



**Securities Class Action Litigation:
How is the System Working Ten Years After Enactment of
the Private Securities Litigation Reform Act?**

*Released by the U.S. Chamber Institute for Legal Reform
February 2006*

SECURITIES CLASS ACTION LITIGATION: HOW IS THE SYSTEM WORKING TEN YEARS AFTER ENACTMENT OF THE PSLRA?

Prior to 1995, claims of securities fraud were governed by court-created rules, as well as by the Securities Act of 1933 and the Securities Exchange Act of 1934. In the mid-1990s, Congress heard testimony that “certain lawyers file[d] frivolous ‘strike’ suits alleging violations of the Federal securities laws in the hope that defendants will settle quickly to avoid the expense of litigation. These suits, which unnecessarily increase the cost of raising capital and chill corporate disclosure, [were] often based on nothing more than a company’s announcement of bad news, not evidence of fraud. All too often, the same ‘professional’ plaintiffs appear[ed] as name plaintiffs in suit after suit.” S. Rep. No. 104-98, at 4 (1995). To address these and other abuses, Congress enacted the Private Securities Litigation Reform Act of 1995 (“PSLRA”). The Act was “intended to lower the cost of raising capital by combating these abuses, while maintaining the incentive for bringing meritorious actions.” *Id.*

After enactment of the PSLRA in 1995, plaintiffs’ lawyers began to file securities claims in state court in order to avoid the provisions of the federal law—even though state courts had never before been a forum for such cases. In response, Congress in 1998 passed and President Clinton signed the Securities Litigation Uniform Standards Act (“SLUSA”), which bars securities class actions in state courts.

These two statutes produced considerable reform of securities litigation, deterring the filing of abusive cases and increasing incentives to pursue greater recoveries on meritorious claims. However, observers of the securities litigation system have raised questions in recent years about several aspects of the process—both because some provisions of the PLSRA and SLUSA have not had their intended effect and because new issues have arisen in the post-PSLRA litigation environment. This memorandum summarizes these questions about securities class action litigation.

PSLRA Provisions Designed To Empower Investors

One of Congress’s principal goals in enacting the PSLRA was to change the system so that clients – not lawyers – would be in control of the litigation. Prior to the adoption of the PSLRA, plaintiffs’ lawyers controlled litigation through a stable of “professional plaintiffs” who owned a few shares of stock in a wide range of companies. After a drop in stock price or another precipitating event, the lawyers engaged in a “race to the courthouse” to file the first complaint, which typically was

awarded “lead case” status by the court, conferring the right to control the litigation and obtain the lion’s share of any attorneys’ fee award. Commenting on this process, a leading plaintiffs’ lawyer famously stated that he had the best legal practice in the world because he had no clients. Jeffrey Toobin, *The Man Chasing Enron*, *The New Yorker*, Sept. 9, 2002, http://www.newyorker.com/printables/fact/020909fa_fact1 (Last visited Feb. 14, 2006).

A. Lead Plaintiff Provision

The PSLRA adopted a system in which the plaintiff with the largest potential loss is favored to be the lead plaintiff. Pub. L. No. 104-67, 109 Stat. 739, 744 (1995). The PSLRA also requires plaintiffs who file complaints early to widely advertise their filing in order to draw out more plaintiffs, some of whom might have a stronger claim to become the lead plaintiff. *Id.* at 738-39.

Congress adopted the lead plaintiff provisions in order to boost the role of institutional investors: “The Conference Committee seeks to increase the likelihood that institutional investors will serve as lead plaintiffs by requiring courts to presume that the member of the purported class with the largest financial stake in the relief sought is the ‘most adequate plaintiff.’” H.R. REP. 104-369, at 34 (1995). To a large degree, this has happened. According to PricewaterhouseCoopers, institutional investors were the lead plaintiffs in 41 percent of cases in 2003, and in an estimated 47 percent in 2004. PRICEWATERHOUSECOOPERS, SECURITIES LITIGATION STUDY 15 (March 2005), http://www.10b5.com/2004_study.pdf. But the statute’s lead plaintiff provisions have generated confusion in several respects.

1. Designating Large Groups of Plaintiffs as a “Lead Plaintiff”

The PSLRA permits either a “person or group of persons” to act as the most adequate plaintiff. These words imply that individuals (natural or corporate) can combine their stakes to qualify as the “group of persons” with the largest stake in a corporation. Courts have taken three different approaches in construing this language. Some courts allow large numbers of unrelated plaintiffs to aggregate themselves into a lead plaintiff “group.” Others define the word “group” narrowly to allow only small coalitions that have common characteristics (such as membership in a partnership). And many courts take a middle ground of limiting a group to a “reasonable size,” which the SEC has argued should be no more than 3-5 persons. At least one court has permitted the appointment of multiple “co-lead plaintiffs,” each with separate counsel and with one vote on litigation decisions. The larger the group, of course, the more diffused the responsibility and the more likely that the attorney will retain practical control of the litigation with little or no effective oversight.

2. Use of Notices to Recruit Lead Plaintiffs

Congress drafted the PSLRA's notice provisions with the goal of ending the rewards of racing to the courthouse, and of lessening the control that plaintiffs' attorneys exercised over their clients. However, plaintiffs' attorneys have started to use the notice provision as a mechanism to recruit plaintiffs. In place of their former practice of keeping shareholders at the ready to act as lead plaintiffs, these attorneys now rush to the courthouse to gain the ability to advertise for more plaintiffs to represent. Clearly, this does not further Congress' goal of reducing the power of plaintiffs' attorneys in securities class actions, or of eliminating the race to the courthouse.

3. Defendants' Ability to Challenge Lead Plaintiff Appointment

Although the text of the statute allows plaintiffs to challenge the appointment of a lead plaintiff, it does not explicitly give the same right to a defendant. Some courts have held that defendants have no standing to challenge the appointment of a lead plaintiff; other courts have granted standing; and some courts will raise the issue themselves.

4. Uncertainty Over How to Determine a Plaintiff's "Financial Interest"

There is uncertainty about how to calculate potential lead plaintiffs' losses for purposes of determining whether they meet the statutory test of having the "largest financial interest" in the relief sought in the lawsuit. For example, should a plaintiff who recovered an offsetting gain in options be permitted to serve as lead plaintiff? Should a plaintiff's gains from the fraud that is the subject of the lawsuit offset its claimed losses?

B. Lead Counsel

The PSLRA was designed to ensure that plaintiffs pick their attorneys, rather than the other way around, stating that "[t]he most adequate plaintiff shall, subject to the approval of the court, select and retain counsel to represent the class." Pub. L. No. 104-76, 109 Stat. at 740, 745. Regarding fees, the statute states: "Total attorneys' fees and expenses awarded by the court to counsel for the plaintiff class shall not exceed a reasonable percentage of the amount of any damages and prejudgment interest actually paid to the class." *Id.* Again, several issues have arisen in the implementation of this provision.

1. Relationships Between Lead Plaintiffs and Law Firms

There are questions regarding the relationship between lead plaintiffs (especially institutional plaintiffs) and established plaintiffs' law firms. One goal of the PSLRA was to harness the financial and legal sophistication of institutional plaintiffs to exert more direct control over the course of the litigation. To some extent this is happening: Professor Fisch has observed that “[a] number of institutions have conducted active searches, selected litigation counsel in their capacity as lead plaintiff, and negotiated fee agreements designed to reduce litigation costs and minimize agency costs.” Jill E. Fisch, *Aggregation, Auctions, and Other Developments in the Selection Of Lead Counsel Under the PSLRA*, 64 LAW & CONTEMP. PROBS. 53, 62 n.57 (2001). Nonetheless, some institutions seem to exercise little oversight over the progress of the case.

The issue is compounded by the fact that many of the most active institutional plaintiffs are public pension funds; as the Third Circuit's Judge Edward Becker has stated, “public pension funds are in many cases controlled by politicians, and politicians get campaign contributions. The question arises then as to whether the lead plaintiff, a huge public pension fund, will select lead counsel on the basis of political contributions made by law firms to the public officers who control the pension funds and who, therefore, have a lot of say in selecting who counsel is.” Panel Discussion, *The Private Securities Reform Act: Is it Working?* 71 FORDHAM L. REV. 2363, 2369 (2003).

2. Auction Process for Selecting Lead Counsel

There is disagreement in the courts about how much oversight the courts may exercise over the lead plaintiff's choice of counsel. One approach, pioneered by (now Chief) Judge Vaughn Walker of the Northern District of California, is to require an “auction” among contending law firms. Under Judge Walker's original process, firms submitted sealed bids, which then were used both to select the attorney and set the fee. Other courts have both adopted and expanded on this mechanism. However, at least one court—the Third Circuit—has prohibited it. Auctions for lead counsel can offer advantages: courts will often choose the lawyer with the lowest fee, thus securing a larger share of any potential settlement for investors.

3. Calculation of Plaintiffs' Attorneys' Fees

There is the question of the size of the fee that plaintiffs' attorneys should receive. According to the statute, plaintiffs can receive a “reasonable percentage” of damages

actually paid to the class. Settlement amounts are skyrocketing—\$3.5 billion in 2005, not including the \$6.1 billion WorldCom settlement. Huge settlements produce gigantic fee awards. As NERA states, “The average settlement in 2005 will yield over \$6 million in fees to plaintiffs’ counsel, as compared to \$3.6 million in 2000.” Elaine Buckberg, Todd Foster, & Ronald I. Miller, *Recent Trends in Shareholder Class Action Litigation: Are WorldCom and Enron the New Standard?* at 7 (National Economic Research Associates, Inc., July 2005), available at http://www.nera.com/image/Recent_Trends_07.2005.pdf. In some circumstances, these awards can produce truly astronomical compensation when calculated on an hourly basis.

PSLRA Provisions Designed To Weed Out Abusive Lawsuits

Another of Congress’s key goals in enacting the PSLRA was to enable the courts to screen out abusive lawsuits more effectively at an early stage of the proceedings.

A. Pleading Standard

Congress concluded that “a uniform and stringent pleading requirement” was necessary to “curtail the filing of abusive lawsuits.” S. Rep. No. 104-98, at 15. It observed that the federal courts of appeals had interpreted the relevant Federal Rule of Civil Procedure “in different ways, creating distinctly different pleading standards among the circuits.” *Id.* With regard to scienter, the Act states: “In any private action . . . the complaint shall, with respect to each act or omission alleged to violate this title, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” Pub. L. No. 104-67, 109 Stat. at 747.

1. Lack of Uniformity

Congress’s goal of establishing uniformity has not been realized. The federal courts of appeals have adopted three different interpretations of this provision of the PSLRA.

a. Second Circuit

The Second Circuit has largely interpreted the PSLRA as an endorsement of its pre-1995 standard, allowing pleading of “motive and opportunity” to suffice. *See Novak v. Kasaks*, 216 F.3d 300, 309-10 (2d Cir. 2000); *In re: Advanta Corp. Sec. Litig.*, 180 F.3d 525, 530-35 (3d Cir. 1999).

b. Ninth Circuit

The Ninth Circuit has taken a much stricter approach. In *In re Silicon Graphics Securities Litigation*, 183 F.3d 970, 979 (9th Cir. 1999), it specifically rejected the Second Circuit “motive and opportunity” standard, and held that plaintiffs “must state specific facts indicating no less than a degree of recklessness that strongly suggests actual intent.” See also *Gompper v. VISX, Inc.*, 298 F.3d 893, 896 (9th Cir. 2002) (“[u]nder the PSLRA, the court ultimately reviews the complaint in its entirety to determine whether the *totality of facts* and inferences demonstrate a strong inference of scienter” (emphasis added)).

c. Eleventh Circuit

The Eleventh Circuit also applies a stringent standard. *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1286 (11th Cir. 1999) (“Because the clear purpose of the [PSLRA] was to curb abusive securities litigation, and because we believe that the motive and opportunity analysis is inconsistent with that purpose, we decline to adopt it.”).

d. Other Circuits

Several other circuits—including the First, Fourth, Fifth, Sixth, Eighth, and Tenth—have taken various intermediary approaches, essentially holding that the plaintiff must plead facts sufficient to form a strong inference of recklessness. Thus, according to the Fourth Circuit, “Congress chose neither to adopt nor reject particular methods of pleading scienter—such as alleging facts showing motive and opportunity—but instead only required plaintiffs to plead facts that together establish a strong inference of scienter.” *Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 345 (4th Cir. 2003); accord *Fla. State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 659-60 (8th Cir. 2001); *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 411-12 (5th Cir. 2001); *City of Philadelphia v. Fleming Cos.*, 264 F.3d 1245, 1261-63 (10th Cir. 2001); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 550-52 (6th Cir. 2001) (en banc); *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 195-97 (1st Cir. 1999). Just recently, the Seventh Circuit expressly acknowledged these conflicting approaches, and joined this intermediate group. *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, No. 04-1687, 2006 U.S. App. LEXIS 1865 (7th Cir. Jan. 25, 2006). Though this circuit split has existed for years, the Supreme Court has not stepped in to resolve the disagreement.

2. Results of Inconsistent Standards

The differences between these standards are not merely semantic; they produce different results. According to one study, the number of issuers sued in the Ninth Circuit fell from 68 the year before the court issued its *Silicon Graphics* standard to 43 the year after. Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. OF ILL. L. REV. 913, 943 (2003). The same study also notes that the *Silicon Graphics* decision has led to a greater percentage of strong allegations in Ninth Circuit cases. *Id.* at 969. And another study states that the number of cases that the Ninth Circuit dismissed increased by 100 percent when comparing the circuit's dismissal rate for the 18 months before the decision to the 30 months following it. See Richard Painter, et al., *Private Securities Litigation Reform Act: A Post-Enron Analysis*, THE FEDERALIST SOCIETY (2005), at 3, citing Woodruff-Sawyer & Co. data, available at <http://www.fed-soc.org/pdf/PSLRAFINALII.PDF>. Perhaps most significantly, according to a University of Michigan study, a survey of cases from 1996 to 2002 shows that Second Circuit courts granted 36 percent of motions to dismiss, while Ninth Circuit courts granted nearly twice as many, 63 percent. A.C. Pritchard & Hillary A. Sale, *What Counts As Fraud? An Empirical Study of Motions to Dismiss Under the Private Securities Litigation Reform Act*, 2 J. OF EMPIRICAL LEGAL RES. 125 (2005).

3. Burden of Erroneous Denials of Motions to Dismiss

Regardless of the standard applied by the district court, if the motion to dismiss is not granted, the case inevitably will settle. With the onset of discovery and the uncertainty of the outcome of a jury trial in a huge case in which the defendant's very survival will be at stake, defendants choose to settle, sometimes for billions of dollars.

That means that the ruling on the motion to dismiss is critical to the outcome of the case. And, while plaintiffs can appeal a decision granting a motion to dismiss, defendants have no such right. An erroneous denial of a motion to dismiss cannot be corrected—and, as a practical matter, will produce a settlement.

This system thus sets up a fundamental imbalance between the parties in the appeals process, a check that is especially important given the ballooning values of securities settlements. Finally, the current system skews the development of the law, by effectively depriving courts of appeals of the opportunity to review motions decided against defendants.

C. Discovery Stay

1. PSLRA Standard

“The cost of discovery often force[d] defendants to settle abusive securities class actions”; moreover, “discovery in securities class actions resemble[d] a fishing expedition. . . . [P]laintiffs sometimes file frivolous lawsuits in order to conduct discovery in the hopes of finding a sustainable claim not alleged in the complaint.” S. Rep. No. 104-98, at 14. Accordingly, the PSLRA—with very limited exceptions—imposes a stay on discovery while a court considers a defendant’s motion to dismiss: “In any private action arising under this title, all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds, upon the motion of any party, that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party.” Pub. L. No. 104-67, 109 Stat. at 741, 747. The statute also requires defendants to preserve evidence during the stay.

2. Decisions Circumventing the Statutory Discovery Stay

Courts in recent years appear to be expanding the scope of the exceptions in order to defeat the spirit—and arguably the letter—of the discovery stay. Thus, they have allowed discovery of documents produced to private parties or to the government in other proceedings, or because plaintiffs asserting non-securities claims were receiving discovery. *See, e.g., In re Williams Securities Litigation*, 2003 WL 22013464 (N.D. Okla. May 22, 2003); *In re La Branche Securities Litigation*, 333 F.Supp.2d 178, 184 (S.D.N.Y. 2004). At least one court, the District of Oregon, allowed plaintiffs to conduct discovery against third parties, despite the statute’s text staying “all discovery.” *In re Flir Systems, Inc. Securities Litigation*, 2000 WL 33201904 (D.Or. Dec. 13, 2000). Also, the District of the District of Columbia allowed discovery for the purpose of determining whether the court had jurisdiction over the case in the Baan Co. litigation. *In re Baan Co. Securities Litigation*, 81 F.Supp 2d 75 (D.D.C. 2000). The Northern District of Illinois, in the Comdisco litigation, allowed what it referred to as “disclosure” as distinguished from “discovery.” *In re Comdisco Securities Litigation*, 166 F.Supp.2d 1260 (N.D.Ill. 2001). These decisions circumvent congressional intent by subjecting defendants and other parties to discovery-type burdens prior to resolution of the motion to dismiss.

PSLRA Reforms Designed To Encourage Defendants to Fight Abusive Claims

The PSLRA's reforms have not changed one aspect of securities class action litigation: virtually none of the cases go to trial. Cases that are not dismissed inevitably produce a settlement.

A. Cases are Settled Because Defendants Fear Huge Verdicts

One key reason that defendants settle these cases is their fear of a jury verdict in the hundreds of millions, or even billions of dollars. When cases are being prepared for trial, plaintiffs' lawyers are permitted to identify a gross amount of damages—typically in the hundreds of millions or billions of dollars—based on speculative calculations regarding the timing of individuals' purchases and sales as well as assumptions regarding multiple trades by the same institutions or individuals. These huge numbers are just estimates—the actual injury to the class members will depend on the timing of those individuals' trades: the amount that the stock price was artificially inflated due to the alleged fraud on the particular days on which they purchased and sold the stock.

B. Per-Share Damages Awards Could Eliminate Unfair Pressure To Settle

Although they are irrelevant to the class members' actual injuries, these huge numbers do have a very important impact in the litigation: they force companies to settle. No company—regardless of its size—wishes to suffer a jury verdict of a billion dollars. Even if the claim is unjustified, the adverse publicity will be huge, and inevitably will harm the ongoing business. Moreover, it may be impossible to obtain an appeal bond for such a gigantic amount. A procedural rule that required juries to be instructed to award only per-share damages—calculating the amount of price “inflation” for each day of the class period—would eliminate this unfair and unjustified leverage.

SLUSA's Goal Of Preventing Circumvention of the PSLRA through State Court Litigation

Congress enacted SLUSA to prevent plaintiffs from using the state court system to avoid the reforms enacted in the PSLRA. As with the PSLRA, issues have arisen in connection with judicial interpretation of SLUSA. Two such questions are now before the Supreme Court.

A. SLUSA Bars Securities Class Actions from State Courts

SLUSA expressly pre-empts certain “covered class action[s]”—those brought on behalf of more than fifty investors—that allege state or common-law claims related to injuries from fraud in connection with the purchase or sale of securities. 15 U.S.C. § 77p(b). In addition to precluding such “covered class actions,” SLUSA also specifies that “[a]ny covered class action brought in any State court involving a covered security . . . shall be removable” to federal court so that the federal court may determine whether the suit is barred by SLUSA. *Id.* § 77p(c). If the district court finds that SLUSA does *not* preempt the removed action, it must remand the case to state court. *Id.* §§ 77p(d)(4), 78bb(f)(3)(D). The Supreme Court granted certiorari in *Kircher v. Putnam Funds Trust*, No. 05-409 (U.S.), to determine whether appellate courts have jurisdiction to review a district court decision to remand a case pursuant to SLUSA, or whether the general federal removal statute, 28 U.S.C. § 1447(d), prohibits appellate review of that remand order. The Seventh Circuit held in that case that it had jurisdiction over the appeal, disagreeing with the Second Circuit.

B. Conflict Over The Scope of SLUSA

In *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, No. 04-1371 (U.S.), the Supreme Court will determine whether SLUSA preempts state law class actions based upon allegedly fraudulent statements or omissions brought on behalf of persons who, as a result of such statements or omissions, were induced to hold or retain (but not purchase or sell) securities. The Second Circuit held that such class actions are not preempted by SLUSA (*see* 395 F.3d 25). According to the Second Circuit, the statutory language limiting SLUSA’s preemptive effect to suits alleging fraud “in connection with the purchase or sale of a covered security”—language borrowed directly from Section 10(b) of the Securities Exchange Act of 1934—must be read in conjunction with the Supreme Court’s decision in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), which held that only those persons who actually purchased or sold a security during the putative class period had standing to bring an action under Section 10(b). *See* 395 F.3d at 28. As construed by the Second Circuit, SLUSA preempts only those actions that could have been brought under Section 10(b), and thus, by virtue of *Blue Chip Stamps*, does not preempt state law securities class actions brought by persons who claim that they were induced to hold or retain (but not purchase or sell) securities. That decision conflicts with *Disher v. Citigroup Global Markets Inc.*, 419 F.3d 649 (7th Cir. 2005), which holds such claims preempted. The Seventh Circuit concluded that SLUSA preempts any class claims alleging conduct that would violate Section 10(b)—whether or not the class would have had standing under *Blue Chip Stamps* to seek damages for the alleged violation. (The *amicus* brief filed by the National Chamber Litigation Center in support of the Seventh Circuit’s

position is available at

<http://www.uschamber.com/nclc/caselist/issues/securities.htm>.)

C. Fragmentation of Federal Class Actions

Some trial lawyers have adopted a strategy of urging pension funds with large potential claims to opt out of securities class actions and instead file separate cases, usually in state court (because these state court claims are not class actions, they are not prohibited by SLUSA). These separate cases multiply the burden of litigation costs, and typically increase the portion of settlement payments devoted to attorneys' fees because more law firms seek a share of the pie.

Considerable attention was devoted to the use of this approach in the *WorldCom* case, with the class representative criticizing the opt-out cases and the federal district judge observing that pension funds opting out of the class action “run the risk of paying a hefty premium to their counsel.” Josh Gerstein, *Judge Approves Return to \$6B to WorldCom Investors*, N.Y. Sun, Sept. 22, 2005, at 8.; see also Press Release, *Lawyer Distorts Results of WorldCom Class Action to Make Himself Look Better*, NY State Office of the Comptroller, Alan G. Hevesi (Oct. 27, 2005), <http://www.osc.state.ny.us/press/releases/oct05/102705a.htm> (last visited Dec. 14, 2005); Stephen Taub, *Class Action And “Opt Out” Lawyers Duke It Out*, Compliance Week, Nov. 8, 2005, <http://www.complianceweek.com> (last visited Dec. 14, 2005); John Gibeaut, *As WorldCom Turns, Cases Pile Up: A Growing Number of Securities Lawsuits Invite More Parallel Proceedings*, 90 A.B.A.J. 40 (Sept. 2004) (“‘You recover more money,’ [attorney William] Lerach says of separate state actions. ‘You have your own lawsuit, and you settle it on your own terms’”; “In a Nov. 17 opinion, [Judge] Cote said Lerach failed to present ‘a forthright description of the advantages and disadvantages of both the individual action and class action options’ and that Lerach's firm had ‘engaged in an active campaign to encourage pension funds not to participate in the class action’ and was ‘running the coordinated individual actions much as a de facto class action’”). Some observers have expressed serious concerns about the impact of these opt-out claims on individual investors.

PSLRA's Goal of Expanding the Pool of Qualified Outside Directors

One of the goals of the PSLRA was to shield outside directors from the risks of unfair and unjustified liability. The Conference Report states that “the investing public and the entire U.S. economy have been injured by the unwillingness of the best qualified persons to serve on boards of directors and of issuers to discuss publicly their future

prospects, because of fear of baseless and extortionate securities lawsuits.” H.R. REP. 104-369, at 31.

A. Outside Directors’ Liability has *Increased* Since Enactment of PSLRA

Outside directors’ liability has actually increased in recent years. One article observed that “outside directors are being named at least as often—if not more often—as defendants in these post PSLRA cases.” Brian E. Pastuszewski & Inez H. Friedman-Boyce, *Defending Outside Directors in Securities Litigation*, ALI-ABA Course of Study Materials (Course No. SJ084, May 2004).

Outside directors were required to contribute personal assets to the settlement in *WorldCom*. Indeed, according to one commentator, pension funds acting as lead plaintiffs are encouraging their lawyers to try to make directors contribute personally to any settlement. John C. Coffee, Jr., *Hidden Issues in 'Worldcom,'* Nat'l L. J., March 21, 2005, at 13 (“[T]he directors’ insurance proceeds were not exhausted. Thus, the lead plaintiff preferred imposing personal liability on directors to maximizing the size of the settlement. This explicit agenda of requiring a personal contribution has traumatized outside directors, and it is being copied by other public pension funds, which are offering bounties to class counsel in the form of higher fee awards if they can compel directors to contribute personally to a class action settlement.”)

B. Expanded Liability Deters Qualified Individuals from Serving as Outside Directors

Plaintiffs’ lawyers also have tried to invoke the “group pleading” doctrine, in which they do not allege facts about specific directors and specific actions, but rather attempt to portray the corporation’s public statements as the collective work of those who serve on its board. Most courts have rejected complaints that utilize “group pleading,” as inconsistent with the PSLRA’s requirement that the plaintiff plead with “particularity facts” indicating that the defendant acted with the required state of mind. *See, e.g., Polar Int’l Brokerage Corp. v. Reeve*, 108 F.Supp. 2d 225, 237-38 (S.D.N.Y. 2000); *Allison v. Brooktree Corp.*, 999 F.Supp. 1342, 1350 (S.D. Cal. 1998); *P. Schoenfeld Asset Mgmt. LLC v. Cendant Corp.*, 142 F.Supp. 2d 589, 620-21 (D.N.J. 2001); *In re First Union Corp. Sec. Litig.*, 128 F.Supp.2d 871, 888 (W.D.N.C. 2001); *Marra v. Tel-Save Holdings, Inc.*, 1999 WL 317103 at *5 (E.D. Pa. May 18, 1999); *Copperstone v. TCSI Corp.*, 1999 WL 33295869 at *16 (N.D. Cal. Jan 19, 1999); *In re Premiere Techs, Inc. Sec. Litig.*, Fed.Sec.L.Rep. (CCH) P.91,293 at 96,653-54 (N.D. Ga. 2000); *Barrie v. Intervoice-Brite Inc.*, 2002 WL 1841631 (N.D. Tex. Aug 8, 2002); *Lemmer v. Nu-Kote Holding, Inc.*, 2001 WL 1112577 (N.D. Tex. Sept. 6, 2001); *Coates v. Heartland Wireless Commc’ns., Inc.*,

26 F.Supp.2d 910, 915 (N.D. Tex. 1998); *Digital Island Sec. Litig.*, 2002 WL 31015632 (D.Del. Sept. 9, 2002).

However, several courts have permitted group pleading, either where the outside directors stayed involved in the day-to-day operations of the corporations, or for a limited purpose such as attributing documents such as registration statements and prospectuses to outside directors. *See, e.g., In re Stac Elecs. Sec. Litig.*, 89 F.3d 1399, 1411 (9th Cir. 1996); *In re Livent, Inc. Sec. Litig.*, 78 F.Supp.2d 194, 219 (S.D.N.Y. 1999); *In re Sunbeam Sec. Litig.*, 89 F.Supp.2d 1326, 1341 (S.D. Fla. 1999); *In re Smarttalk Teleservices, Inc. Sec. Litig.*, 124 F. Supp. 2d 487, 501 (S.D. Ohio 2000); *In re Aetna Inc. Sec. Litig.*, 34 F.Supp. 2d 935, 949 n.7 (E.D. Pa. 1999); *In re Silicon Graphics, Inc., Sec. Litig.*, 1996 WL 664639 (N.D. Cal. Sept. 25, 1996); *In re Silicon Graphics, Inc., Sec. Litig.*, 970 F. Supp. 746, 759 (N.D. Cal. 1997); *Rubin v. Trimble*, 1997 WL 227956 (N.D. Cal. Apr. 28, 1997); *Powers v. Eichen*, 977 F.Supp. 1031, 1041 (S.D. Cal. 1997); *In re Valujet, Inc., Sec Litig.*, 984 F.Supp 1472, 1477 (N.D. Ga. 1997).

These developments are deterring qualified individuals from serving as outside directors. Increasingly, they are unwilling to put their entire life savings at risk in return for fees that are infinitesimal compared to their potential liability exposure, notwithstanding their desire to use their experience to guide corporate management as representatives of investors. Start-ups and growth companies are the hardest hit, because they present the greatest litigation risk. Yet they are the entities most in need of experienced advisors. And individual investors' interests are the most compromised because they lack institutional investors' ability to interact directly with management.

To eliminate these adverse effects, it may be appropriate to consider limiting directors' personal liability to a multiple of directors' fees for the years in which the allegedly wrongful conduct occurred—at least for companies that maintain an appropriate level of directors' insurance, and perhaps for all companies (sometimes the start-up companies least able to afford insurance may be the ones most in need of advice from experienced directors). Some also have suggested codifying an express prohibition of group pleading, or at the very least, to permit such pleading only for those outside directors who are involved in the day-to-day operation of a defendant corporation.

Do Securities Class Actions Effectively and Efficiently Compensate Injured Investors?

A. Studies of the Economics of Securities Litigation

The fundamental goal of securities litigation is to compensate injured investors. Last fall, the U.S. Chamber Institute for Legal Reform released a study and research paper on the economic reality of securities class actions and on their unintended economic consequences, prepared by Dr. Anjan V. Thakor. The study is the first empirical analysis of its kind. It assesses how investors fared in securities class action cases over the past ten years. The study draws some striking conclusions about how large institutional investors and small undiversified investors are compensated, provoking thought about how such actions are structured. The companion academic paper surveys the relevant literature to draw conclusions about the overall economic consequences of securities class actions. These documents show that there is a substantial disconnect between what the system is supposed to do and what it actually does.

The economic study indicates that the current system is much better for institutional investors than it is for individuals. It concludes, among other things, that indeed, some institutional investors actually are overcompensated by the current system. *See* Anjan V. Thakor, Ph.D. and Navigant Consulting *The Economic Reality of Securities Class Action Litigation* (2005).

The research paper draws a number of interesting conclusions about the unintended negative economic consequences of securities class actions. For example, it notes that the mere filing of a securities class action suit leads to an immediate 3.5 percent decrease in a company's equity value which can have negative implications for the economy as firms substitute capital investment with cost-cutting measures when stock prices are low. *See* Anjan V. Thakor, Ph.D. *The Unintended Consequences of Securities Litigation* (2005). Both the study and the paper are available at: <http://www.instituteforlegalreform.com/resources/index.php?p=papers>

B. SEC Fair Funds Provisions

Any problems associated with compensation are compounded by the SEC's growing "Fair Funds" program. In March 2004, the SEC promulgated a series of new regulations which created the Fair Funds program. The regulations became effective on April 19, 2004. The regulations are codified as §§ 17 C.F.R. 201.1100 – 201.1106 and were authorized by Congress under the Sarbanes-Oxley Act of 2002.

The Fair Funds regulations provide that in any administrative enforcement proceeding in which the Commission has the power to require the respondent to pay disgorgement *and* civil monetary penalties, the Commission may create a fund in order to disperse the disgorgement and penalties to investors injured by the violation. See 17 C.F.R. §§ 201.1100 – 201.1106. A recent GAO study found that the SEC had designated more than \$4.5 billion for return to investors, but “only a small amount of the funds have been distributed” due to administrative problems. GAO, “SEC and CFTC Penalties” at 1 (August 2005), *available at* <http://www.gao.gov/highlights/d05670high.pdf>; *see also* Alix Nyberg Stuart, “Penalty Box,” CFO Magazine (Feb. 2006), *available at* http://www.cfo.com/article.cfm/5435460/c_5461573?f=magazine_alsoinside.

Moreover, there is now no relationship between the Fair Funds process and the litigation system: each proceeds on separate tracks. Obviously, investors should not be able to collect twice – if they obtain compensation from the Commission’s process, they should not be able to seek compensation in the litigation system.

Conclusion

A significant number of serious questions have been raised about whether the current securities litigation system satisfies the goals that Congress set when it enacted the PSLRA and SLUSA. In some instances, these statutes have been interpreted in a manner that appears inconsistent with congressional intent. In others, the system has evolved to create new obstacles to fulfilling Congress’s purposes. Finally, economic analysis of the impact of this litigation on investors – the group that the law is intended to help – indicates that the most vulnerable investors may receive the least protection. These issues warrant additional analysis and, where appropriate, legislative correction to ensure that this very important litigation system functions appropriately in the interest of all investors.