

# MAKING SECURITIES FRAUD CLASS ACTIONS VIRTUOUS

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Few things are as American as the class action. Housed in this single procedural device is the mechanism that accords equal footing to the common man in his dispute with the large corporation. Where the single claimant could not proceed individually because her expenses would dwarf the expected recover, the class action can be brought on behalf of all who are similarly situated. And the sheer size of the aggregated claim attracts not only the entrepreneurial instincts of the class lawyer but also commands the full attention of the defendant. The class action thereby has an important deterrent feature which give it a quasi-public character; it can thus be seen as an extension of the state's enforcement arm and an expression of society's will. Though the class action is the great equalizer of our day, it is not intended as a tool for redistributing wealth. Securities class actions proceed with the objective of permitting those separated wrongfully from their wealth to get some of it back. It is in the class action's empowerment of the small claimant that we find the spirit of America—"equal justice for all under the law." The spirit is further unleashed by the American Rule whereby the party losing the suit is not required to pay his opponents' litigation costs. We thus openly encourage pressing out on doctrinal frontiers through novel theories for which recovery is sought. Moreover, the class action provides the economic basis for much of the expansion of rights for groups, such as consumers and investors. Because risks are not lightly taken in the expensive litigation world, the prospect of a large recovery, and hence an equally large fee, is necessary to attract the attention of the creative entrepreneurial attorney. The potential recovery on behalf of a large class offers just such a reward. Here, too, the class action captures the spirit of capitalism that is America. And nothing is more representative of capitalism than the image of the class action attorney whose mission is quite similar to that of the bounty hunters who populated the West in the 19th century. Though we may see all litigators as hired guns of one sort or another, the class action attorney is not on a retainer but lives on his skill of bringing down his prey. But her efforts, according to the classic descriptions of the class action attorney, are all driven by a calculus

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that is bounded by relative risks and rewards of continued pursuit of the case.

It is not mere coincidence that the most significant expansion in class action procedures occurred in the 1960s, a decade of great social change in America, a decade defined by its idealism and marked by the expansion of rights for all its citizens. Placed in the contemporary context of its creation, Federal Rule of Civil Procedure 23(b)(3) can appropriately be seen as full embodiment of the idealism of the time as well as an unwavering belief that private parties could share in the enforcement of social norms. In this sense, the class action is not only American, it is republican.<sup>1</sup> But that was then, and this is now! How nearly thirty years makes such a great difference.

The modern class action may be undergoing serious growing pains as the romantic images of its virtue, such as that described above, mesh poorly with the experiences it leaves in its wake. The virtue of the class action has been envisioned in its placement of small claimants on a footing equal to that of the defendant. This has its greatest social appeal where we are comfortable with the claims that underlie the suit, for without the class action no single claimant would be able to pursue her rights because the cost of doing so would overwhelm the expected recovery. For this situation we also find greater comfort with the contingency fee arrangement that is so prevalent in class actions. Class action procedures overcome the fortuity of the defendant escaping responsibility because his misconduct caused only small injuries to numerous individuals. Our comfort with the class action in this case, however, turns to malaise, and then skepticism, when the class action is the vessel that launches highly speculative claims. Though we may champion the attorney's right to press the frontiers of doctrine by initiating "long-shot" suits,<sup>2</sup> in the class action context we may question whether permitting this to occur skews the equation whereby the adversaries assess their litigation strategies; the equation may, due to the sheer weight of the class' possible damages, be unduly biased in favor of the class. Certainly this causes the targets of such suits to cry the class action is being abused and, therefore, is unvirtuous. The defendants' cry resonates among those not involved in the litigation whose distant assessment of the suit's merits may too easily give way to jealousy because, though they have claims against others that are equally speculative, no one has initiated an action on their behalf to test whether their own speculative claims will bear a reward. The virtue associated with garnering an award through the class action award is thus akin to winning the lottery. Moreover, society too frequently views the class' recovery as producing a reward that to the individual class member is economically insignificant, but which is quite significant, if not devastating, to the defendant. Thus, the class action, though holding the defendant accountable for her misconduct, produces a recovery to each class member that is not substantial and in many cases is unexpected, whereas the award's negative effects on the defendant

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1. See Owen M. Fiss, *The Political Theory of the Class Action*, 53 WASH. & LEE L. REV. 21 (1996).

2. See Charles M. Yablon, *The Good, the Bad, and the Frivolous Case: An Essay on Probability and Rule 11*, 44 UCLA L. REV. 65 (1996) (standards for imposing Rule 11 sanctions should return to pre-1983 era so as to nurture socially beneficial long-shot suits).

are far more visible. The sharpness of this contrast erodes the social appeal of the class action because it can be confused with the perception that the claim giving rise to the class action was itself insignificant and speculative. The class action may thus be seen as the mechanism compensating individuals who have not suffered any "true injury" and who were unaware that they had suffered a loss. Being a member of the class action, therefore, is a fortuitous event rather than a step toward placing the individual on the same footing as the corporate defendant. And, the class' virtue is tarnished further by the popular belief that, because the class members are numerous and their individual claims are small, the true winners in the suits are the well-paid attorneys representing the class whose funds "come off the top." The complaint is that class suits are lawyer driven and not driven by the justness of their underlying claims. It is within this tarnished image that the securities law class action finds itself. Much like the value (virtue) of a single house, its attraction is affected by what else is going on in its neighborhood.

The class action is under review, indeed attack, on a variety of fronts. The securities class action continues to be a source of debate, even though in 1995 Congress introduced several changes in the conduct of securities class actions. Part I below examines some of the bases for today's distrust of the securities class action. The effort there is not to reexamine the evidence before the Congress in its consideration of reforming securities class actions, but to question whether the right empirical questions have been addressed. I show in Part II that the empirical data is consistent with the view that securities class actions are compensatory so that they should be viewed as not solely for the benefit of the class counsel as many critics would lead us to believe. In Part III, the changes introduced by the Private Securities Litigation Reform Act of 1995 are examined to determine their likely impact on addressing the concerns that prompted the legislation. Part IV identifies who is the guardian of the class action's virtue.

## I. LIES, DAMN LIES AND STATISTICS<sup>3</sup>

When Mark Twain condemned the analysis of data with his now immortal words he most certainly must have contemplated the hearings conducted by the securities subcommittee of the U.S. Senate Committee on Banking, Housing and Urban Affairs<sup>4</sup> and the Telecommunications and Finance Subcommittee of the U.S. House of Representatives Committee on Energy and Commerce<sup>5</sup> during the 103rd Congress. Like the combatants in a trial, before the Congress each side of the debate surrounding class actions marshaled its experts to support its position regarding whether securities class actions are abusive to industry, especially high-tech companies, and whether class actions inadequately compensate injured

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3. MARK TWAIN, MARK TWAIN'S AUTOBIOGRAPHY 246 (1924).

4. *Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 103d Cong., 1st Sess. (June 17 & July 21, 1993) [hereinafter 1993 Hearings].

5. *Securities Litigation Reform, Hearings Before the House Subcomm. on Telecommunications and Finance of the Comm. on Energy and Commerce*, 103d Cong., 2nd Sess. (July 22 & Aug. 10, 1994) [hereinafter 1994 Hearings].

investors. Thus, for example, various captains of industry mouthed the popular rhetoric that suits commonly follow a sharp decline of 10% or more in a stock's price;<sup>6</sup> a study was then produced by a member of the plaintiffs' bar demonstrating that a class action arises in only a small number of cases when a company's shares decline 10% or more.<sup>7</sup> Equally conflicting data was submitted on whether securities class actions were increasing at epidemic proportions or remaining relatively stable.<sup>8</sup> And the greatest condemnation of securities class actions and conflicts in the data arose over whether the amount recovered by class members is significant in comparison to their losses.<sup>9</sup> The purpose here is not to review the empiricism on securities class actions but to question whether the empiricists have addressed the right questions.

Consider first the relevance of the number of class action suits. Does one make the case that there is an excessive amount of appeals within the federal courts in view of the fact that it took one year to fill the first 5000 pages of the Federal Reporter but only three and one-half months to compile the last 5000 pages?<sup>10</sup> Obviously not, because with growth in the U.S. population, and the continuing accretion of laws, one fully expects more litigation. Moreover, the complexity of transactions and law are such that a polished opinion that once concisely put a matter to rest in a few pages may not be possible today. Similarly, one would fully expect an ever-increasing number of lawsuits, certainly over the past two decades. Consider that the number of companies listed on the New York Stock Exchange have increased nearly 64% between 1980 and 1994, and those traded on NASDAQ have increased over 69%.<sup>11</sup> All this reflects the vibrancy of the economy which in

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6. See, e.g., Statement of Edward R. McCracken, 1993 Hearings, *supra* note 4, at 11; Statement of Thomas Dunlap, Jr., 1993 Hearings, *supra* note 4, at 19. The press popularizes this view. See Michael Selz, *Lawsuits Often Follow When Small Firms Go Public*, WALL ST. J., Jan. 13, 1992, at B2 (companies are sued whenever there is a sudden and substantial decline in the price of their stock).

7. See Testimony of Leonard B. Simon, 1994 Hearings, *supra* note 5, at 309-14.

8. Claims of a litigation crisis are not new, and there were many such bald assertions made before the Congress. The SEC's director of enforcement presented the only data on the number of class action securities cases, which presented a mixed impression. See Testimony of William R. McLucas, 1993 Hearings, *supra* note 4, at 121. For example, according to data Mr. McLucas acquired from the Administrative Office of the United States Courts, 305 cases were filed in 1973, 108 cases were filed in 1987, and 268 cases were filed in 1992. *Id.*

9. Compare Frederick C. Dunbar & Vinita M. Juneja, *Recent Trends II: What Explains Settlements in Shareholder Actions?*, in 1993 Hearings, *supra* note 4, at 739, with the Princeton Venture Research, Inc. study, in 1993 Hearings, *supra* note 4, at 153.

10. The first reported opinion which appeared in the Federal Reporter is dated January 24, 1880, and a total of 5000 pages in the reports was reached on January 26, 1881. In contrast, at the time this manuscript was prepared, the most recent bound report was 89 Federal Reporter 3d, whose last opinion was published on July 16, 1996; working backward in time, the 5000th page was an opinion dated April 4, 1996.

11. See THE IRWIN BUSINESS AND STATISTIC ALMANAC 1996, 231 (Sumner N. Levine & Caroline Levine eds., 1996) (2570 companies listed on NYSE and 4902 companies traded on NASDAQ in 1994); THE 1983 DOW JONES-IRWIN BUSINESS AND INVESTMENT ALMANAC 339 (Sumner N. Levine & Caroline Levine eds., 1983) (1570 companies listed on

1992 dollars grew 43.2% from 1980 through 1994." So considered, only one who doubts the wisdom of Copernicus would expect the volume of litigation to remain flat. More importantly, counting the number of suits does not take into account the impact of economic cycles. There is every reason to expect that more suits will be filed after the economy has headed south than when even the least efficient firm is able to survive because of a rapidly expanding economy. Thus, comparative data that does not control for both the relative size of the economy and the effects of economic cycles is much like counting pages in the Federal Report to determine the litigiousness of America.

In contrast to information bearing on the numbers of class actions filed over a discrete time interval, data on the amount recovered by class members expose the soft underbelly of the securities class action. The most comprehensive study of settlements before the Congress was the study by the National Economic Research Associates, Inc. (NERA) of 254 settlements between 1991 and 1993, finding that, for cases in which investor losses were calculated, the median payment to class members was 5% of their losses.<sup>12</sup> More generally, the median settlement in the NERA study was about \$4 million.<sup>13</sup>

Evidence that the preponderance of securities class actions produce small recoveries is consistent with a variety of hypotheses. The least likely conclusion is that it is in the nature of securities class actions that the violation prompting the suit causes relatively minor damages to the classes of investors. This would be so if the misrepresented fact, albeit material, is not of epic proportions in relation to the overall market capitalization of the security's issuer. If this indeed were the case, there would be cause to question the social benefits of class action litigation. The class action would amount to no more than swatting gnats while causing harmful side effects, such as excessive precaution costs in making mandated disclosures and reluctance to make voluntary disclosures.

A second hypothesis consistent with the prevalence of small recoveries is there were no available funds for a larger recovery. The plaintiffs' bar is quick to respond that settlements frequently are reached in the shadow of an insurance policy whose value declines as the defendants' attorneys fees are charged against that policy. Insurance thus becomes something of a wasting asset so that delay, especially when on the part of the defense, reduces the value of the cause of action. This thesis raises two important questions: what is the relationship, if any, between the amount of insurance and settlements reached in securities class actions and why in practice is insurance such a powerful constraint on settlements.<sup>14</sup>

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NYSE and 2894 companies traded on NASDAQ in 1980).

12. GDP was \$4611.9 billion in 1980 and \$6604.2 billion in 1994. U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES tbl. 687 (1996) (in 1992 dollars).

13. Dunbar & Juneja, *supra* note 9, at 750 tbl. 3. Average attorneys fees equaled 31.32% of the settlement. *Id.* at 754 tbl. 7.

14. *Id.* at 750 tbl. 3.

15. On this point, there is ample theory supporting the view that, given the choice between accepting a settlement within existing policy limits or prolonging the suit by

A third, and even more troubling, hypothesis is that low settlements are indicative of strike suits. On this point, it is interesting how the debate has framed the hypothesis regarding the utility of securities class actions. The argument is that because low recoveries predominate, suits are hypothesized to have been brought for their nuisance value rather than for any harm actually suffered by the members of the class. Thus, the class action's critics invoke data that class members recover extremely small amounts in most securities class actions.<sup>16</sup> The weakness of this view is that their data is equally consistent with the view that highly meritorious suits are brought, but settled for too little. Also, the argument that settlements are small in comparison to recoverable damages is flawed by the models used to estimate recoverable damages.<sup>17</sup> Each of these points is examined below.

Under the substantive rules that predominate in securities class actions, the defendant is liable only for that portion of the plaintiffs' losses that are related to the defendant's misrepresentation.<sup>18</sup> Thus, any portion of a stock's decline that is attributable to events unrelated to the defendant's violation are not compensable under the securities laws. The defendant's right to mitigate his damages is good news not simply to the defendant but also for the cottage industry of financial experts who are retained by the litigants to determine what portion of a stock's price change over the interval of the fraud is attributable to the defendant's misrepresentation. Because there are numerous assumptions relevant to applying the conventional economic models to the individual case,<sup>19</sup> not to mention wide

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aggressively pursuing the private wealth of the defendants, the class attorney will pursue the former. See John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement Through Class and Derivative Actions*, 86 COLUM. L. REV. 669 (1986). There is also the potential that any payments in settlement by the defendant officers and directors will ultimately be borne by the corporation pursuant to the officers' or directors' indemnification rights. But the courts may bar enforcement of a liberal indemnity provision on the ground that there is an implicit requirement that the officer or director must not be aware that her conduct constituted a knowing violation of the securities laws. See *Waltuch v. Conticommodity Servs., Inc.*, 88 F.3d 87 (2d Cir. 1996) (Delaware statute authorizing indemnification in addition to that provided in its statute nevertheless imposes the "good faith" requirement found in its express indemnification provisions on the extrastatutory indemnity agreements between the corporation and its officers).

16. See, e.g., Grundfest, *infra* note 60.

17. The NERA study's worth is eroded by its use in determining recoverable losses of a model that systematically overstated the amount of losses. The model used by the NERA study measured class losses by the differences between what class members would have earned with investment performance equal to that of the Standard and Poor's Industrial 500 Index and what investors actually earned on their investment in the defendant company. This model overstates investor losses because it does not distinguish between the investors' losses attributable to the false statement and those attributable to market-wide events, such as rising interest rates or inflation which would produce greater declines in the security invested in than would be reflected in the index. Dunbar & Juneja, *supra* note 9, at 742 n.3.

18. See *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335 (9th Cir. 1976) (Sneed, J., concurring). See generally JAMES D. COX ET AL., *SECURITIES REGULATION* 765-74 (2d ed. 1997).

19. See generally Mark L. Mitchell & Jeffrey M. Netter, *The Role of Financial*

differences<sup>20</sup> in measuring damages depending on which model is used, much of the debate among the parties is not so much a dispute on the utility of securities class actions as over disagreement on the appropriate model and the underlying assumptions for its variables. The following illustrates this point.

Quite different conclusions can be drawn from data comparing settlements to the amount of the plaintiff's "losses" depending on whether the plaintiff's losses include price declines which were not caused by the defendant's violation. For example, Professor Janet Cooper Alexander played a prominent role in sparking the debate over the social benefits of securities class actions. She concluded from her analysis of a small sample of class action settlements that virtually all securities class actions are settled regardless of their merits. This conclusion was based on the results of six settled class actions in which settlements ranged from 20% to 27.35% of the allowable recovery.<sup>21</sup> Though one may wonder whether it is appropriate ever to draw such a sweeping conclusion from a sample as slender as that used by Professor Alexander, doubt turns to shock when we understand that Professor Alexander's determination of allowable damages ignored the possibility that the defendants could successfully have mitigated their damages by showing some or most of the market decline was unrelated to their misrepresentation.<sup>22</sup> This step was taken by Professors Elliott Weiss and John Beckerman. Using Professor Alexander's six companies, Professors Weiss and Beckerman show that after removing industry-wide effects on the respective share prices of the six companies, the settlements ranged from 23.11% to 79.77% of recoverable damages.<sup>23</sup> With the classes' damages so determined the foundation that underlies Professor

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*Economics in Securities Fraud Cases: Applications at the Securities and Exchange Commission*, 49 BUS. LAW. 545 (1994); Bradford Cornell & R. Gregory Morgan, *Using Finance Theory to Measure Damages in Fraud on the Market Cases*, 37 UCLA L. REV. 883 (1990).

20. See Janet Cooper Alexander, *The Value of Bad News in Securities Class Actions*, 41 UCLA L. REV. 1421, 1424-26 (1994).

21. Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 516-17 (1991) (Though she examined eight cases, two were settled for smaller percentages due to factors also unrelated to the merits.).

22. Professor Alexander reasons that to adjust her data by the amount of market decline not attributable to the defendants' misconduct "would open the door both to manipulation of the results and to taking the merits into account in determining the stakes." *Id.* at 519 n.71. It would thus appear that Professor Alexander in fact assumes in her analysis of the data the very hypothesis she seeks to prove, namely that the merits do not matter.

Though it is common for settlements to permit each class member to recover up to the total amount of their *market* losses, rather than their *recoverable* losses, this occurs to prevent settlement funds going unclaimed and does not fix the amount of the defendants' liability. See Alexander, *supra* note 20, at 1450.

23. See Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2083-84 (1995).

Alexander's thesis that the merits do not matter stands rejected.<sup>24</sup>

In the subcommittees' hearings, widely differing studies were offered comparing settlements of securities class actions with the damages suffered by the class. Though the most positive report is a study introduced by a leading class action lawyer, Mr. William Lerach, showing that plaintiffs recovered 60% of their losses, the study may well not be sufficiently representative since it included only twenty companies.<sup>25</sup> This testimony was countered by studies that reflected

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24. This is not to say, however, that there is a perfect correlation between settlement amounts and the suit's relative merits. A good many exogenous factors, such as the solvency of the defendants and the availability of insurance, discussed later, may cause the settlements not to be correlated with the overall merits of the action. Moreover, to say that the merits matter does not mean that they always matter enough. In any case, in the abstract there is a good deal of intuitive appeal for the proposition that settlements should be sensitive to the merits of a case, and, quite independently, the relative wealth of the defendants. For example, we would expect settlements to be greater for cases brought under Section 11 of the Securities Act of 1933 than those initiated solely under the antifraud provision of the Securities Exchange Act of 1934. The former imposes absolute liability on issuers, and other defendants are liable for a registration statement's misrepresentations, unless each defendant establishes their "due diligence" defense. In contrast, the antifraud provision requires the plaintiff prove the defendant committed the misrepresentation with scienter. But settlements were not found to be sensitive to whether liability was premised on Section 11 cases or the antifraud provision. See Dunbar & Juneja, *supra* note 9, at 595 tbl. 15. A factor that materially boosts the settlement amount is whether "deep pockets" such as those possessed by accountants and underwriters are included among the defendants. *Id.* at 561.

Any evidence that the merits play an insignificant role in the class action attorney's valuing the case challenges all models used in examining the gaming of settlements. The standard model for considering the relative bargaining positions entering settlements includes the expected value of any recovery—the possible recoverable amount discounted by the probability of recovery. See, e.g., RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 522–28 (4th ed. 1992); Stephen Shavell, *Suit, Settlement, and Trial: A Theoretical Analysis Under Alternative Methods for the Allocation of Legal Costs*, 11 J. LEGAL STUD. 55 (1982). Each of these inputs, and particularly the measurement of probability, have substantive components dependent on the case's merits. Even in considering the bargaining power of a case *known* to have a negative expected value (i.e., the plaintiff's cost to prosecute the case < the expected recovery), the expected recovery reflects the suit's merits. See Lucian Arye Bebchuk, *A New Theory Concerning the Credibility and Success of Threats to Sue*, 25 J. LEGAL STUD. 1, 10 (1996) (expected judgment is the product of the probability of success at trial and the award to be received if successful). At the same time, the models provide only a range within which settlements among rational actors are likely to occur. They do not, for example, support the notion that a case having stronger merits will always settle at a higher end of the predicted range than will a case with weaker merits. The data appears to suggest no more than that the presence of deep pockets is more likely to move a settlement to the higher end of the settlement range than is statistically observable for such merit-based considerations as whether the suit is prosecuted under Section 11 or the antifraud provision.

25. See Princeton Ventures Research, Inc., study, *supra* note 9, at 150–53. Various methodological problems with this data, such as the appropriateness of relying on a handpicked pool of 20 class actions and determining recoverable damages are examined in



recovery rates well below 10%.<sup>26</sup> Equally damaging to the image of the class action is a letter by the State of Wisconsin Investment Board which reported that in a sample of cases in which it was a plaintiff, the case settled for approximately 11% of their total damages, with the plaintiff's attorney garnering 30% of the recovery.<sup>27</sup>

Recently, Professors Carleton, Weisbach and Weiss have carefully demonstrated how estimates can vary widely for the amount recoverable by the securities class depending not only on what model is employed to estimate damages, but also on what assumptions are used for the model's variables.<sup>28</sup> Under the "naive" model that assumes class members only purchase during the fraud interval,<sup>29</sup> their study of 340 class actions settled between 1989 and 1994 reflects median estimated damages of \$65.7 million. However, using a more sophisticated model which assumes that some portion of investors are in-and-out traders, whereas others buy and hold throughout the fraud interval, median estimated damages range from \$27.6 million to \$2.8 million, depending on the set of assumptions regarding just what portion of investors in the company's shares are owned by traders and their portion of the shares traded.<sup>30</sup> Another important variable is whether damage estimates for a studied group are reported as the median or the mean; mean estimates of damages tend statistically to be higher than median estimates because of the presence of a few substantial damage cases in any sample.<sup>31</sup> Carleton, Weisbach and Weiss, using the more conservative, albeit more realistic, two-trader market model, find that 24.1% of the settlements recovered at least one-half of estimated damages, 19.3% recovered one-fourth of estimated damages, and 31.8% recovered less than 10% of estimated damages.<sup>32</sup> These outcomes appear clearly inconsistent with the strike-suit hypothesis. Indeed, Professors Carleton's, Weisbach's and Weiss's data set provides a much more positive report on the benefits of securities class actions than have other studies.

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Alexander, *supra* note 20, at 1464-65.

26. See Dunbar & Juneja, *supra* note 9, at 750 tbl. 3; 1993 Hearings, *supra* note 4, at 140 (statement of Vincent E. O'Brien).

27. See Staff Report, *Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 103d Cong., 2d Sess. 31 n.70 (May 17, 1994). The percentage quoted by the Wisconsin figure is consistent with the case study involving the Public Service Company of New Mexico, introduced by Mr. Lerach; though in that case \$21.4 million was recovered for members of the class, this represented only 6.51% of their allowed claims. See *id.* at 239-40.

28. See Willard T. Carleton et al., *Securities Class Action Lawsuits: A Descriptive Study*, 38 ARIZ. L. REV. 491, 494-99 (1996).

29. As used here, "fraud interval" refers to the time period that defines which investors may be included in the class action. It thus is synonymous with the opening and closing of the class period which in turn generally are determined by when the first false statement was issued that alleged impacted the security's price and when the market price is alleged to reflect the corrected information.

30. Carleton et al., *supra* note 28, at 499 tbl. 2.

31. *Id.*

32. *Id.* at 500 tbl. 3. Consistent with the views of others, settlements are statistically larger for cases that include professionals as defendants than cases that do not. *Id.* at 507 tbl. 9.

Some of the polish placed on the securities class action by the Carleton-Weisbach-Weiss data is tarnished by the finding by Professors Bohn and Choi that initial public offerings (IPOs) underwritten by underwriters with high reputations are more likely to give rise to a securities class action than are IPOs underwritten by underwriters with lower reputations.<sup>33</sup> How this finding supports the strike-suit thesis depends on several well-recognized relationships. There is a wealth of theory and evidence supporting the existence of a social hierarchy in underwriting whereby higher quality offerings are carried out by higher quality underwriters.<sup>34</sup> In this context, the underwriter's reputation is an important signal of the offering's quality because underwriters, as repeat players whose reputation is an important asset, are unwilling to associate with offerings that are likely to lose money for buyers, or more precisely, damage their reputations. Thus, finding a positive correlation between the underwriter quality and their vulnerability is not what one would expect to find because the investigator would expect higher incidents of suits among low quality issuers whose offerings would be carried out by low reputation underwriters. Professors Bohn and Choi suggest the explanation lies in the high quality underwriter being vulnerable to a strike suit; faced with damaging publicity by their involvement in a suit alleging lack of diligence in their review of the registration statement, the high quality underwriters arguably choose the expedient of deflecting the suit with a settlement calculated to make the plaintiffs' lawyer go away.<sup>35</sup> In a sense, high quality underwriters' concern for preserving their reputations may make them easy prey for the unscrupulous class action counsel.

There are several independent considerations that question the strength of Professors Bohn's and Choi's findings. In another portion of their study they confirm the finding of others that higher quality underwriters associate themselves with larger IPOs and that lower quality underwriters associate themselves with smaller offerings.<sup>36</sup> Consider this factor in light of their finding that very few suits are brought against smaller offerings. Though this factor may suggest that the underwriters in smaller offerings, having lower reputations, are not nearly as easy prey as the reputationally conscious underwriters in larger offerings, Professors Bohn and Choi offer a more persuasive explanation. They reason that there is underenforcement of frauds in connection with small IPOs, arguably on the grounds that the recoverable amounts are insufficient to compensation the class action attorneys for their fixed costs for such suits.<sup>37</sup> If this is indeed the reason why few class actions arise from smaller IPOs, then it would also explain the correlation between underwriter reputation and the likelihood of an IPO producing a class action. Higher reputation underwriters, by associating with larger offerings, for that reason are the natural prey of the class action lawyers. Indeed, one would be

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33. James Bohn & Stephen Choi, *Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. PA. L. REV. 903, 952-55 (1996). However, their finding is statistically significant only at the 20% level. *Id.* at 952 tbl. 3.1.

34. See, e.g., Glenn A. Wolfe et al., *An Analysis of the Underwriter Selection Process for Initial Public Offerings*, 17 J. FIN. RES. 77 (1994).

35. See Bohn & Choi, *supra* note 33, at 955.

36. *Id.* at 955-57.

37. *Id.* at 952.

surprised not to find that higher reputation underwriters tend more frequently to be involved in securities class actions arising from IPOs than lower reputation underwriters. Thus contrary to the authors' conclusion that the strike-suit thesis is suggested by their finding that the higher underwriter quality, the higher the likelihood of suit, their overall data merely confirms that larger offerings attract not only higher quality underwriters but also cost-conscious class action lawyers.

Bohn and Choi attempt to meet the two possible explanation argument by controlling their study for offering size and examining the influences of both variables—size and underwriter reputation—on the frequency of suits. After so controlling, they find relative underwriter reputation significant at the 20% level. Even this correlation may overstate their findings. For example, with litigation skewed toward issuers engaged in larger offerings,<sup>38</sup> we may question whether within this subset the variations in reputation among underwriters is sufficiently great to permit the investigator, or for that matter, the class action attorney, to discriminate among underwriters. We may also question the intuitive appeal that strike-suit-minded attorneys necessarily would discriminate on the percentage of the offering's underwriters that is represented by higher reputation than lower reputation underwriters. Because underwriter liability is not joint and several, but proportional to each underwriter's allotted share of the offering,<sup>39</sup> it would be far more important to the strike-suit-minded attorney what percentage of an offering's shares are allotted to high quality underwriters. We do not know how Professors Bohn and Choi computed their index of underwriter reputation for each offering. Since each underwriter's allotment for individual offerings is not disclosed in SEC filings,<sup>40</sup> the average reputation they report for each offering would not be weighted by each underwriter's relative participation and, hence, relative liability for that offering, so that serious misweighting likely is reflected in their calculations. Thus it is not likely that the correlation they found between underwriter reputation and the frequency of suit reflects a correlation between the underwriters' relative

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38. Another important finding by Professors Bohn and Choi was that even though a majority of the IPO offerings were for less than \$10 million and had aftermarket losses of under \$5 million, most IPO-based class actions involved companies with aftermarket losses exceeding \$5 million, whose offerings exceeded \$10 million. They conclude that "[m]ost IPOs, therefore, receive relatively little private enforcement." *Id.* at 948. Thus, the data gathered by Bohn and Choi may expand the weak incentive hypothesis so that it includes the class action attorney's lack of interest in pursuing actions posing smaller overall gains for the class and, perhaps, for the attorney. At the same time, consider the data from a large sample of securities class actions which reports that 40% of the cases settled for under \$2.5 million. 1993 Hearings, *supra* note 4, at 139 (statement of Vincent E. O'Brien). Such a recovery for the underenforced IPO cases would approach one-half of the maximum recoverable damages, far higher than the percentage reaped by securities class actions generally. One inference is that the risks are simply not worth the expected returns for such small cases such that there exists systematic underenforcement of private claims for such small offerings.

39. 15 U.S.C. § 77k(e) (1994).

40. See Regulation S-K, Item 508(a), 17 C.F.R. § 229.508(a) (1996) (registration statement need only disclose the nature of the underwriter's commitment, e.g., best efforts or firm commitment).

exposure to liability in those suits.

A further consideration prompted by Professors Bohn's and Choi's finding is the notion that underwriters settle suits to spare their reputations being sullied by the continued prosecution of the suit. One test of this assumption would examine whether settlement amounts are inversely correlated with the reputational quality of the underwriters settling the suits. Bohn and Choi, however, did not include in their analysis any information regarding the amount of settlements. If the strike suit were pursued to its logical conclusion, one would expect settlements to be of a lower amount to reflect the suit's nuisance value and the savings expected by deflecting the plaintiff's attorney by putting some money on the table. But if this scenario were true, then it would appear that the strike-suit should be of value in smaller securities offerings, provided some nonminimal portion of the offering was within the allotment of a high reputation underwriter. Thus a question for further investigation is whether any high quality underwriters participate within the subset of offerings where Choi and Bohn found few class action suits, and for which they believed there was underenforcement.

A final weakness is the notion that underwriters will eagerly settle baseless claims so as to preserve their reputation. Consider that Bohn and Choi examine data on reported suits, so that there is already public disclosure that the underwriters have been sued. This is not, therefore, a case of providing "hush" money that will keep the claimant quiet; Professor Bohn's and Choi's data regarding filed suits was necessarily very public information. All underwriters have a stake in their reputations,<sup>41</sup> not just preserving them, but also seek to move up the social hierarchy to bigger and more important underwriting participations. Thus, some underwriters who are on the fringes of the "bulge" may have as much a stake in enhancing their reputations as "major bracket" underwriters. A quick settlement, therefore, is as likely to occur when the suit is against the upwardly mobile underwriter as it is against one with an established reputation. And, there is always the question whether suits against underwriting offerings that are dominated by higher quality underwriters provide a sounder chance that there is real money to be recovered than suits involving smaller offerings by lower reputation underwriters where insurance and other funds may not be as available as in the larger offerings. More generally, the factor of insurance or other recoverable assets has not been examined by the empiricists and needs to be examined to determine the role it plays in screening what companies, offerings and defendants are the target of the class action suits. Until this occurs, the strike-suit hypothesis has only the appearance of simplicity.

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41. One may well believe that given the frequency of suits against *underwriters*, see Alexander, *supra* note 21, at 558, the underwriter's involvement in such a suit is not merely seen as a right of passage for major market participants, but data bearing on the number of offerings in which they participate. It is a data point that can easily be understood as a positive, and not a negative, reflection of the underwriter's status in the industry.

## II. WHY THE SECURITIES CLASS ACTION SHOULD CONTINUE

As seen from the testimony before Congress, the securities class action's opponents charge it produces small rewards for investors allegedly harmed by the defendant's violations. Though such attacks can be met by more closely examining just what damages were recoverable so that it is possible to conclude that class actions recoveries are at least ample in terms of the relative amounts recovered by members of the class, the securities class action's social value is more problematic in the face of arguments that examine the source of the settlement funds.

A reason that the securities class action poorly serves both a compensatory and a deterrent objective is the circuitry problem that arises when the source of a settlement is the corporation that commits the misrepresentation.<sup>42</sup> Though the inanimate character of the business entity assures that misrepresentations can physically be committed only by its personnel,<sup>43</sup> it is the entity, and not its actors, that provides the settlement funds. For a variety of reasons, its responsible officers and directors only rarely contribute to the recovery. The corporation's payment for the sins committed by its personnel is, transparently, a payment made proportionately by all its owners. Hence, a circularity problem arises for settlements of securities class actions involving securities class actions arising from the misleading reports of corporate defendants. If plaintiffs recover a settlement of \$10 million from Alpha Inc. for misrepresentations in its annual report that induced the plaintiffs to purchase their Alpha shares, and assuming no insurance,<sup>44</sup> the plaintiffs necessarily provide, albeit indirectly, some portion of their own settlement recovery. The degree of circularity involved by such a settlement depends primarily on what portion of the company is owned by the members of the class action, a consideration that likely is dependent on the length over which the fraud was committed, the relative turnover of the company's shares, and the number of class members who pursued a buy-and-hold-strategy versus an in-and-out-strategy.<sup>45</sup> If we assume that the class represents 5% of Alpha's shares when the

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42. For a review of these arguments and a recommendation that deterrence, not compensation, should guide the mission of securities class actions, see Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 646-57 (1996). See also FRANK A. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* ch. 12 (1991).

43. See, e.g., *In re Atlantic Fin. Management, Inc.*, 784 F.2d 29 (1st Cir. 1986), cert. denied, 481 U.S. 1072 (1987).

44. And even if there were insurance, one would expect that the policy's premiums would include the actuarial determinations that over some discrete time period the corporation would incur premiums that would equal the settlement, unless its liability or probability liability was greater than the actuarial determinations informing its premium obligations. Also, insurance is not the only concern here as the corporation may also recover from its accountants for their failure to earlier discover the managers' fraudulent practices. See Edward Brodsky, *Accountants' Liability for Fraud of Clients*, N.Y.L.J., Aug. 14, 1996, at 3.

45. Another determinant is the fundamental efficiency of the market for Alpha shares. Those members of the class who sold their Alpha shares before the settlement will suffer no later diminution in their net wealth because of such settlement. Their purchasers may incur

settlement occurs, then effectively 5% of the settlement was paid by members of the class. And, if the corporation bears the full economic weight of the settlement, though it was its personnel who committed the offense, then 95% of the settlement's effects are borne by Alpha's non-class member shareholders.

Though the rejoinder to the concern for circularity is that most of the class' recovery does not come from the class members themselves, so that circularity occurs only at the margins, we may still question why we should continue a system of liability whose impact falls on parties as innocent as the class members—the Alpha stockholders who were not members of the class. This innocent set of stockholders can easily be seen as also victims; their managers betrayed their owners' trust by committing the securities violation. On this point, consider the findings of one study of securities class actions that most such cases arise from managers purposely either concealing the financial problems of the firm, or otherwise projecting a false appearance of financial stability, as part of their desperate attempt to "turn things around." This is the so-called last period agency problem where the managers commit frauds that can be seen as both furthering their own interests of avoiding their incurring the repercussions of the reporting firm's poor performance as well as the managers striving to further the firm's interest by attempting to overcome the causes for its present financial distress. Under this view, managers may withhold information regarding the firm's financial distress from capital markets so that, for example, additional funds can be raised or time will permit an upswing in the company's affairs. Professors Jennifer Arlen and William Carney found in their study of 111 frauds on the market cases arising since 1975 that 67.7% of the cases involved potential last period agency problems,<sup>46</sup> because the apparent motive for the managers' misrepresentations was to shield themselves from the consequences of their firm's poor performance during their stewardship. Because the managers' interest so clearly dominates their reasons for committing the violation, questions abound why the fault should not, as it is in the instance of insider trading, be solely that of the managers.<sup>47</sup> That is, the class action's critics question why should any portion of the loss fall on the innocent owners of the employing company?

That managers may act to serve their interest at their owner's expense is neither unexpected nor isolated to securities violations. Too frequently managers engage in antisocial behavior—concealing the defects of the company's products, conspiring to fix prices or flaunting environmental standards—for reasons that are consistent with advancing their careers, preserving perquisites, or avoiding dismissal. All such conduct has given rise to class action recoveries against the

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diminution if the market does not reflect the ill effects of the settlement on Alpha.

46. See Jennifer Arlen & William Carney, *Vicarious Liability for Fraud on Securities Markets: Theories and Evidence*, 1992 U. ILL. L. REV. 691, 725 (50.5% involved false positive statements designed to conceal declines in earnings and 17.2% withheld other types of bad news regarding the issuer's performance).

47. See Langevoort, *supra* note 42, at 655 ("[M]any forms of open-market securities fraud bear a closer family resemblance to insider trading...[so that] we are left to wonder why the law makes insider trading largely a matter of individual liability, while self-serving securities fraud is addressed almost completely from an entity liability standpoint.").

corporate employer with consequential effects on the firm's passive, and innocent, stockholders. The question of entity liability is not, therefore, limited to securities law violations and there seems little reason to so isolate the debate of the propriety of entity liability to securities violations. Managerial misbehavior, after all, is a portion of the risk that accompanies ownership. It is a risk internalized through the concept of entity liability.

The financial burdens of a securities fraud settlement borne by the innocent stockholders of the corporate violator is indistinguishable from the burden borne by the shareholders of the corporation that produces a defective product or violates the environmental laws. Being a burden of ownership, it is inherent in the feature of enterprise liability that the enterprise internalize the costs of its activities. Though the last period agency problem appears to be advancing the personal rather than the corporation's interest, this clearly is too narrow a view of the managers' motivation. Managers who defraud securities markets as part of their attempt to rescue the firm from financial failure cannot be seen as acting solely without a consciousness of the corporation's interests.<sup>48</sup> Even the increasingly prevalent instances in which managers proffer unreasonably optimistic financial forecasts, the managers' act with their corporation's interest at heart. Professor Langevoort observes that the corporate culture seems to breed the type of optimism that invites class action suits for misleading financial forecasts.<sup>49</sup> To the extent this is the case, it would seem to argue for owner responsibility since it was their enterprise that gave rise to the culture calling for such optimism; and since ambiguity will most certainly exist with respect to whether the manager was acting at least in part to serve her employer's interest, the case for entity responsibility becomes even stronger. Though the burden of the innocent Alpha stockholders is as unexpected, and certainly unwanted, as knowledge that the company's management has knowingly infringed on a competitor's product, it nevertheless is a risk and cost properly shared proportionately among its owners.

There is a rich body of literature on the appropriateness of entity liability, as opposed to liability only for the managers who committed the violation.<sup>50</sup> Entity liability provides incentives for owners to employ efficient strategies to reduce costly violations of the law. One such strategy is the use of outside directors and another is according a strong oversight role to the audit committee with respect to the company's financial reporting. For example, whatever may be the personal incentive of the full-time officers to misrepresent the company's financial position and performance, their ability to coerce the firm's outside accountants into acceding to management's disclosure choices is greatly reduced by the presence of

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48. See *id.* at 655.

49. See *id.* at 656.

50. See, e.g., Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857 (1984); Lewis A. Kornhauser, *An Economic Analysis of the Choice Between Enterprise and Personal Liability for Accidents*, 70 CAL. L. REV. 1345 (1982); Christopher D. Stone, *The Place of Enterprise Liability in the Control of Corporate Conduct*, 90 YALE L.J. 1 (1980); Note, *An Efficiency Analysis of Vicarious Liability Under the Law of Agency*, 91 YALE L.J. 168 (1981).

a truly independent audit committee when one of the functions of the committee is to mediate disagreements between management and the auditors. The audit committee members' independence and judgment in such matters is formed not solely because they have professional lives outside the organization, but because their responsibility is to oversee management's stewardship of the firm. The presence of entity liability, therefore, not only underscores the importance of the outside directors' task, but also gives content to the discharge of that task.<sup>51</sup>

Perhaps the greatest condemnation of the securities class action is the evidence that approximately 96% of securities class action settlements are within the typical insurance coverage, with the insurance proceeds often being the sole source of settlement funds.<sup>52</sup> More specifically, testimony to Congress reported that companies commonly carry \$10 million to \$20 million of insurance and approximately 40% of the cases are settled for under \$2.5 million, 43% for between \$2.5 million and \$10 million, and about 13% for between \$10 million and \$20 million.<sup>53</sup> One observation that could be made from the earlier-described study of Professors Carleton, Weisbach and Weiss is that using the two-trader model with conventional estimates for its variables, the above settlement data indicates that companies carry insurance that comes very close to estimating the median expected damages in securities fraud matters. That is, the median estimate of damages is \$11.1 million for the two-trader model assuming that 20% of the shares are held by traders who account for 95% of the share volume.<sup>54</sup> Thus, 83% of settlements occur within the Carleton-Weisbach-Weiss median expected damage level. One may, therefore, conclude in light of the testimony before Congress that not only do settlements occur within policy limits, but that insurance is purchased for an appropriate amount of risk. Though each explanation complements the other, each can, of course, be an independent explanation of what is being observed.

The good news derived from this data is that the securities class actions do not simply shift money from one set of investors to another, at least not among

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51. Professors Arlen and Carney argue against entity liability, believing there is little basis to believe it leads to meaningful precautionary steps that will deter final period agency costs, whereas they favor agent liability believing that insurance carriers will then be better monitors for agent misconduct than would the agent's employer. See Arlen & Carney, *supra* note 46, at 712-15. However, Professors Arlen and Carney did not consider the possible effects that entity liability has on structural responses such as the institution of an audit committee or the retention of higher quality auditors.

52. 1993 Hearings, *supra* note 5, at 139 (statement of Vincent E. O'Brien). The implications of testimony, however, may be better understood if compared with the settlement experience in other areas, such as antitrust class action settlements, medical malpractice settlements, or even insurance settlements. One would fully expect that insurance plays an important, if not dominant, role in those contexts as well. If so, the condemnation would be of the legal system's nurturing what many would consider expeditious choices in settling disputes. But one must also be mindful of the social costs of not exercising that choice.

53. *Id.* Mr. O'Brien, though his numbers total to 96% nevertheless concludes, "it would appear that in fully 94% of these cases, there is no chance that any deterrence has been achieved." *Id.* (emphasis added).

54. Carleton et al., *supra* note 28, at 499 tbl. 2.



investors within the same corporate family. Class members fare better when the settlement amounts come largely from external sources, such as insurance, accountants, or underwriters who are implicated in the misconduct. This is clearly new money, or so it would seem. And, just as an insurance company stands behind every accountant and underwriter, we may generalize that there similarly stands an insurance company in about 96% of the settlements of securities class actions. Thus, the empirical question that is ripe for exploration is just how dominant a role insurance plays in settlements. And, though not an empirical question, we should question as well whether an insurance-based recovery in so many cases complements or defeats the objectives sought through the private enforcement of the securities laws. More specifically, if deterrence is among the objectives to be served by the securities class actions, does insurance vitiate its fulfillment of this objective?

One unflattering assessment of the role of insurance is advanced by Professor Kent Syverud who advises that there is a wasteful cycle of insurance causing larger settlements and awards which in turn lead to more insurance being purchased which leads to larger settlements and awards, and so on.<sup>55</sup> Even critics of the data Syverud marshals to support his thesis admit that "the presence of liability coverage alters the legal landscape more than most observes recognize."<sup>56</sup> If insurance is such a dominant factor guiding settlements, and one would be surprised if it were not, should this change our assessment of the social value of securities class actions?

Just as widows, widowers and orphans are both class members and the owners of companies that are defendants in their class action, they also are the beneficiaries of profitable performance by insurance companies. Most large insurance companies are publicly traded so that unexpected claims diminish their share values. And, most Americans also have the status of being an "insured" for some risk. Even though insured against a risk other than that of securities fraud, the insured will find that her premiums are not invariable to her carrier's experiences in other insurance products. Thus, should we think of securities class actions as shifting resources from one set of widows, widowers and orphans to another? Are investors who are compensated by insurance policy merely diminishing the wealth of the insurance company's stockholders?

To fear that class action securities frauds may adversely impact the profits of insurance companies or cause their customers' premiums to increase is a bit like weeping for casinos because sometime they have to pay those who win at their roulette tables. Insurance companies and casinos are both in the odds business—they earn their profits probabilistically. Insurance companies' stock prices reflect their success at managing risk. Similarly, consumers presumably consider premium rates when purchasing insurance so that any adverse experiences incurred by the insurance company in one sector of its business impacts the premiums for other

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55. Kent D. Syverud, *On the Demand for Liability Insurance*, 72 TEX. L. REV. 1629 (1994).

56. Randall R. Bovbjerg, *Liability and Liability Insurance: Chicken and Egg, Destructive Spiral, or Risk and Reaction*, 72 TEX. L. REV. 1655, 1678 (1994).

sectors. Unexpected claims ultimately will burden the company's owners as well because the insurance company will have a competitive disadvantage to the extent the adverse experiences are not systematically shared by its competitors.<sup>57</sup>

Because insurance carriers make money by acutely playing the odds and pricing their product accordingly, the cost of settlements can be traced to those who acquire insurance. Though some part of this is traceable obviously to the class members themselves as occurred in the Alpha example earlier, the burden is not theirs alone. It is truly a shared risk, and one that is somewhat sensitive to the expected exposure to suit. Thus, to argue that most settlements occur in the shadows of an insurance policy does not totally answer the question whether the securities class action is serving its mission, whatever it may be, or is simply a menace. It merely says that insurance serves a useful purpose of spreading the loss over a wider range of individuals than those who were the immediate victims of the managers' misbehavior. Such a result seems entirely consistent with the view that the securities class action is compensatory.<sup>58</sup> Only if one were to cry for the defendant's head does insurance appear to pose a conflict.

At least two quite different hypotheses arise from evidence that the size of a settlement is strongly influenced by the amount of available insurance, each questioning why recoveries do not more frequently exceed the amount of available insurance. The first hypothesis is that meritorious cases are not pursued beyond the insurance policy's limits because there are insufficient incentives to do so.<sup>59</sup> The second hypothesis is that most settled cases lack merit so that the insurance policy's limits by definition will be more than sufficient to satisfy the class action attorney. The second hypothesis returns us to the "strike suit" perception of securities class actions and resonates well with statistics reflecting that nearly one-half of class action settlements are under \$2 million.<sup>60</sup> The two hypotheses are not alternative ones; they are indeed complementary and each likely has a measure of truth.

Of interest is that both hypotheses would seem to suggest that, but for the risk aversion of directors, officers and their advisors and employers, the best strategy for any corporate entity is to carry only a small amount of insurance. They could

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57. See Thomas A. Smith, *Institutions and Entrepreneurs in American Corporate Finance*, 85 CAL. L. REV. (forthcoming 1997).

58. Professors Arlen and Carney, for example, reason that entity liability is consistent with a compensatory view of securities class actions. See Arlen & Carney, *supra* note 46, at 719.

59. See, e.g., John C. Coffee, Jr., *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working*, 42 MD. L. REV. 215 (1983).

60. See Joseph A. Grundfest, *Why Disimply?*, 108 HARV. L. REV. 727, 742-43 (1995) (examining data in Dunbar & Juneja, *supra* note 9, to conclude that 23% of the sample settled for less than \$2 million, with the average settlement being about \$1 million, suggesting that "settlement values may often be less than avoided litigation costs"); 1993 Hearings, *supra* note 4, at 48 (statement of Dr. Vincent E. O'Brien) (40% of settlements are for less than \$2.5 million, less than the defendants' costs if they proceeded to trial); Carleton et al., *supra* note 28, at 511 (settlement to damage ratios lower for settlements below \$2 million is consistent with nuisance suit hypothesis).

then avoid the premiums that come with greater levels of coverage and still enjoy the same practical constraint on their exposure, the policy's coverage limits. That this "go bare," or nearly so, strategy does not prevail is attributable to the belief that insurance is the means to address aversion to risk so that policy limits tend to reflect amounts believed necessary in the worst case scenario. Thus, policy limits can be expected to hover toward the expected level of liability. The answer to the strike-suit hypothesis is not the absolute size of the settlement, but the size of the settlement in relation to the amount of recoverable damages. As seen earlier, when conservative estimates of damages recoverable in the suit are used, settlements appear sufficiently ample to reject the strike-suit hypothesis.

### III. THE HIDDEN MESSAGE OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

The 103rd Congress bestowed a unique honor on securities fraud actions by enacting the Private Securities Litigation Reform Act of 1995,<sup>61</sup> and thus providing special procedural rules for securities fraud cases. To date, no other area has earned its own procedural rules. As seen in the preceding section, the legislation followed lengthy hearings that produced a good deal of conflicting impressions and empirical data on the social value of securities class actions. Though it cannot be said that either side of the argument put forth a convincing presentation, the mood within Congress clearly was reform-oriented. The winds of reform were unquestionably fanned by the substantial lobbying by the accountants and representatives of high-tech companies.

At the core of the legislation was tweaking the incentives that surround the initiation, conduct and settlement of class actions. A central concern was the relative lack of restraint that so characterizes class action litigation. Thus, the Reform Act introduces procedures to attract a "lead plaintiff," which the Act provides is presumptively a class member with a large claim.<sup>62</sup> The purpose of the lead plaintiff requirement is to harness a large investor's self-interest to the lawsuit to reduce the incentive for the class action lawyer to become lead counsel by such practices as rushing to be the first to file a complaint and then encouraging other counsel to file copycat complaints to assure the first filing counsel's selection as lead counsel. The Act addresses these practices by providing that among the lead plaintiff's tasks is the selection or dismissal of counsel.<sup>63</sup> After the enactment of the lead plaintiff provision, being first to file no longer provides a leg up on becoming lead counsel. And similarly, there is little reason for the earliest filing attorney to encourage others to file copycat complaints so as to support the earliest filing attorney's selection as lead counsel. With the race to file assuming a less important

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61. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C. (1994 & Supp. I 1995)) [hereinafter Reform Act].

62. Reform Act, *supra* note 61; § 27(a)(3)(B)(iii) of the Securities Act and § 21D(a)(3)(B)(iii) of the Exchange Act.

63. *Id.*; § 27(a)(3)(B)(I)(v) of the Securities Act and § 21D(a)(3)(B)(I)(v) of the Exchange Act.

role in the selection of lead counsel, there is cause to expect that the decision whether to file suit will be a more thoughtful and deliberate process than it has been in the past. Moreover, the Act opens up the possibility for the lead plaintiff to aggressively pursue competitive bidding by class action attorneys with respect to their fees. It is also possible that the lead plaintiff may select a counsel for the purpose of moving the case's dismissal on the grounds it was improvidently initiated or that the burdens it likely will impose on the corporation will overwhelm the expected value of its prosecution.

The lead plaintiff provision provides a variety of possible challenges to the class action lawyers whose contact with the class representative was far more attenuated. First, the lead plaintiff may well convince the court that an attorney less bent toward the prosecution of the case would be appropriate. Thus, a shift in lawyers from the "plaintiffs' law firm" to the "commercial law firm" could be a step toward a different perspective on whether the suit is appropriate. Though there may be serious questions whether a lead plaintiff would wish to undertake such a daring move for fear of exposing itself to charges of having harmed the other class members by setting in motion a course of action that ultimately caused a premature termination of a valuable cause of action, any fear of such liability is misplaced. The lead plaintiff can only make recommendations to the court, with the decision to remove counsel being ultimately that of the presiding judge. Because class counsel's removal or even the dismissal of the case would bear the court's imprimatur, a substantial, if not unerodeable, presumption of propriety would attach to the decision to substitute counsel.

A second concern for the plaintiffs' bar is that the lead plaintiffs will exercise their right to select counsel as a means to force the class attorney to undertake meaningful negotiations with regard to its fee.<sup>64</sup> Thus, the lead plaintiff can be seen as a market-based<sup>65</sup> approach to controlling fees received by class action attorneys. Whether lead plaintiffs can be more successful than the courts<sup>66</sup> in fostering meaningful bidding among counsel remains to be seen. There is a good deal of intuitive appeal to the position that the consumer of the services will have a more acute sense of what it seeks from the attorney than the court will have because the court may value auction results that produce a cleaner bases for comparing fees among attorneys but which may not provide the incentives that are likely to boost the settlement ultimately extracted. For example, a court may prefer a fee arrangement that provides a fee that declines as a percentage of the overall

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64. See Dan Starkman, *Fund Displaces Law Firm to Lead CellStar Lawsuit*, WALL ST. J., Oct. 2, 1996, at B9.

65. The ultimate market-based approach is to completely overcome the separation of representation of the class members and the class members by permitting parties to purchase from the class the cause of action. See Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1 (1991). But see Randall S. Thomas & Robert G. Hansen, *Auctioning Class Action and Derivative Lawsuits: A Critical Analysis*, 87 NW. U. L. REV. 423 (1993).

66. See, e.g., *In re Oracle Sec. Litig.*, 131 F.R.D. 688, 690 (N.D. Cal. 1990).

recovery.<sup>67</sup> In contrast, the lead plaintiff may prefer a compensation arrangement that maximizes the likely return to the class, so that the lead plaintiff may prefer, within some limits, a fee structure that pays increasingly higher amounts to the class' lawyer as the recovery increases.<sup>68</sup> Competition among attorneys for fees may indirectly, and most likely only marginally, reduce the incidence of frivolous lawsuits by reducing some of the gains from their conduct while introducing a substantial uncertainty whether the lead plaintiff may not scuttle the suit before it has barely begun. More likely competition, particularly as broadened with the introduction of the lead plaintiff, is likely to bring about a change in scale for fees in at least securities class actions. One can also expect that the lead plaintiff provision will have an overall positive influence on the design of the attorney's fee schedule so that the attorney's compensation more closely matches the members' interest with those of its attorney.

A third effect of the lead plaintiff's economic interest being harnessed to the class action is making the settlement hearing more adversarial. Whatever the correctness of Judge Friendly's observation that at settlement the plaintiff's and defendant's lawyers stand locked arm in arm before the court,<sup>69</sup> there is no reason to expect this picture also includes the lead plaintiff who continues to have the power to raise with the court who should retain their position as lead counsel. Minimally, the presence of an investor with a large financial interest in the class action does not make the attorneys' role easier in obtaining the court's approval of the settlement.

The most remarkable feature of the lead plaintiff provision is not that it now becomes institutionalized for securities class actions but that legislation was needed for the above benefits to be so institutionalized. Before the Reform Act there were few instances when a large institutional investor was relied upon to rescue the class action from its counsel. The most famous incident is that arising out of the class actions involving California Micro Devices in which the court replaced the class action's original plaintiff with the Colorado Public Employee Retirement Association who then objected to the fees being sought by the class' counsel because the settlement involved primarily nonpecuniary awards for the class with most of the cash that was pried from the defendant being awarded to the class' counsel.<sup>70</sup> Because courts clearly have the power to substitute a more adequate

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67. This was the case in *In re Oracle Sec. Litig.*, 132 F.R.D. 538, 548 (N.D. Cal. 1990). Recently in the suits arising from alleged price fixing by Archer Daniels Midland, the court, through competitive bidding among attorneys, chose the class representative who agreed that no fee would be required for sums recovered in excess of \$25 million. There was a large protest, and resulting amendment of the recovery, when the attorney proposed a settlement for \$25 million. Laurie Cohen, *Bargain at the Bar: Archer-Daniels Cuts Surprisingly Good Deal in Price-Fixing Suit*, WALL ST. J., Apr. 12, 1996, at A1.

68. See Weiss & Beckerman, *supra* note 23, at 2107.

69. See *Alleghany Corp. v. Kirby*, 333 F.2d 327, 347 (2d Cir. 1984) ("Once a settlement is agreed, the attorneys for the plaintiff stockholders link arms with their former adversaries to defend the joint handiwork....").

70. *In re California Micro Devices*, No. C-94-2817-VRW, 1995 WL 476625 (N.D. Cal. Aug. 4, 1995).

plaintiff for the class' current representative," we may see the Reform Act as merely making this once latent power invoked more regularly. So viewed, we should then question why courts have so rarely exercised this latent power. Addressing this question, which was not addressed in any of the hearings preceding the Reform Act's enactment, may tell us a good deal more about the problems of class actions than the evidence that was amassed at the Act's hearings.

The Reform Act also alters the environment in which settlements are considered. In a vaguely worded provision, the act now limits attorneys fees to "reasonable percentage of the amount of any *damages* or prejudgment interest actually *paid*."<sup>71</sup> Though the provision will still permit attorneys fees, if the court so wishes, to be awarded using the lodestar method, a fair interpretation of the Act's change is that the lodestar figure so calculated must fall within a reasonable percentage of the recoverable amount. More importantly, if nonpecuniary benefits constitute part of the settlement," those benefits are not among the "damages...paid" so that they do not provide by themselves a basis for the award of attorneys fees; an attorney who seeks the award of fees for settling a class action with only nonpecuniary benefits would appear not to be entitled to the award of any attorney fees. The obvious thrust of this provision is concern that nonpecuniary settlements of dubious value to the class members are often the expeditious route to the receipt of attorneys fees. The Reform Act addresses this concern by removing the settlement's nonpecuniary benefits from the scale in weighing the attorney's request for fees.

Further attempts to address the incentives surrounding settlement appear in provisions requiring disclosure to class members upon settlement of the average amount of damages per share the parties agree the class would have been entitled to recover if the plaintiff prevailed on each claim; if the attorneys cannot agree to such a figure, each side must elaborate on the points, presumably relative to the amount of damages, on which they disagree."<sup>72</sup> Intuitively, if the class action's counsel were forced to disclose that she believed substantially more was recoverable at trial than was received in the settlement, the shape of the settlement would likely be affected. But it is also likely that even such a disclosure, if it occurred, is likely to have little impact on the attorneys' incentives. For example, if the class member is confronted with widely varying presentations from the class action's attorney and defense counsel on the suit's merits and the amount recoverable, class members learning that a wide gulf separates the defendants' and

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71. See, e.g., Weiss & Beckerman, *supra* note 23, at 2105-08.

72. Reform Act, *supra* note 61; § 27(a)(6) of the Securities Act and § 21D(a)(6) of the Exchange Act.

73. For example, in *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970), the Supreme Court awarded plaintiff attorneys fees, though no damages were recovered, because the suit had successfully established a technical violation of the proxy rules. Ultimately, no damages were recovered, and for that portion of the suit, no attorneys fees were recoverable. See *Mills v. Electric Auto-Lite Co.*, 552 F.2d 1239 (7th Cir.), *cert. denied*, 434 U.S. 922 (1977).

74. Reform Act, *supra* note 61; § 27(a)(7)(B) of the Securities Act and § 21D(a)(7)(B) of the Exchange Act.

plaintiffs' lawyers may well conclude that they are lucky to have received anything. Though the disclosure now required by the Reform Act may stimulate some coordination among those members of the class with the largest claims, there is no reason to believe this coordination would not exist without this part of the Reform Act. Certainly the lead plaintiff, if it is a large investor, can learn who the larger stakeholders in the class are and, with such knowledge, can be the catalysts of any action necessary to respond to the settlement. In any case, there is cause for skepticism whether the additional disclosure is likely to introduce any discipline that was not present prior to the Reform Act.

The Reform Act's tightened pleading requirements<sup>75</sup> and narrowed discovery rights more than any other feature probably account for any decline in the number of class action securities suits initiated since its enactment.<sup>76</sup> As an effort to prevent the filing of a complaint from becoming the attorney's ticket to "flesh out" her pleadings through discovery, the Reform Act stays any discovery during the pendency of any motion to dismiss.<sup>77</sup> The bar to discovery compounds the class action attorney's task in satisfying the Reform Act's heightened pleading standard. Arguably, the pleading requirement should have only an indirect impact on the respective positions of the parties as they undertake settlement negotiations. The force of the pleading requirement is that it will allow courts to dismiss a larger number of cases than have heretofore been dismissed under more lax pleading

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75. Section 21D(b)(2) of the Exchange Act provides that when scienter is required in private securities litigation the plaintiff must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." The exact demands of this heightened pleading requirement are a matter over which judges opinion vary widely. *Compare* *Marksman Partners L.P. v. Chantal Pharm. Corp.*, 927 F. Supp. 1297 (C.D. Cal. Sept. 25, 1996) (scienter may be pleaded by alleging defendant's motive and opportunity to commit fraud) *with In re* *Silicon Graphics Inc. Sec. Litig.*, 1996 WL 664639 (N.D. Cal. 1996) (scienter not pleaded by facts setting forth defendant's motive and opportunity to defraud).

76. *See Other Developments*, Fed. Sec. L. Rep. (CCH) No. 1725, July 31, 1996, at 9-10 (reporting on announcement by Mr. Richard H. Walker, General Counsel of the SEC, that during the first seven months since the Reform Act's becoming effective, 40 federal class action suits had been initiated whereas in earlier years, about 150 actions were customarily filed in the first seven months of a new year). For a more complete review of the data for the first year, see John C. Coffee, Jr., *First Anniversary: PSLRA of 1995*, N.Y.L.J., Jan. 30, 1997, at 5 (reviewing recent National Economic Research Associates' study suggesting slight decline in number of suits initiated in federal courts during 1996 from 1995, but significant increase in filings in state courts for 1996 over 1995).

77. Reform Act, *supra* note 61; § 27(b)(1) of the Securities Act and § 21D(b)(3)(B) of the Exchange Act. Exceptions to this bar arise upon a court determining that particularized discovery is needed "to preserve evidence or prevent undue prejudice to the party." *Id.* The discovery bar is stricter with respect to motions for summary judgment on actions subject to the Reform Act's safe harbor for forward-looking statements for which the "undue prejudice" exception does not apply. *See id.* § 27A(f) of the Securities Act and § 21E(f) of the Exchange Act. *See generally* John C. Coffee, Jr., *The Future of the Private Securities Litigation Reform Act: Or, Why the Fat Lady Has Not Yet Sung*, 51 BUS. LAW. 975, 986-88 (1996).

standards.<sup>78</sup> The new pleading requirement will have its greatest impact in the Ninth Circuit which before the Reform Act permitted scienter to be plead generally, i.e., the pleading need only state that scienter existed.<sup>79</sup> Though lax pleading requirements made the nuisance value of a suit much more difficult to address through pretrial motions, it must also be understood that the Reform Act's heightened pleading standard credentials suits that survive pretrial motions so that it will have greater settlement value than such suits had on average before the Reform Act. This result can be expected even for suits with negative expected value for which the heightened pleading standard does not alter the plaintiffs' costs to proceed to the next litigation level,<sup>80</sup> but the heightened pleading standard very much affects the defendants' assessment of the range of outcomes and their associated probabilities for the defendants. In any case, class action counsel should feel more confident in the case after satisfying the new pleading requirements than the counsel who previously had to know less and plead less to withstand a challenge to the pleadings. Thus, if one were to investigate settlements after the Reform Act, it may be difficult to untangle the impact of the lead plaintiff on the one hand and the tightened pleading requirements on the other because each are likely to contribute to larger settlements on average.

The bar to discovery should have a neutral impact on settlements once the pleadings have been tested, but overall the tightened pleading requirement can be expected to reduce the number of class actions that are commenced. The lack of discovery will hobble the potentially meritorious suit from withstanding a test of its pleadings by denying the plaintiff access to information necessary to specifically plead a violation by the defendant. Discovery can be expected to always play a more important role in suits arising from forward-looking statements than in allegations that certain historical facts regarding the firm's performance or financial position were misrepresented. As to the former, there is little in the public domain on which the plaintiff can rely other than that the forecast differed materially from what ultimately occurred. Such a variance between what was forecast and what was achieved does not itself plead a violation; the plaintiff must have access to documents or other information that challenge whether those proffering the forecast must have known there was a serious chance the forward-

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78. There are widely varying statistics on the percentage of securities fraud cases dismissed as a consequence of pretrial motions. Compare Dunbar & Juneja, *supra* note 9, at 750 tbl. 1 (11–16% of securities class actions were dismissed on pretrial motions between 1991–1993) and Alexander, *supra* note 21, at 544 (pretrial motions are ineffective in reducing incidence securities class actions because many peripheral claims survive and the courts generally provide leave to amend the complaint) with Joel Seligman, *A Comment on Professor Grundfest's Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 108 HARV. L. REV. 438, 455 (1994) (38% of securities fraud cases in 1990 and 1991 were dismissed on pretrial motions). There may be some modest inflation in Professor Seligman's data because included within the dismissal category was a small number of cases that were voluntarily dismissed, but later refiled. *Id.* at 445 n.33.

79. See, e.g., *Decker v. GlenFed, Inc.*, 42 F.3d 1541, 1547 (9th Cir. 1994).

80. See *Bebchuck*, *supra* note 24, at 15–19.



looking statement was misleading.<sup>81</sup> This information is generally in the possession of the defendant corporation so that the lack of discovery in such cases seriously impedes the initiation of such suits. And, information that is in the public domain that would support the complaint's pleading may well also support the conclusion that no misrepresentation was committed.<sup>82</sup> In contrast, allegations that the defendants misrepresented certain historical facts, such as the reserves for uncollectible accounts, can be supported by facts frequently in the public domain, such as restatement of accounting statements or the reconstruction of the defendant's probable knowledge in light of the information that was public knowledge. However, such information frequently arises years later when the accountants or others uncover the earlier fraudulent practices by the firm's managers.

The most damaging aspect of the discovery bar for so many cases is its interplay with the Supreme Court's embrace of a shortened statute of limitations for antifraud actions. In *Lampf, Pleva, Lipkind, Prupis v. Gilbertson*,<sup>83</sup> the Court held that the statute of limitations for suits under Section 10(b) and Rule 10b-5 is that provided for the express causes of action: suit must be brought within one year of discovery of the fraud and not later than three years of the violation.<sup>84</sup> After the Reform Act, *Lampf* becomes an even greater menace because of the Reform Act's bar to discovery that would otherwise be resorted to to ascertain whether an actionable violation had occurred. The bar to discovery in many cases would not be a problem because ultimately the true facts will become public knowledge; however, the bar now assumes great importance in those cases where such public knowledge arises more than three years after the violation. Suits that do not commence within three years can be expected to be the type where the defendants have successfully withheld from the public information that would either put investors on notice of a misrepresentation or that a misstatement or omission was the product of a unlawful misconduct. The bar to discovery can well mean that an even larger number of suits will be barred by the statute of limitations because the plaintiffs cannot depend on discovery to unearth whether a misrepresentation was innocently made or was committed with scienter.

A final step taken by the Reform Act is its reversal of the diluting effects of the

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81. See, e.g., *Moss v. Healthcare Compare Corp.*, 75 F.3d 276 (7th Cir. 1996); *Marx v. Computer Sciences Corp.*, 507 F.2d 485, 489 (1974).

82. This refers to the "truth on the market" defense that has recently been developed by the courts and used extensively in suits arising out of forecasts regarding products or operations. See, e.g., *In re Convergent Tech. Sec. Lit.*, 948 F.2d 507, 513 (9th Cir. 1989) (computer company did not mislead investors by failing to disclose its established products would become obsolete in the fast developing software industry where evidence introduced that many analysts described the defendant's products as being in transition).

83. 501 U.S. 350 (1991).

84. Because *Lampf* applied retroactively, Congress attempted to ameliorate some of *Lampf*'s impact by grandfathering all suits pending when *Lampf* was pending. See 15 U.S.C. 78aa-1 (1994). The Supreme Court held that subsection (b) of this provision violated the separation of powers doctrine by purporting to reopen cases that had been dismissed pursuant to *Lampf*. *Plaut v. Spendthrift Farm, Inc.*, 514 U.S. 211 (1995).

1993 amendments to Rule 11, so that presiding judges are required to make a finding in all securities fraud litigation whether Rule 11 has been violated.<sup>85</sup> If a violation is found, the Act establishes a clear presumption of the sanction to be imposed.<sup>86</sup> In the case of a "substantial failure of any complaint to comply with any requirement of Rule 11(b)" the court *must* impose a sanction which is presumed be "an award to the opposing party of the reasonable attorney fees and other expenses incurred in the action."<sup>87</sup> Congress, in enacting this provision, expressed its clear intent for the courts to be tougher on those who file frivolous securities actions than they had been previously or is called for under Rule 11 in other types of litigation. Also, the Act, by making the sanctions mandatory on a finding of a Rule 11 violation and providing a presumption that the appropriate sanction is awarding the opposing party's costs, repudiates the purely deterrent purposes of Rule 11.<sup>88</sup> By far the largest change in the operation of Rule 11 in securities litigation is that the prospect of a sanction is not dependent on the motion of an opposing counsel and there is no opportunity to cure the situation by withdrawing the complaint or motion as there is under current Rule 11 which after the 1993 amendment provides a 21-day notice period during which time the object of the sanction can amend or withdraw the complaint or motion.<sup>89</sup>

Overall, the Reform Act changes Rule 11's purpose and dynamics significantly from what exists in nonsecurities fraud litigation. The Reform Act clearly places the momentum for Rule 11 sanctions with the presiding judge who more than ever before is charged to provide a compensatory orientation to the proceeding. By not conditioning Rule 11 determinations on the litigant's motion, the procedure provides less opportunity for litigants to include in their settlement discussions the respective positions regarding motions for Rule 11 sanctions, and subjects each to more uncertainty regarding their pleadings and strategies than exists under 1993 amendment to Rule 11. Prior to the Reform Act, Rule 11 sanctions were only rarely invoked in securities cases; it may well be that this will not change after the Reform Act.

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85. Section 27 of the Securities Act and § 21D of the Exchange Act.

86. The court must give notice prior to making an adverse finding so that the responsible attorney is provided an opportunity to respond. See § 27(c)(2) of the Securities Act and § 21D(c)(2) of the Exchange Act.

87. Section 27(c)(3)(A)(ii) of the Securities Act and § 21D(c)(3)(A)(ii) of the Exchange Act. Similar requirements apply to other pleadings and motions. Section 27(c)(3)(A)(i) of the Securities Act and § 21D(c)(3)(A)(i) of the Exchange Act.

88. For the view that Rule 11 is not intended to compensate the opposing party but to deter attorney and litigant misconduct, see *Kirk Capital Corp. v. Bailey*, 16 F.3d 1485 (8th Cir. 1994); *Pelletier v. Zweifel*, 921 F.2d 1465 (11th Cir. 1991). *Contra* *Levy v. Aaron Faber, Inc.*, 148 F.R.D. 114 (S.D.N.Y. 1993) (award in the amount of the defendant's costs in defending the action that is payable to the defendant is appropriate sanction for Rule 11 violation).

89. However, if the court raises Rule 11 sua sponte, the 21-day period does not apply. FED. R. CIV. P. 11(c)(1)(B). Also, Rule 11 provides that the sanction ordinarily should be paid into the court instead of to the injured party. *Id.* at committee notes to subdivisions (b) and (c).

But the important message of the Reform Act with respect to its treatment of Rule 11 and the other reforms it introduces is not in the procedural changes the Act introduces. As seen from the above, most of these changes are modest and can be seen as refinements in doctrines or processes that could have been made without legislative intervention. The Reform Act sought to change the dynamics of class action securities litigation through its call for a lead plaintiff, expanded disclosures for settlement notices, prescription that attorneys' fees not exceed a reasonable allocation of the damages *paid*, and placing the court as the principal movant in Rule 11 matters. In each of these developments the Reform Act calls for more aggressive supervision of the class action by the court. Thus, if reform was introduced, it was not so much reforming the natural tendencies of the litigants but a reminder to the presiding court of the important role it is required to play in such matters.

#### IV. VIRTUE'S SLUMBERING GUARDIAN

The most interesting feature of the hearings that preceded the Reform Act is the witness list, or rather who was not on the witness list. Though much of the testimony involved jousting over data gleaned from studies or the witnesses' experiences with a securities class action, no testimony was received from any judge who had presided in a securities class action. Evidence was received regarding settlement amounts and the attorneys' fees relative to settlement amounts. There was a good deal of discussion on the relative difficulty of disposing of cases on their pleadings and the abuses of discovery. But no firsthand evidence was collected by the House and Senate committees on the perceptions of judges who have presided in such cases.

A question that should have been addressed is, if the abuses are as the opponents of securities class actions assert, why have not the presiding judges rejected more settlements or imposed more sanctions? To be sure, the presiding judge does not enjoy the same informational advantages as the litigants regarding the relative fairness of a settlement or the appropriate amount of fees. But, as seen, there are demonstrative cases where judges have involved themselves closely in these questions, and other matters relative to the conduct of the securities class action, so that we may ask why such involvement does not occur more frequently.

The problem with reforming the securities action may be a problem of focusing on the wrong set of problems. To be sure, pleading standards can be tighter, and there also are benefits of greater uniformity in such pretrial matters such as avoiding wasteful forum shopping. Moreover, requiring a truly adequate plaintiff in the sense of a plaintiff with a sufficient economic stake in the proceeding enlivens the attorney-client relationship for the class action. But legislation was not necessary for the class action court to appoint a "more" adequate plaintiff or for the court to impose its own sanctions for spurious claims filed. That is, the major mistake committed with the Reform Act is that it deals with the problem as a two-party problem, being between the defendants' and the plaintiffs' lawyers. The problem has a third dimension, the presiding court.

That there are few instances where courts have replaced the class representative with a more sophisticated class member, where courts have more tightly controlled counsel fees, and where courts have rejected settlements, are each consistent with the view that presiding courts have turned a blind eye toward the problem. Though there is a fairly robust body of literature suggesting that settlement hearings are not adversarial proceedings, there is a dearth of cases pushing the litigants to justify why more was not recovered on behalf of the class. How strange it is, therefore, that we create an environment for the class action attorney to function as an entrepreneur with no safeguards to assure that the attorney does not merely satisfy herself. That is, the incentives that surround the class action attorney are undoubtedly sufficient to cause the suit to be initiated and to pursue the suit to the limits of immediately available corporate resources, e.g., the insurance policy. It would seem appropriate for the opinions approving settlements to illuminate why other sources of funds, such as the assets of individual wrongdoers, were not tapped by the class action. We can speculate that had the congressional subcommittees pursued this line of inquiry they would have received testimony that class counsel's pursuit of funding sources beyond the company's insurance policy would have met with greater resistance and, hence, delay in the settlement so that such aggressiveness would not have been efficient. If this is the case, it would appear appropriate for the presiding court to consider such factors in their determination of the attorneys fees to be awarded or the overall fairness of the settlement. But more importantly, the court's close review of settlements that occur within the limits of available insurance appears especially necessary to address the strike-suit thesis suggested by those suits that yield extremely small amounts in settlements. Simply stated, the courts must not only become more active in their reviews but also must make the overall process more transparent.

Thus, reform of class actions may not require more than an awakening within the judiciary that it is its duty to make the class action virtuous. Attorneys, whether for the plaintiffs or the defendants, are acting within their own set of incentives. Those incentives, as seen earlier, naturally cause paths of least resistance to be pursued. If there is a problem with class actions, it is that the litigants have been permitted to behave according to the incentive structure that prevails in class actions. The Reform Act changes very little of the incentive structure; its most, and perhaps only, effective measure being the lead plaintiff. From there it appears up to the courts to awaken themselves to the Reform Act's call that they become more involved in the conduct of class actions. This invitation is found in the Reform Act's treatment of Rule 11, the presumptive bar to discovery, and limiting damages to a reasonable percentage of the amount *paid*. Without the presiding court's resolve to give meaning to these provisions, the virtue of the securities class action will continue to be debated.