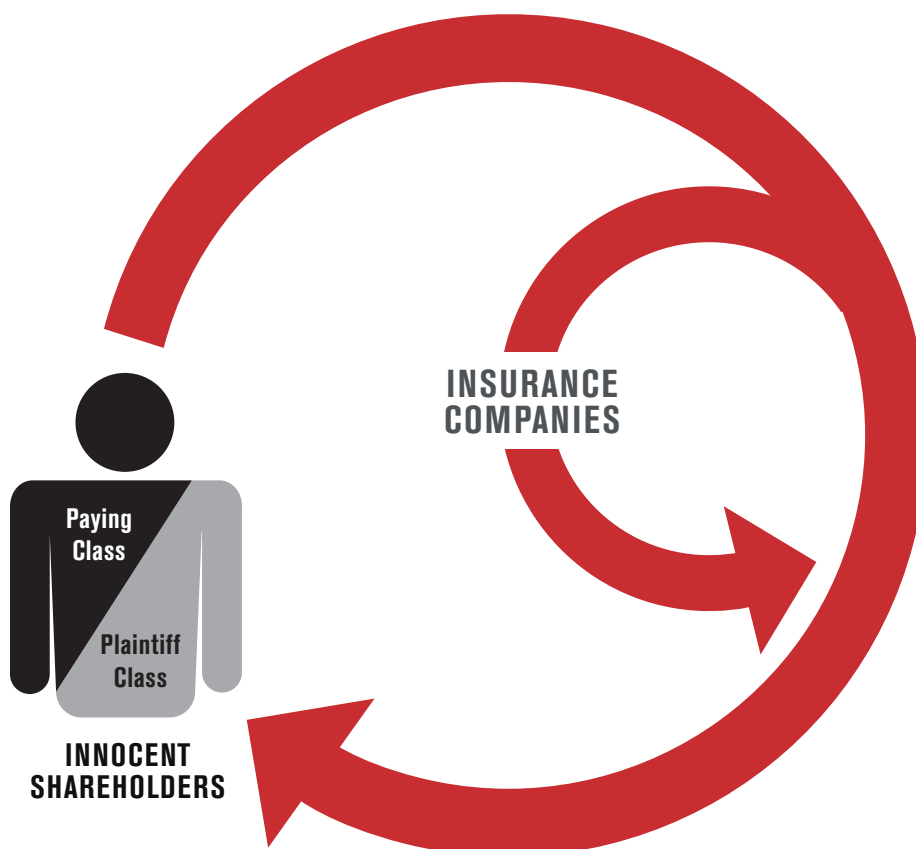
⁴² Letter from Donald C. Langevoort et al. to the Honorable Christopher Cox, Chairman, U.S. Securities and Exchange Commission (Aug. 2, 2007), available at <http://www.the10b-5daily.com/archives/Chairman%20Cox%20SEC%20Letter.pdf> (signed by Professors Donald Langevoort, James D. Cox, Jill Fisch, Michael A. Perino, Adam C. Pritchard, and Hilary A. Sale).

The circularity of the system stems from the fact that the defendant company, and not the individuals guilty of any actual wrongdoing, almost always pays the settlement. Indeed,

the evidence suggests that, on average, individuals accused of wrongdoing contribute less than one-half of one percent of the typical settlement fund.⁴³ A prime example is the settle-

► The Existing System is Pointlessly Circular

Figure 4



⁴³ Donald C. Langevoort, *Capping Damages For Open Market Securities Fraud*, 38 Ariz. L. Rev. 639, 648 & n.43 (1996) [hereinafter Langevoort, *Capping Damages*]; see also Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 Stan. L. Rev. 1487, 1499 (1996).

ment of securities class action litigation against the Cendant corporation in 2000, which totaled \$3.2 billion at the time of settlement; the company itself paid \$2.85 billion with no individual contribution (the company's auditor paid the rest).⁴⁴

And the company's financial burden is not limited to the settlement amount. Defense expenditures are often 25-30% of the settlement amount, and fees to defense counsel that approach 50% and even 100% of the settlement value are not infrequent.⁴⁵

Even when a company's insurance covers the settlement and litigation costs, the company ultimately ends up footing much of the bill because insurance premiums inevitably increase to reflect the higher risk of liability. These spiraling expenditures in part explain why insurance costs for a Fortune 500 company are over six times higher in the United States than in Europe.⁴⁶

The billions of dollars in settlement and litigation costs paid by a company, moreover, do not materialize out of thin air. The economic burden of these huge payments is borne by existing shareholders—the owners of the company: “nearly all the money paid out as compensation in the form of judgments and settlements comes, one way or another, from investors themselves.”⁴⁷ Yet existing shareholders as a group gain no benefit from any past fraud regarding the value of the company's stock—the monetary gain from the fraud typically would be reaped by the investors who sold their stock at an inflated price while the fraud was ongoing. Those investors, however, are not obliged to disgorge those gains, because they generally are innocent beneficiaries of the fraud. Unlike the typical common law fraud claim, in which the party who gains from a fraud is required to compensate the party who was injured by the fraud, the compensation burden in

⁴⁴ Donald C. Langevoort, *On Leaving Corporate Executives “Naked, Homeless and Without Wheels”: Corporate Fraud, Equitable Remedies, and the Debate over Entity Versus Individual Liability*, 42 Wake Forest L. Rev. 627, 628 n.2 (2007) [hereinafter Langevoort, *Without Wheels*].

⁴⁵ Coffee, *supra* note 2, at 1546 & n.38.

⁴⁶ *Interim Report*, *supra* note 25, at 78.

⁴⁷ Langevoort, *Capping Damages*, *supra* note 43, at 648.

securities class actions falls upon innocent shareholders.

One group of innocent shareholders—those who hold the stock at the time of legal judgment against the company or when the claim is settled—thus ends up paying another group of innocent shareholders—those who are in the litigation class.⁴⁸ Professor John Coffee aptly analogized this “perverse” system “to punishing the victims of burglary for their failure to take greater precautions.”⁴⁹

Compounding this inherent circularity problem is the fact that upon the issuance of any corrective disclosure, the price decline in a company’s stock often includes the anticipated cost of an eventual settlement or judgment in the class action that is sure to follow. In other words, average shareholders who hold the company’s stock at the time of such a disclosure—let alone any eventual settlement—“inevitably

bear a fraction of the cost of the litigation and settlement that is borne by the corporation...and the plaintiff class is, in effect, suing itself.”⁵⁰

After Legal Fees and Other Costs Are Deducted from a Settlement Fund, Injured Investors Typically Receive Only Pennies on Each Dollar of Alleged Loss

Beyond this senseless circularity, private securities class actions do not even provide much compensation to those investors who actually may have been injured. Indeed, once settlements are negotiated and lawyers and other middlemen have taken their cut, injured investors usually recover only a miniscule share of their alleged losses—averaging pennies on the dollar.⁵¹ As Professor Donald Langevoort has observed, “[w]ere this [system] sold as an insurance product, consumer-protection advocates might well seek to have it banned as abusive because the hidden costs are so large.”⁵²

⁴⁸ *Interim Report*, *supra* note 25, at 79.

⁴⁹ Coffee, *supra* note 2, at 1538, 1562.

⁵⁰ Grundfest Statement, *supra* note 1, at 2-3.

⁵¹ Thakor, *Economic Reality*, *supra* note 39, at 8.

⁵² Langevoort, *Without Wheels*, *supra* note 44, at 635.

One recent study found that over the past five years, the median ratio of settlements compared to investor losses ranged between only 2% and 3%, and has declined over the past two years, dropping to 2.4% in 2007.⁵³ These already miniscule percentages are further reduced by the substantial transaction costs associated with private class action lawsuits—primarily legal fees and charges by various other middlemen, including claims administrators, consultants, and brokers. It has been estimated that such transaction costs constitute as much as 47 cents of each settlement dollar, substantially reducing further whatever eventually trickles down to injured investors.⁵⁴

The legal fees taken by plaintiffs' attorneys are the largest component

of these costs. Studies have estimated that plaintiffs' lawyers typically take approximately one-third of the amount recovered pursuant to the average settlement.⁵⁵ Accordingly, the aggregate numbers suggest that nearly \$17 billion went directly into the pockets of plaintiffs' attorneys in the past decade alone.⁵⁶ These enormous payouts are highly concentrated among a few firms: in 2007, three firms (Coughlin Stoia, Milberg, and Schiffrin & Barroway) accounted for 58% of all settled cases.⁵⁷

Soaring fee awards, moreover, have accompanied the dramatic increase in settlement amounts. According to one recent study, the average securities class action settlement in 2005 yielded over \$6 million in fees paid to plaintiffs' counsel, as compared to \$3.6 million in 2000.⁵⁸ In cases with the largest set-

⁵³ *Recent Trends*, *supra* note 3, at 14; see also *Interim Report*, *supra* note 25, at 79; *Chamber Commission Report*, *supra* note 4, at 29; Coffee, *supra* note 2, at 1547.

⁵⁴ See Eleanor Laise, *Picked Clean—Plaintiff's Attorneys and Middlemen Thrive under the Securities Class-action System; What's in it for You? Pretty Much Bupkis*, SmartMoney, May 1, 2005.

⁵⁵ See Coffee, *supra* note 2, at 1546; Elaine Buckberg *et al.*, NERA Econ. Consulting, *Recent Trends in Shareholder Class Action Litigation: Bear Market Cases Bring Big Settlements* 10 (Feb. 2005); see also *Interim Report*, *supra* note 25, at 79.

⁵⁶ It is estimated that plaintiffs' attorneys obtain 32% of the value of a settlement in fees, and in the past decade securities class action defendants settled for a total of nearly \$52 billion. Coffee, *supra* note 2, at 1546 & n.38; *Class Action Settlements*, *supra* note 20, at 5.

⁵⁷ *Class Action Settlements*, *supra* note 20, at 14.

tlements, legal fees frequently run into the hundreds of millions of dollars.⁵⁹

Worse still, legal fees in securities class actions are often higher than in other types of litigation. Indeed, the hourly rate awarded to lawyers in securities class actions—averaging \$1,370 per hour according to one study—is significantly higher than the rate in

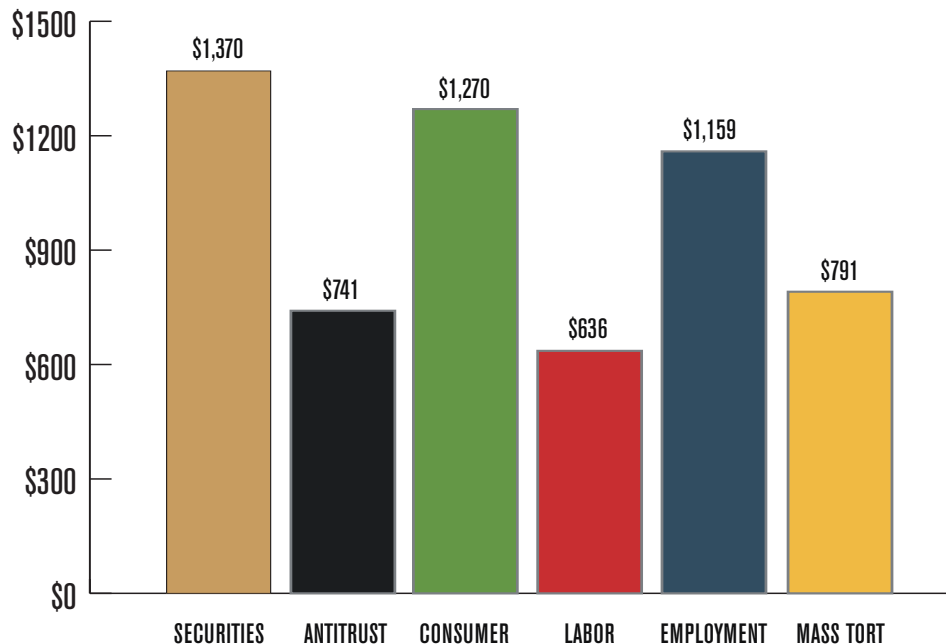
antitrust, labor, discrimination, or mass tort class actions. (See Figure 5).

Small, Individual Investors Typically Benefit the Least from the Private Securities Class Action System

The class action mechanism is intended to open the legal system to those individual investors with claims that are too small to justify a stand-

► Average Hourly Rate Awarded to Plaintiffs' Counsel

Figure 5



Source: Stuart J. Logan et al., *Attorney Fee Awards in Common Fund Class Actions*, 24 Class Action Rep. 167, 196 (2003).

⁵⁸ Buckberg et al., NERA Econ. Consulting, *Recent Trends in Shareholder Class Action Litigation: Are Worldcom and Enron the New Standard?* 7 (July 2005).

⁵⁹ See, e.g., *In re WorldCom, Inc. Sec. Litig.*, 388 F. Supp. 2d 319 (S.D.N.Y. 2005) (approval of \$336 million fee); Nathan Koppel, *Law Firms to Ask For \$460 Million In Tyco-Case Fees*, Wall St. J. (Nov. 1, 2007).

alone lawsuit. Perversely, however, it is these small investors who are least likely to receive substantial compensation pursuant to a class action settlement. This is true in part because individual retail investors generally buy stock and hold it for the long run, thus reducing the likelihood that they acquired shares during the “class period”—the period of time within which the stock must have been purchased for the buyer to be legally entitled to participate in a class action.⁶⁰

By contrast, sophisticated and large institutional investors tend to benefit disproportionately. Frequently trading investors, such as hedge funds, are more likely to benefit from securities class action recoveries because they are more likely to have purchased stock within a given class period. Moreover, the existing system overcompensates large diversified institutional investors who, on the whole,

are just as likely to derive benefits from actual fraudulent conduct when they sell some stocks at fraud-inflated prices as they are to suffer harm when they buy other stocks at fraud-inflated prices.⁶¹

This overcompensation problem is compounded by the benefit that all plaintiffs—including sophisticated and diversified investors—receive from the “fraud-on-the-market” presumption. Under this judicially created theory, plaintiffs need not prove actual reliance on a defendant’s alleged misstatement because it is presumed that an efficient market internalizes the misrepresentation.⁶² While this theory may plausibly be defended when it comes to small investors who rely on market pricing and generally may not as a practical matter be able to show actual reliance on any alleged misstatements, it makes no sense when it comes to the large institutional investors who dispropor-

⁶⁰ *Interim Report*, *supra* note 25, at 80; Thakor, *Unintended Consequences*, *supra* note 19, at 10-11; Thakor, *Economic Reality*, *supra* note 39, at 18-19.

⁶¹ Coffee, *supra* note 2, at 1560; see also *Interim Report*, *supra* note 25, at 80; Thakor, *Unintended Consequences*, *supra* note 19, at 10-11; Thakor, *Economic Reality*, *supra* note 60, at 12-18.

⁶² *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

tionately benefit from the existing system. Those large investors are sophisticated enough to make trading decisions based on their own market evaluations and, when necessary, to prove actual reliance on any alleged misstatements that may in fact have influenced their evaluations

Of course, many individual investors effectively hold their stock through such institutions, either because they own shares in mutual funds or have a future entitlement to their pensions. However, because such institutions tend to allocate their settlement recoveries to the portfolio that held the affected security or to a general fund, and not to the individuals who were hurt by the fraud when it happened, the result is “a serious mismatch between the beneficiaries of the settlement and those who have been harmed by the [underlying] securities violation.”⁶³

Even when small investors directly

participate in a class action that results in a settlement, the process by which settlement funds are distributed is so costly, difficult, and inefficient that it is impossible for many of them to collect their money at all, let alone in a timely fashion. Many small investors are unable to navigate the myriad obstacles to recovery, including complex forms, high fees, and unnecessary middlemen. For example, settlement claims administrators tend to rely on the record holders of the stock—generally brokerage firms—to contact individual investors, but this process can be burdensome and is at best incomplete. Even when small investors do receive compensation—in most cases an amount far less than their alleged investment losses—it may only come years after the case was settled.⁶⁴

⁶³ James D. Cox & Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence And Legal Implications Of The Failure Of Financial Institutions To Participate In Securities Class Action Settlements*, 58 Stan. L. Rev. 411, 449 (2005).

⁶⁴ See generally *Laise*, *supra* note 54.

Public Enforcement by the SEC, DOJ, and Other Authorities Better Serves the Goals of Compensation and Deterrence than Private Class Actions

Parties that engage in fraud or assist the fraudulent acts of another are subject to the ample regulatory, civil, and criminal enforcement powers of the Securities and Exchange Commission (“SEC”), the Department of Justice (“DOJ”), state authorities, and other financial services self-regulatory organizations. These authorities are sufficient to deter wrongdoers effectively and to compensate shareholders efficiently, without the tremendous costs of the private class action litigation system. Indeed, according to the Independent Committee on Capital Markets Regulation, “[t]he United States has the toughest administrative enforcement of securities laws in the world.”⁶⁵

Public enforcement by the SEC has been particularly robust in recent years. In fiscal year 2007 alone, the SEC brought 656 enforcement actions, a 14% increase over 2006. Over the past two fiscal years, the SEC has initiated a total of 1676 investigations, brought 480 suits and 750 administrative proceedings, and obtained orders for almost \$5 billion in disgorgement and penalties from securities law violators (contributing to a total of \$13.8 billion ordered from FY 2003 to FY 2007).⁶⁶ These results track a significant increase in personnel dedicated to enforcement; between 2002 and late 2004, the SEC hired more than 1000 accountants, lawyers, and staff, a 27% increase in its professional staff.⁶⁷

Pursuant to the Sarbanes-Oxley Act, the SEC is authorized to use a mechanism known as “Fair Funds” to compensate injured investors.⁶⁸ The Fair Funds system was created to allow the SEC to place disgorge-

⁶⁵ *Interim Report*, *supra* note 25, at 71.

⁶⁶ U.S. Securities and Exchange Commission (“SEC”), *2006 Performance and Accountability Report 8*, available at <http://tinyurl.com/ygyfv8> [hereinafter *SEC, 2006 Report*]; SEC, *2007 Performance and Accountability Report 25*, available at <http://www.sec.gov/about/secpar/secpar2007.pdf>. [hereinafter *SEC, 2007 Report*].

⁶⁷ Carrie Johnson, *Motivated to Prosecute*, Wash. Post, Oct. 20, 2004, at E1.

⁶⁸ Sarbanes-Oxley Act, Pub. L. No. 107-204, § 308(a), 116 Stat. 745 (codified 15 U.S.C. § 7246(a)).

ment recoveries and civil penalties into funds reserved for the benefit of those investors harmed by the punished conduct. The funds are distributed pursuant to plans that must be approved either by a court or by the SEC after a period for public comment, thus ensuring proper identification of the eligible beneficiaries and accurate calculation of their shares of the fund. Since 2002, at least 115 Fair Funds have been created, \$8.4 billion has been recovered from securities law violators, and nearly \$4 billion has already been distributed to injured investors.⁶⁹ Unlike plaintiffs' lawyers, however, the SEC does not take one-third of such recoveries in attorneys' fees and can use prosecutorial discretion to wield its authority when recovery is justified on the merits, rather than in pursuit of a payday.

The SEC, moreover, has a wide range of additional tools beyond financial penalties at its disposal, including: officer and director bars, injunctive relief, cease-and-desist orders, and orders requiring corrective disclosures and corporate governance changes.⁷⁰ As one commentator has observed, "what is remarkable is the breadth of the SEC's ability to reach individual corporate executives" who participate in "fraud influencing the investing public."⁷¹ Moreover, parties that engage in fraud often can be held criminally liable for their actions, with the possibility of imprisonment and substantial monetary penalties. Between July 2002 and April 2008, the Justice Department's Corporate Fraud Task Force has obtained nearly 1300 guilty pleas and convictions (including those of over 200 CEOs), levied billions in fines, and ordered hundreds of mil-

⁶⁹ Christopher Cox, Chairman, U.S. Securities And Exchange Commission, *Statement On FY 2007 Enforcement Division Statistics* (Washington, D.C., November 15, 2007), available at <http://www.mondovisione.com/index.cfm?section=news&action=detail&id=70898>; SEC, *2006 Report*, *supra* note 66, at 23; *A Review of Investor Protection and Market Oversight With the Five Commissioners of the Securities and Exchange Commission*, Hearing Before the House Comm. on Financial Services, 110th Cong., 1st Sess. (June 26, 2007); U.S. GAO, *Securities and Exchange Commission: Additional Actions Needed to Ensure Planned Improvements Address Limitations in Enforcement Division Operations 25-27* (Report to the Ranking Member, Committee on Finance, U.S. Senate, Aug. 2007); SEC Press Release, *SEC Announces \$103 Million Fair Fund Distribution to Investors Injured by Market Timing* (Jun. 18, 2008), available at <http://www.sec.gov/news/press/2008/2008-114.htm>.

⁷⁰ See Vincent J. Badolato, *Securities Law Techniques* §§ 7.06-87.07 (Matthew Bender 2006).

⁷¹ Langevoort, *Without Wheels*, *supra* note 44, at 652.

lions to be paid in restitution.⁷² The possibility of massive individual penalties, career-ending sanctions, and imprisonment is a far greater deterrent to wrongful conduct than private enforcement through class actions, given that individuals rarely must contribute to the resolution of class actions, and that class actions virtually always are settled without any determination regarding the wrongfulness of the defendants' conduct.⁷³

In addition to enforcement of the securities laws by the federal government, there are other public and semi-public mechanisms for policing fraud in connection with publicly traded securities. State attorneys general and other state officials have been vigorous in challenging fraud. Financial services self-regulatory organizations have been no less vigilant: the National Association of

Securities Dealers and the New York Stock Exchange annually discipline hundreds of individuals and dozens of firms, and in July 2007 these two groups merged their regulatory oversight functions and established the Financial Industry Regulatory Authority (FINRA), the largest non-governmental regulator for securities firms in the U.S.⁷⁴ Remedial action under state law constitutes another effective mechanism for pursuing recovery from individual corporate wrongdoers.⁷⁵

The Securities Class Action System is Plagued by Abuse

The private securities class action system is more than just burdensome and inadequate to the task of protecting the average shareholder—it has been hijacked by trial lawyers who have abused the system in order to obtain a share of soaring attorney fee awards. Congress passed the Private Securities

⁷² U.S. Department of Justice, Corporate Fraud Task Force, Report to the President, at iii (Apr. 2008), available at <http://www.usdoj.gov/dag/cftf/corporate-fraud2008.pdf>; U.S. Department of Justice, Fact Sheet: President's Corporate Fraud Task Force Marks Five Years of Ensuring Corporate Integrity (July 2007), available at http://www.usdoj.gov/opa/pr/2007/July/07_odag_507.html.

⁷³ Coffee, *supra* note 2, at 1534.

⁷⁴ See, e.g., <http://www.oag.state.ny.us/press/agpress04.html> (New York Attorney General obtained more than \$1 billion in settlements in 2004 alone); NASD Statistics, <http://www.nasd.com/PressRoom/Statistics/index.htm>; FINRA, *FINRA Statistics* (last updated 6/6/08), available at <http://www.finra.org/PressRoom/Statistics/index.htm>.

⁷⁵ Langevoort, *Without Wheels*, *supra* note 44, at 640-48.

Litigation Reform Act (PSLRA) in 1995 in part to address concerns over such abuses. Not only have some of the most egregious abuses by plaintiffs' lawyers continued well after enactment of the PSLRA—such as secret illegal payments to so-called “professional plaintiffs”—but new abuses have emerged with the rapid rise of a modern “pay-to-play” culture of corruption.

The Continuing Problem of Illegal Payments to Repeat Plaintiffs

When Congress enacted the PSLRA, one of the abuses it sought to curb was the practice of lawyers paying “bounties” to repeat plaintiffs or so-called “professional plaintiffs”—individuals who held small amounts of stock in a large number of public companies and were thus ready to sue upon a moment's notice. Attorneys would collaborate with these repeat plaintiffs so they could be the first to the courthouse to file a complaint and

thus secure lead attorney status. The PSLRA made this practice illegal by prohibiting payments of bounties to class action plaintiffs.⁷⁶

But these illegal payments have continued to plague the American legal system, as seen most clearly in the conviction of four former partners at the preeminent plaintiffs' law firm in the country, Milberg Weiss LLP (now known simply as “Milberg LLP”) and the firm's own admission of wrongdoing. The problem seems to be systemic and fundamental. As Bill Lerach, one of the former Milberg Weiss partners who recently fell from the top of the plaintiffs' class action industry to a federal prison cell, told the Wall Street Journal, his illegal conduct was merely “industry practice.”⁷⁷ A recent empirical study by law professor Michael Perino suggests that while this conduct may have enriched the lawyers and repeat

⁷⁶ 15 U.S.C. § 78u-4(a)(2)(A)(vi) (requiring lead plaintiffs to certify that they “will not accept any payment for serving as a representative party on behalf of a class beyond the plaintiff's pro rata share of any recovery” or the plaintiff's reasonable costs and expenses); H.R. Conf. Rep. No. 104-369, *reprinted in* 1995 U.S.C.C.A.N. at 731-32 (describing how professional plaintiffs receive “bounty payments” and how the PSLRA would discourage the use of professional plaintiffs).

⁷⁷ Peter Lattman, *Mr. Lerach Mulls Life Behind Bars, Guilty but Defiant, The Plaintiffs' Lawyer Kicks Back in La Jolla*, Wall St. J., Feb. 12, 2008.

plaintiffs involved, it did not benefit absent class members in terms of leading to higher recoveries.⁷⁸

According to the Milberg Weiss indictment, between 1979 and 2005, senior firm partners formed a conspiracy to obstruct justice, perjure themselves, and engage in bribery and fraud by paying kickbacks to repeat plaintiffs.⁷⁹ The indictment alleged that this scheme brought in more than \$251 million in “tainted” attorneys’ fees.⁸⁰ The alleged conspirators also purportedly used subterfuge and outright lies—including false and misleading statements in court documents and under oath during depositions—to conceal the existence of the scheme from judges and other parties.⁸¹ The alleged conduct of Milberg Weiss and its princi-

pals over a period of more than two-and-a-half decades is a stunning demonstration that the payment of secret kickbacks to repeat plaintiffs is an ongoing problem. Indeed, the indictment describes illegal payments made after the enactment of the PSLRA.⁸²

The scope of the admitted corruption is staggering. In June 2008 the firm itself admitted wrongdoing and settled the federal suit against it for \$75 million.⁸³ And prior to that there had been eight guilty pleas. Four former named or managing partners, three repeat plaintiffs, and one expert witness have pleaded guilty to criminal felonies:

- Bill Lerach, a former named partner who left Milberg Weiss in 2003 to start another plaintiffs’ firm and was for years the most feared name in

⁷⁸ Michael A. Perino, “The Milberg Weiss Prosecution: No Harm, No Foul?”, AEI Legal Center, *available at* http://www.aei.org/publications/pubID.28060/pub_detail.asp.

⁷⁹ Second Superseding Indictment, *United States v. Milberg Weiss LLP*, CR 05-587 (D)-JFW, ¶¶ 24, 27, 37 (C.D. Cal.) (Oct. 2006 Grand Jury), *available at* <http://online.wsj.com/public/resources/documents/milbergweissindict.pdf>. [hereinafter Second Superseding Indictment].

⁸⁰ *Id.* ¶ 85.

⁸¹ *Id.* ¶¶ 27, 29, 37, 41-43.

⁸² *Id.* ¶¶ 50, 52, 57, 59; *see also id.* ¶¶ 31-33 (noting that kickbacks to Lazar continued until 2004, that kickbacks to Vogel continued until 2005, and that kickbacks to Cooperman continued until 1999—all long after the passage of the PSLRA).

⁸³ Ashby Jones, *The Saga’s End (Almost): Milberg, Feds Reach \$75 Million Settlement*, Wall Street Journal Law Blog, Jun. 17, 2008, <http://blogs.wsj.com/law/2008/06/17/the-sagas-end-almost-milberg-feds-reach-75-million-settlement/>; Dan Slater, *More Terms Emerge on Milberg’s Expected Non-Pros Agreement*, Wall Street Journal Law Blog, Jun. 16, 2008, <http://blogs.wsj.com/law/2008/06/16/more-terms-emerge-on-milbergs-expected-non-pros-agreement/>.

securities class actions, pleaded guilty to conspiracy, agreed to pay nearly \$8 million in fines and penalties, and accepted disbarment. In February 2008, U.S. District Judge John Walter sentenced Lerach to two years in federal prison, remarking that Lerach's crimes corrupted the legal system and his law firm "in the most evil way";⁸⁴

- Melvyn Weiss, the co-founder of Milberg Weiss and one of the architects of the securities class action industry, pleaded guilty to conspiracy, admitting he lied to judges and paid kickbacks to plaintiffs over the course of 25 years. He agreed to pay nearly \$10 million in fines and penalties. In June 2008, Judge

Walter sentenced Weiss to 30 months in prison, condemning Weiss's criminal conduct which struck "directly at the core and heart of the judicial system";⁸⁵

- Steven Schulman, a former named partner at Milberg Weiss, pleaded guilty to a racketeering charge, agreed to pay a \$250,000 fine and to forfeit \$1.85 million in ill-gotten gains, and has been disbarred;⁸⁶

- David Bershad, a former named partner and managing partner at Milberg Weiss, pleaded guilty to conspiracy and agreed to pay a \$250,000 fine and forfeit \$7.75 million in ill-gotten gains;⁸⁷

⁸⁴ Jane Wells, *Bill Lerach: A Case Of How The Mighty Have Fallen* (Feb. 12, 2008), available at <http://www.cnbc.com/id/23128503>; Carrie Johnson, *Lerach Enters Guilty Plea In Class-Action Controversy*, Wash. Post, Oct. 30, 2007, at D7, available at <http://www.washingtonpost.com/wp-dyn/content/article/2007/10/29/AR2007102901796.html>; Barry Meier, *Lawyer Will Plead Guilty in Kickback Scheme*, N.Y. Times, Sept. 18, 2007, available at http://www.nytimes.com/2007/09/18/business/18lerach.html?_r=1&hp&oref=slogin; Press Release, U.S. DOJ, *William Lerach, Former Name Partner in Milberg Weiss, Sentenced to 2 Years in Federal Prison for Obstructing Justice and Mak[ing] False Statements to Federal Judges*, Feb. 11, 2008, <http://www.usdoj.gov/usao/cac/pressroom/pr2008/012.html>.

⁸⁵ Amanda Bronstad, *Mel Weiss Sentenced to 30 Months for Kickback Scheme*, The Nat'l Law J. (Jun. 3, 2008), available at <http://www.law.com/jsp/article.jsp?id=1202421890210>; Press Release, U.S. DOJ, *Melvyn Weiss, Co-Founder of Milberg Weiss Law Firm, Sentenced to 2 1/2 Years in Prison for Racketeering*, June 2, 2008, <http://www.usdoj.gov/usao/cac/pressroom/pr2008/075.html>.

⁸⁶ Gina Keating, *Milberg partner pleads guilty to racketeering*, Reuters, Oct. 9, 2007, available at <http://www.reuters.com/article/bondsNews/idUSN0942321920071009>; Press Release, U.S. DOJ, *Steven Schulman, Former Name Partner in Milberg Weiss, Agrees to Plead Guilty to Federal Racketeering Offense and Admit Role in Paid Plaintiff Kickback Scheme*, Sept. 20, 2007, <http://www.usdoj.gov/usao/cac/pressroom/pr2008/075.html>.

⁸⁷ Carrie Johnson, *Guilty Plea Puts Pressure On Firm*, Wash. Post, July 10, 2007, at D1, available at <http://www.washingtonpost.com/wp-dyn/content/article/2007/07/09/AR2007070901761.html>; Press Release, U.S. DOJ, *Former Name Partner in Milberg Weiss Law Firm to Plead Guilty to Participating in Illegal Kickback Scheme*, July 9, 2007, <http://www.usdoj.gov/usao/cac/pressroom/pr2007/089.html>.

- Steven Cooperman, a repeat plaintiff who, along with certain relatives and associates, collaborated with Milberg Weiss in approximately 70 lawsuits and allegedly collected at least \$6.2 million in illegal kickbacks, pleaded guilty to conspiracy to obstruct justice and making false statements and agreed to pay at least \$250,000 in fines (and could receive up to five years in prison, plus three years of supervised release),⁸⁸
- Seymour Lazar, a repeat plaintiff, who along with certain family members, collaborated with Milberg Weiss in approximately 67 lawsuits from 1976 to 2004 and allegedly collected \$2.6 million in illegal kickbacks, pleaded guilty to obstruction of justice, filing a false tax return, and making a false declaration and agreed to pay a \$600,000 fine and forfeit \$1.5 million in ill-gotten gains;⁸⁹
- Howard Vogel, another repeat plaintiff for Milberg Weiss, pleaded guilty to lying under oath to a judge to conceal his kickbacks and making a false declaration to a court. Vogel agreed to forfeit \$2 million of his illegal gains;⁹⁰ and
- John Torkelsen, Milberg Weiss's principal damages expert, pleaded guilty to perjury for lying to numerous federal judges about his fee arrangements with Milberg Weiss. The firm allegedly paid him contingent fees—an illegal fee structure that gave him a direct financial interest in the cases in which he testified. Torkelsen allegedly received vast sums from Milberg Weiss, includ-

⁸⁸ Second Superseding Indictment, *supra* note 79, ¶ 33; Matthew Hirsch, *Former Lead Plaintiff's Guilty Plea May Spell Trouble for Lawyer Lerach*, *The Recorder*, Feb. 1, 2007, available at <http://www.law.com/?com/?jsp/?article.jsp?id=1170237762709>; Press Release, U.S. DOJ, *Former Name Partner in Milberg Weiss Law Firm to Plead Guilty to Participating in Illegal Kickback Scheme*, July 9, 2007, <http://www.usdoj.gov/usao/cac/pressroom/pr2008/075.html>.

⁸⁹ Second Superseding Indictment, *supra* note 79, ¶ 31; *Another Guilty Plea in Milberg Weiss Case*, *N.Y. Times*, Oct. 18, 2007, available at http://www.nytimes.com/2007/10/19/business/19milberg.html_r=1&oref=slogin.

⁹⁰ Press Release, U.S. DOJ, *Milberg Weiss Law Firm, Two Senior Partners Indicted In Secret Kickback Scheme Involving Named Plaintiffs In Class-Action Lawsuits*, May 18, 2006, <http://www.usdoj.gov/usao/cac/pressroom/pr2006/061.html>.

ing \$60 million from 1993 to 1996 alone.⁹¹

Given the scope of the admitted Milberg Weiss conspiracy and Lerach's admission that such conduct was "industry practice," Congressional leaders have already called for bipartisan hearings on these abuses and potential legislative reforms.⁹²

The Rise of "Pay-to-Play" and the New "Class Action Industrial Complex"

Unfortunately, the scandal at Milberg Weiss may be just the tip of the iceberg in terms of abuse in the new "class action industrial complex."⁹³ The problem seems to extend far beyond just one corrupt law firm and its clearly illegal activities. As institutional investors like public pension funds play an increasingly important role as lead

plaintiffs in securities class actions, a "pay-to-play" culture has emerged in which plaintiffs' law firms contribute to the political campaigns of officials who control the decisions of those funds. As succinctly described by the late Judge Edward Becker of the United States Court of Appeals for the Third Circuit: "[P]ublic pension funds are in many cases controlled by politicians, and politicians get campaign contributions. The question arises then as to whether the lead plaintiff, a huge public pension fund, will select lead counsel on the basis of political contributions made by law firms to the public officers who control the pension funds and who, therefore, have a lot of say in selecting who counsel is."⁹⁴

Law professor John Coffee has recognized that "unless halted, 'pay-to-

⁹¹ Peter Elkind, *The fall of America's meanest law firm—Milberg Weiss, the lawsuit factory that took corporations for \$45 billion, is in the feds' cross hairs*, *Fortune*, Nov. 3, 2006; Dan Slater, *Expert's Plea in Milberg Case Brings Out . . . Another Lawyer!*, *Wall Street Journal Law Blog*, Mar. 7, 2008, available at <http://blogs.wsj.com/law/2008/03/07/experts-plea-in-milberg-case-brings-out-another-lawyer/>; Press Release, U.S. DOJ, *New Jersey Man Who Served As Expert Witness In Numerous Class Actions Agrees To Plead Guilty To Perjury For Concealing Arrangements With Law Firms*, Feb. 28, 2008, www.usdoj.gov/usao/cac/pressroom/pr2008/020.html; Dan Slater, *Law Blog Afternoon Roundup: Torkelsen to Plead (and More!)*, *Wall Street Journal Law Blog*, <http://blogs.wsj.com/law/2008/02/28/law-blog-afternoon-news-roundup-torkelsen-pleads-and-more/>.

⁹² John Boehner & Lamar Smith, *Letter to the Honorable John Conyers, Jr.*, May 2, 2008, available at http://wsj.net/public/resources/documents/WSJ_ConyersLetter.pdf.

⁹³ Neil Weinberg & Daniel Fisher, *The Class Action Industrial Complex*, *Forbes*, Sept. 20, 2004, available at <http://www.forbes.com/business/forbes/2004/0920/150.html>.

⁹⁴ Edward R. Becker et al., *The Private Securities Law Reform Act: Is It Working?*, 71 *Fordham L. Rev.* 2363, 2369 (2003).

play' will likely become the dominant technique for locking-in a large plaintiff as a client."⁹⁵ The available evidence appears to bear that out. For example, USA Today's investigation and analysis of campaign finance records in five states and two major cities found that "[l]aw firms chasing jackpot-size fees are showering money on politicians with influence at large public pension funds—which, in turn, are hiring them to file multi-million-dollar lawsuits against U.S. companies."⁹⁶ The investigation uncovered serious potential abuses in states such as Pennsylvania and New York, where trial lawyers had given hundreds of thousands of dollars to politicians who had the authority to select counsel or to appoint those who did, and where those same lawyers were ultimately chosen to represent pension funds in lawsuits that netted them tens of millions of dollars in legal fees.⁹⁷

Concerns about the rise of pay-to-play are not limited to campaign contributions. Another recent investigation revealed that the general counsel and longtime advisor to some of Illinois' largest public and private pension funds received more than \$750,000 in direct payments from an outside plaintiffs' law firm (Milberg Weiss) that was selected to represent some of those same funds in class action litigation. The \$750,000 in payments related to four settled cases in which the lawyer's pension fund clients claimed losses totaling only about \$225,000. Attorneys' fees in the cases, however, ultimately amounted to \$44 million.⁹⁸

The end result of this pay-to-play culture is "the equivalent of hanging a 'for-rent' sign out over the pension fund."⁹⁹ This dynamic is well illustrated by the recent switch of lead counsel in a lawsuit against Fannie Mae. In an unusual

⁹⁵ John C. Coffee, Jr., *Nobody Asked Me, But . . .*, Nat'l L. J., Jan. 18, 2007.

⁹⁶ Kevin McCoy, *Campaign Contributions or Conflicts of Interest?*, USA Today, Sept. 11, 2001.

⁹⁷ *Id.*

⁹⁸ David Kidwell, *Illinois Lawyer Tied to Indicted Law Firm*, Chicago Tribune, June 22, 2006.

⁹⁹ Joseph Tanfani and Craig R. McCoy, *Lawyers Find Gold Mine in Philadelphia Pension Cases*, Philadelphia Inquirer, Mar. 16, 2003, A1 (quoting Professor Coffee).

move, the law firm representing two Ohio state retirement funds in a fraud suit against Fannie Mae was replaced—at the behest of the state’s attorney general, who was overseeing the case—sparking concern that the irregular switch was made for political considerations. The old firm had contributed more to the attorney general’s opponent than to the attorney general in the most recent election; the son of the lead lawyer at the new firm contributed \$25,000 to the attorney general’s campaign and to his political party.¹⁰⁰

Finally, the abuses plaguing the securities class action system go beyond just pay-to-play. For example, a Delaware judge recently sanctioned two law firms who brought a securities class action even though the lead plaintiff owned no stock in the company he was suing. The judge said that the firms tried to keep confidential “damaging facts” in a cover-up that “served

only to advance their selfish motives.”¹⁰¹

And in yet another case, former class members represented by Milberg have filed racketeering claims against the firm claiming that it not only paid bribes to lead plaintiffs, but also falsely inflated the amount of money the lead plaintiffs lost so Milberg could be named the lead counsel in the case.¹⁰²

These and other examples of abuse clearly demonstrate that not only is the current system broken, it is subject to abuse by those who know how to take advantage of its flaws—i.e., the trial lawyers who today continue to control securities class actions. As one editorial board recently queried: “Milberg Weiss clearly is not an isolated bad apple. ...Where is Congress in all this?”¹⁰³

Potential Areas for Reform

Common sense reform measures should be enacted in order to ensure

¹⁰⁰ Nathan Koppel, *Lead Counsel in Fannie Suit is Switched Out*, Wall St. J., Oct. 8, 2007.

¹⁰¹ Carlyn, Kolker, *Coughlin, Brualdi Firms Ordered Pay Defendants’ Fees by Judge*, Bloomberg, Mar. 7, 2008.

¹⁰² Roger Parloff, *Civil Suit Against Milberg Weiss is Score Settling*, Fortune.com, Aug. 7, 2007, available at <http://legalpad.blogs.fortune.cnn.com/2007/08/07/civil-suit-against-milberg-weiss-is-score-settling/>.

¹⁰³ Editorial, *Milberg Settlement Should Be Only the Beginning*, Wash. Examiner, June 19, 2008.

that securities class actions serve the interests of investors, and thus improve, rather than undermine, the health and competitiveness of our capital markets and the overall U.S. economy. Among the areas for potential legislative reform:

Enact the Securities Litigation Attorney Accountability And Transparency Act

The culture of corruption pervading the securities class action system is significant, including the “Milberg-type” abuses and pay-to-play activities. Many observers have recognized the need for increased scrutiny of political contributions and other payments by lawyers seeking to be appointed as lead counsel in order to protect those innocent shareholders who ultimately bear the burden of abusive and wasteful litigation. For example, the Committee on Capital Markets Regulation recommended that, at a minimum, courts should require “disclosure of all political contributions or fee-sharing arrangements between class counsel

and a lead plaintiff (or controlling individuals within the lead plaintiff organization).”¹⁰⁴ As noted by the Committee, the municipal bonds industry could provide a potential model for reform along these lines.¹⁰⁵ Further, kickbacks and other payments to plaintiffs in these cases should never occur.

The Securities Litigation Attorney Accountability And Transparency Act (“SLAATA”) (S. 3033, H.R. 5463)—introduced by Senator John Cornyn and Congressman Jeb Hensarling—addresses these concerns. The proposed legislation would cast sunlight onto the relationships between attorneys and plaintiffs by requiring disclosure of payments, fee arrangements, and political contributions in an attempt to ferret out conflicts of interest and other suspicious connections.

The legislation would also introduce a competitive bidding process as one criterion for the selection of lead counsel.¹⁰⁶ Finally, the Senate bill would call

¹⁰⁴ *Interim Report*, *supra* note 25, at 13, 84.

¹⁰⁵ *Id.* at 83-84.

¹⁰⁶ *Blueprint*, *supra* note 25, at 70.

for further investigation into the hourly fees paid to plaintiffs' attorneys in securities class action litigation.

Improve Accuracy in the Selection of Lead Plaintiffs

To prevent the submission of broad, inflated loss calculations by putative lead plaintiffs and their counsel in an effort to secure the lead plaintiff role and control over the class action, Congress should require detailed documentation and verification of alleged losses. For example, a recent civil RICO class action suit filed against Milberg Weiss by a fellow plaintiffs' firm includes allegations that Milberg Weiss repeatedly inflated its clients' alleged losses in court filings in order to secure appointment as lead counsel. In one case, Milberg was appointed co-lead counsel after alleging losses of \$610,000 and it was revealed later that the plaintiff fund's losses were only \$80,000. The presiding judge acknowledged that

had he known the accurate figure he would not have appointed Milberg co-lead counsel, but he imposed only a \$50,000 penalty on the firm—a small amount in comparison to the \$25 million attorneys' fee.¹⁰⁷

Curb the Abuse of the Discovery Mechanism

The tremendous costs of discovery in securities class actions drive the pressure to settle to a significant extent. The burden does not fall evenly on the parties: whereas plaintiffs typically possess few, if any, documents, relevant to the litigation, the corporate defendants that are the target of securities class actions often possess substantial quantities of documents and electronic data that can cost tens of millions of dollars to produce. Indeed, the dramatic increase in the volume of potentially discoverable information fueled by the expanding use of electronic data storage and the greater expense

¹⁰⁷ Parloff, *supra* note 87.

incurred in producing such information have further augmented the costs of discovery, with estimates of discovery costs in 2007 approaching \$3 billion.¹⁰⁸ Plaintiffs' attorneys are naturally aware of the costs of discovery in these cases and harness liberal discovery rules to exact settlements.

Congress should modify the existing rules on civil discovery to curtail this practice. For example, it could amend Federal Rule of Civil Procedure 26 to permit the cost of discovery to be shifted from defendants to plaintiffs when the plaintiffs request information only loosely related to the claims and defenses being litigated. While the Rules were amended in 2000 to address concerns about overbroad discovery by imposing a "good cause" requirement, the changes did little to stem the crush of discovery abuse. By mandating cost-shifting whenever a party seeks discovery that is not directly relevant to the claim or defense of a party, the pro-

posed change will make attorneys think twice before serving abusive, unnecessary discovery requests. This approach will have the additional benefit of reducing the amount of judicial resources consumed by resolution of disputes that arise from aggressive attempts to abuse the discovery mechanism.

Provide Equal Access to Interlocutory Appeals

Securities class action plaintiffs may immediately appeal a trial court's decision to grant a defendant's motion to dismiss. Securities class action defendants, however, have no equivalent right because denial of a motion to dismiss or denial of a motion for summary judgment is not considered to be a "final" judgment, and thus is normally not subject to immediate appeal. As a result, defendants can be pressured to settle meritless suits as long as plaintiffs can survive a dismissal motion, and erroneous denials are never corrected because these cases rarely if ever go

¹⁰⁸ *Faced With Data Explosion, Firms Tap Temp Attorneys*, Fulton Co. Daily Report, Oct. 17, 2005.

to trial. According to the Bloomberg/Schumer Report, which supports this reform measure, providing securities class action defendants with equal access to interlocutory appeals will (i) make “it less likely that [defendants] will settle lawsuits even in the absence of wrongdoing, merely to avoid the significant discovery and other litigation costs that an unfavorable interlocutory judgment entails,” and (ii) “provide broader benefits to the securities industry and to the judicial system by enhancing the likelihood of obtaining valuable precedent-setting judgments on the merits.”¹⁰⁹ Congress should correct this fundamental imbalance by authorizing defendants to appeal the erroneous denial of motions to dismiss in securities class actions.¹¹⁰

Close Gaps in the Private Securities Law Reform Act (“PSLRA”) and Securities Litigation Uniform Standards Act (“SLUSA”)

Responding to “abuses of the class-action vehicle in litigation involving

nationally traded securities,” Congress enacted the PSLRA to install a series of substantive and procedural controls on the securities class action industry.¹¹¹ The procedural mechanisms impose new methods for choosing lead plaintiffs and lead counsel, mandate imposition of sanctions for frivolous suits, and authorize a stay of discovery during the pendency of a motion to dismiss. Substantively, Congress required plaintiffs to satisfy a heightened pleading standard for certain elements of securities claims and offered various safe harbors for corporate statements.¹¹²

The plaintiffs’ bar attempted to use the state courts as an escape valve from the PSLRA’s restrictions.

Consequently, in order to “prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of” the [PSLRA], Congress enacted

¹⁰⁹ Bloomberg/Schumer Commission Report, *supra* note 25, at 104.

¹¹⁰ Blueprint, *supra* note 25, at 68.

¹¹¹ *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 81 (2006).

¹¹² *Tellabs, Inc. v. Makor Issues & Rights Ltd.*, 127 S. Ct. 2499, 2508 (2007).

SLUSA.”¹¹³ SLUSA contained two key provisions: it preempted state-law class actions alleging fraud and provided for the removal of such actions to federal court.¹¹⁴

In the years since the enactment of these statutes, plaintiffs’ lawyers have opened statutory loopholes that prevent accomplishment of Congress’s goals. Amendments are needed to enable these laws to fulfill their purpose.

- First, Congress should address two key pleading standards that constrain securities class action complaints. Recently, in *Dura Pharmaceuticals, Inc. v. Broudo*, the Supreme Court recognized the importance of requiring plaintiffs to demonstrate a clear link between the challenged conduct and the alleged loss suffered. Rejecting a standard that would permit a plaintiff to survive a motion to dismiss merely by pointing to an alleged

inflated purchase price, the Court required plaintiffs to plead that a “defendant’s misrepresentation (or other fraudulent conduct) proximately caused the plaintiff’s economic loss.”¹¹⁵ However, this formulation has less bite than bark because a complaint may survive dismissal even though it alleges loss causation in only very general terms. Congress can remedy this situation by mandating that plaintiffs plead loss causation with the same level of specificity currently reserved for scienter (or intent).¹¹⁶

The effectiveness of the pleading standard for scienter imposed by Congress in the PSLRA also is imperiled. The promise of the Supreme Court’s decision in *Tellabs, Inc. v. Makor Issues & Rights Ltd.*—where the Court held that a complaint will survive a dismissal motion “only if a reasonable person would deem the inference

¹¹³ *Dabit*, 547 U.S. at 82, quoting SLUSA §§ 2(2), (5), 112 Stat. 3227.

¹¹⁴ *Id.* at 82-83 & n.7, citing 15 U.S.C. § 78bb(f)(1)-(2).

¹¹⁵ *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U. S. 336, 346 (2005).

¹¹⁶ *Blueprint*, *supra* note 25, at 69.

of scienter cogent and at least as compelling as any opposing inference”—has faded with its application by the lower courts.¹¹⁷ Several courts appear to have interpreted *Tellabs* as *lowering* the pleading standard for scienter.¹¹⁸ Congress should restore the original meaning of the PSLRA's pleading provision by restating the standard, which will give courts an important tool for screening out unjustified claims.

- Second, Congress should address the problem of the serial amendments that often follow a successful dismissal motion. Defendants today are often forced to incur the costs of disposing of an inadequate complaint three and four times over. Congress should limit the number of “bites at the apple” afforded to the plaintiffs’ bar and cap the number of times that trial lawyers may amend a repeat-

edly unsuccessful complaint. Such a cap would discourage frivolous and costly amendments.

- Third, courts have expanded the exceptions to the PSLRA's stay on discovery, permitting plaintiffs to engage in fishing expeditions during the pendency of a dismissal motion that defeat the entire purpose of the stay.¹¹⁹ Plaintiffs’ attorneys have also used state law claims not subject to federal removal to circumvent the discovery stay. Congress should close these loopholes, forestalling costly discovery until a court has ruled on a motion to dismiss.¹²⁰

- Fourth, the Supreme Court (in *Kircher v. Putnam Funds Trust*) ruled that a defendant who removed a case to federal court pursuant to SLUSA may not appeal a district court decision ordering a remand to state court.¹²¹

¹¹⁷ *Tellabs, Inc. v. Makor Issues & Rights Ltd.*, 127 S. Ct. 2499, 2510 (2007).

¹¹⁸ See, e.g., *Miss. Pub. Emples. Ret. Sys. v. Boston Sci. Corp.*, 523 F.3d 75 (1st Cir. 2008).

¹¹⁹ *In re Global Crossing*, 322 F. Supp. 2d 319 (S.D.N.Y. 2004); *In re WorldCom, Inc. Sec. Litig.*, 234 F. Supp. 2d 301 (S.D.N.Y. 2002).

¹²⁰ *Blueprint*, *supra* note 25, at 69, 71.

¹²¹ *Kircher v. Putnam Funds Trust*, 547 U.S. 633 (2006).

The effect of the *Kircher* decision is to insulate a district court ruling, no matter how erroneous as a matter of law, and permanently ensconce a securities class action in state court where it is subject to none of the PSLRA's protections. Congress should reject the rule adopted in *Kircher* and allow defendants to obtain immediate appellate review in order to effectuate the purpose and intent of SLUSA, which was to prevent the recruitment of state courts as accomplices to the avoidance of stricter federal standards for securities class action lawsuits.¹²²

- Fifth, plaintiffs' lawyers have circumvented federal pleading and discovery restrictions, as well as the removal provisions of SLUSA, by encouraging pension funds with large claims to opt out of federal securities class actions and file separate, non-class actions in state court. State-law claims filed

in state court by a small number of plaintiffs do not trigger SLUSA, but their effect is no less deleterious than the state court class actions covered by SLUSA.

Indeed, these opt-out suits burden investors, impose costs on the judiciary, and threaten to produce inconsistent rulings. Congress should either preclude such opt-out suits or amend SLUSA to require a stay of such actions until the final resolution of parallel federal class actions.¹²³

- Finally, Congress should amend the PSLRA to bar aggregation of plaintiffs for the purpose of determining lead plaintiffs. Exploiting the provision of the PSLRA that permits a "group of persons" to act as the lead plaintiff, some plaintiffs' lawyers seek to obtain lead counsel status by aggregating large numbers of unrelated plaintiffs into a lead plaintiffs' group. The danger of such aggregation is that responsibility dif-

¹²² *Blueprint*, *supra* note 25, at 71.

¹²³ *Id.* at 71.

fuses among the group and control eventually shifts to the lead attorney, with little or no effective oversight from the plaintiff. Congress should prohibit such aggregations of unrelated “persons.”¹²⁴

Refine the Measure of Damages in Securities Class Actions

Today’s broad but unclear damages standards encourage huge claims, and in turn impose enormous financial burdens on investors and shareholders. Current law fixes damages on the basis of “the loss the purchaser sustains when the facts become generally known and as a result share value depreciate[s]” from its fraud-inflated price.¹²⁵ While specific damages models vary, they generally involve a principle of aggregate damages, which requires imprecise estimates of the number of shares purchased during the class period at a supposedly inflated price and then subsequently held

or sold at a lower price after the discovery of the alleged fraud.¹²⁶

Congress should alter the damages calculus to reduce the perverse incentives that have mangled the securities class action system. For example, as suggested by many commentators, Congress should focus on the defendant’s gain, rather than the plaintiff’s loss. Relatedly, Congress should cap liability for corporations that do not issue shares during the relevant period, as suggested by Professors Langevoort and Coffee, among others.¹²⁷ “Greatly reducing the amount of money at stake in open market fraud actions” would “reduce the incentive to bring class actions for reasons other than their merits as well as the incentive of corporate defendants to settle for too high a price” and would realign the connection between the merits of cases and the amount of settlement.¹²⁸ This reform

¹²⁴ *Id.* at 69.

¹²⁵ *Dura*, 544 U.S. at 344 (internal quotation marks and ellipsis omitted).

¹²⁶ Kenneth M. Lehn, *Private Insecurities*, Wall. St. J., Feb. 15, 2006, A16.

¹²⁷ See, e.g., Langevoort, *Capping Damages*, *supra* note 43, at 648; John C. Coffee, Memo to Congress: Reform and Its Perils, 238 N.Y.L.J. 5 (Nov. 15, 2007); Alexander, *supra* note 43, at 1511-12.

¹²⁸ Langevoort, *Capping Damages*, *supra* note 43, at 641.

accordingly would limit the impact upon innocent shareholders of the circularity problem discussed above, protecting them from bearing the economic burden of huge settlements accompanied by huge transactions costs. Ultimately, it would result in the “improved enforcement of the securities laws.”¹²⁹

Congress also should address the fact that payments by defendant companies punish innocent existing shareholders, while investors (often large, diversified investors) who sold their shares at an inflated price before the disclosure of the fraud reap windfall gains. It should ameliorate this compensatory mismatch by requiring any calculation of damages to be offset by the net gains of class members who sold shares prior to the disclosure of fraud, and thus benefited from an artificially high fraud-induced price.¹³⁰

Moreover, in order to further reduce already inflated settlement amounts, Congress should require that dam-

ages be calculated on a per share basis equivalent to the number of shareholders who actually submit valid claims. “Estimates of aggregate damages require estimates of the number of shares that were purchased during the class period at an allegedly inflated price and subsequently held or sold at a price after the alleged fraud is discovered. But there is no scientifically valid way of estimating the number of these shares. Instead of using untested models that often result in highly inflated aggregate damages, damages should be thought of in terms of per-share inflation, with investors required to come forward to prove their claims.”¹³¹ Congress should also mandate the refund of any undistributed amount of settlement funds.

Finally, in the distribution of settlement funds, Congress should give priority to small, retail investors who need the protection of the securities class action system the most.

¹²⁹ Alexander, *supra* note 43, at 1512.

¹³⁰ Thakor, *Economic Reality*, *supra* note 39, at 6; *Blueprint*, *supra* note 25, at 69.

¹³¹ Lehn, *supra* note 126.

Increase Transparency in the Settlement Process

Opacity in the settlement process shields the extent to which small investors are harmed by the imbalanced payment of settlement proceeds to large and institutional investors. Congress can bring this process into the open by requiring settlement administrators to file a public report describing the claims filed and paid (but withholding information identifying the claimant in order to protect privacy). This will make clear which categories of investors reap the benefits from class action settlements.

Maintain the Efficiencies of The Securities Industry Arbitration System.

The present widespread use of arbitration in the securities industry encourages a fair and efficient method of resolving disputes without imposing the tremendous costs of lit-

igation. The arbitration procedures used by self-regulatory organizations (NASD and NYSE, now combined as FINRA) have passed through the regulatory gauntlet with flying colors: the SEC's exercise of its statutory authority to oversee such arbitrations has been deemed "effective and efficient," and Professor Michael Perino concluded in a 2002 SEC-commissioned report that "empirical evidence suggests that SRO arbitrations are fair and that investors perceive them to be fair."¹³² Moreover, the Congressional Research Service rebuffed those critics of the system who perceived a pro-industry bias, writing that "there appears to be little concrete evidence" of such bias."¹³³ Given its tremendous benefits, which include reduced costs and shorter resolution timelines, this system of arbitration clearly should be preserved and encouraged.¹³⁴

¹³² Office of the Inspector General, Securities and Exchange Commission, *Oversight of SRO Arbitration*, Audit 289 (Aug. 24, 1999), available at <http://www.sec.gov/about/oig/audit/semoct99.pdf>; Michael A. Perino, Report to the Securities and Exchange Commission Regarding Arbitrator Conflict Disclosure Requirements in NASD and NYSE Securities Arbitrations, 48 (Nov. 4, 2002), available at <http://www.sec.gov/pdf/arbconflict.pdf>.

¹³³ Gary Shorter, *Securities Arbitration: Background and Questions of Fairness*, CRS Rep. RS22127, at 1-3 (Apr. 26, 2005), available at https://www.policyarchive.org/bitstream/handle/10207/4111/RS22127_20050426.pdfsequence=1.

¹³⁴ *Blueprint*, supra note 25, at 69.

Coordinate Fair Funds and Private Recovery

The SEC's "Fair Funds" authority allows the SEC to compensate injured investors by placing disgorgement recoveries and civil penalties into funds reserved for the benefit of those investors harmed by fraudulent conduct. Those same investors, however, may also be entitled to recovery in concurrent, private securities class action lawsuits. In order to promote efficient compensation and prevent wasteful, duplicative recovery, Congress should ensure coordination between public and private enforcement.¹³⁵ Because Fair Funds are not subject to attorneys' fees and the other transaction costs attendant to private class actions, the program should be the primary means of recovery. Accordingly, as recommended by multiple recent studies, private damages awards should be offset in the first instance by any Fair

Funds collected by the SEC for compensating shareholders.¹³⁶

Conclusion

The sheer economic impact of the securities class action industry has exploded during the past decade and continued into 2008 unabated. The high average settlement values, increasing number of filings, and inherent inefficiencies of the current system are growing, and all indications suggest that worse days may be yet to come in light of the recent economic downturn. Nor has the past year witnessed any dissipation of the harm to smaller shareholders, the threat to the global competitiveness of the U.S. capital markets, or the wasteful transfer of resources to the pockets of plaintiffs' attorneys. Looming over this broken system is the shadow of corruption and illegality perpetrated by the plaintiffs' bar, symbolized by the incarceration and penalization of the industry's

¹³⁵ *Id.* at 71.

¹³⁶ *Interim Report*, *supra* note 25, at 82; *Chamber Commission Report*, *supra* note 4, at 88.

leaders for a significant abuse of the judicial system.

These factors mandate one, clear conclusion: the current system of checks developed by Congress is not sufficient. Congress must act, and it must act soon: to provide better mechanisms and greater transparency in the process of choosing the stewards of class action litigation; to curb discovery abuse; to create fair appellate procedures; to close off the loopholes that weaken Congress's previous reforms; to pre-

serve the efficiencies of the current widespread use of arbitration; to dispel the opacity that envelops the settlement process; and to refine how damages are measured in order to better serve the interests of fairness to the innocent shareholders who pay the bills and of those smaller investors who actually suffer injury.

The costs of inaction—for shareholders, for our economy, and for our capital markets, which face increasing foreign competition—are simply too great to bear.

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