U.S. CHAMBER
Institute for Legal Reform

A Rising Threat

The New Class Action Racket That Harms Investors and the Economy

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U.S. CHAMBER
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Prepared for the U.S. Chamber Institute for Legal Reform by

Andrew J. Pincus, Mayer Brown LLP

Executive Summary

The securities class action system is spinning out of control. Abusive lawsuits are imposing huge costs on investors without providing any benefit. The only winners are the lawyers, who take home millions of dollars in fees. And we have seen this movie before.

Securities class actions took off in the 1990s, largely focusing on technology companies. Plaintiffs' lawyers initiated and controlled the lawsuits, using professional plaintiffs who purchased a few shares of stock in multiple companies so they would be able to sue whenever called upon by the lawyers. Claims were based on little more than an unexpected decline in a company's stock. Because class actions are expensive to defend, companies typically settled. And those settlements provided millions of dollars to lawyers but only pennies for investors. Congress responded in 1995 by enacting the Private Securities Litigation Reform Act (PSLRA) to protect investors against harm from unjustified class actions.

Today, however, the securities class action system suffers from abuses eerily similar to those of the 1990s.

Once again, the number of lawsuits is skyrocketing and has reached levels not seen since before the enactment of the PSLRA. In 2018, more than eight percent of all public companies, or one out of every twelve companies, will be sued in a securities class action.

And lawsuits are again filed without regard to their merit. Instead of an unexpected drop in stock price, the trigger today is a merger and acquisition (M&A) deal valued at over $100 million: 85% of such deals were met with a lawsuit last year. It strains belief to suggest that virtually all such deals were affected by fraud.

Previously, these M&A lawsuits were focused in Delaware state courts. However, following Delaware's 2016 crackdown on settlements that provide little to no benefit for investors but large sums in attorneys' fees, the plaintiffs' bar quickly migrated to federal court and resumed the same abusive practices. Of all the M&A lawsuits filed last year, 87% were federal securities class actions.

A second variety of securities class actions has also emerged that seeks to capitalize on adverse events in a company's underlying business, such as a product liability lawsuit, data breach, or similar high-profile, unexpected negative occurrence. The securities class action lawsuit does not seek damages for harm from the underlying event, which is addressed through other lawsuits. Rather, the securities claim asserts that the company defrauded investors by intentionally or recklessly failing to warn that the adverse event might occur, even though these events are—by definition—unexpected.

Legal experts are skeptical about the merits of these claims: Columbia law professor John Coffee says they "push the envelope." But they are powerful weapons for extorting settlements, regardless of the merits, due to the cost of defending the case in court and the reputational harm to the defendant company were the underlying event to appear in the headlines.

Indeed, it is clear from the way securities class actions are being resolved that these two types of claims lack merit. Courts are dismissing a greater number of cases, and the cases that are not dismissed are settled—typically for an amount equal to the costs of defending the lawsuit. In other words, defendants are opting to settle because settlements are often equal to the cost of defending the lawsuit, but provide an end to litigation and eliminate the risk of additional costs.

But the settlements cost investors millions of dollars and mostly benefit the lawyers. That is particularly true of M&A lawsuits, where lawyers get two-thirds of the payments.

The securities class action system again exhibits the same symptoms of abuse that were on display in the 1990s because it suffers from the same basic affliction: litigation is controlled by plaintiffs' lawyers, not by plaintiffs.

Congress tried to address that systemic flaw in 1995, creating a "lead plaintiff" process designed to give institutional investors a key role in managing these lawsuits. But that process is broken. Many institutional investors have remained on the sidelines, and plaintiffs' lawyers have used political contributions and other techniques to "capture" government pension funds and return lawyers to the driver's seat.

As a result, individual plaintiffs are again playing a key role. And in many cases, particularly M&A lawsuits, professional plaintiffs have returned—with the same individuals serving as plaintiffs in lawsuits against numerous different companies.

As was the case in the 1990s, the only way to fix this broken system is for Congress to intervene and enact reforms that will deter the filing of meritless suits, encourage cases involving real fraud, and prohibit the abusive practices that enable the filing of unjustified actions.

Introduction

When it enacted securities litigation reforms in 1995, Congress found that:

- "[T]oday certain lawyers file frivolous 'strike' suits alleging violations of the Federal securities laws in the hope that defendants will quickly settle to avoid the expense of litigation";
- These lawsuits "are often based on nothing more than a company's announcement of bad news, not evidence of fraud"; and
- Securities class action claims "have added significantly to the cost of raising capital and represent a 'litigation tax' on business."[1]

Overwhelming bipartisan majorities in the House and Senate passed the Private Securities Litigation Reform Act (PSLRA) "to strike the appropriate balance between protecting the rights of victims of securities fraud and the rights of public companies to avoid costly and meritless litigation"—emphasizing that "[o]ur economy does not benefit when strike suit artists wreak havoc on our Nation's boardrooms and deter capital formation."[2]

Two decades later, the very same harms are back, resulting from a tidal wave of new types of abusive securities class action lawsuits that are designed to circumvent the reforms Congress put in place in 1995.

Former Securities and Exchange Commission (SEC) Commissioner and Stanford Law Professor Joseph Grundfest put it well:

> The PSLRA was designed to deter plaintiffs from filing low-quality complaints, but this surge in complaints that are dismissed with greater frequency suggests that the law is no longer having its intended quality-enhancing effect. Policymakers should, I think, study these data carefully and ask whether the time is nigh for further reform.[3]

Congress therefore should revisit the securities class action system and again enact reforms to eliminate this new, and even more onerous, litigation tax on our capital markets—a tax that is borne almost entirely by innocent investors.

The Explosion in Securities Class Action Litigation

Securities class action filings are increasing dramatically, reaching levels not seen since enactment of the 1995 reform law.

The numbers tell the story. Filings in 2017—415 or 412, depending on the particular study being examined[4]—are:

- More than 50% higher than 2016's total number of filings;
- More than double the average annual case filings over the past twenty years (193 cases); and
- Against 8.4% of all U.S.-listed companies—more than double 2014's percentage of 3.5%—which means one out of every twelve public companies was sued in a securities class action in 2017.[5]

Moreover, 2018 is on track to match 2017's record year, with more than 200 cases filed in the first half of the year.[6] Importantly, the percentage of public companies sued is likely to remain above eight percent; in other words, one in twelve will again be the victim of a securities class action, which means that "the chance of an individual listed company experiencing a securities class action lawsuit is significantly elevated compared to long-term historical norms."[7]

> "[O]ne out of every twelve public companies was sued in a securities class action in 2017."

"The trend toward greater securities class action litigation frequency is now well-enough established that it could be argued that long-term securities litigation frequency risks have changed categorically," wrote *The D&O Diary's* Kevin LaCroix. This means that "publicly traded companies not only now face an overall greater risk of securities class action litigation than in the past, but it also means that their D&O insurers also may be facing a significantly increased litigation frequency risk as well."[8]

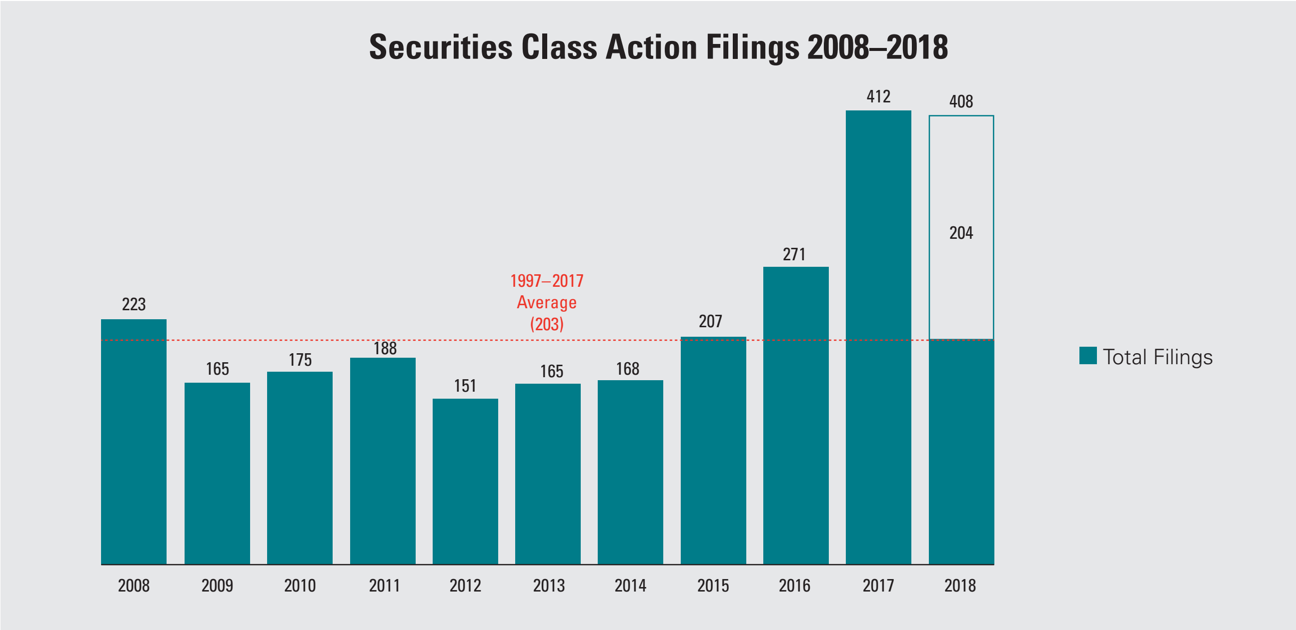
Moreover, these two record years are coming on top of 2016's previous record-high for post-1995 Reform Act filings, with 271 cases. That was a 31% increase over 2015.[9]

Indeed, annual filings for 2008 through 2016 ranged from 151 to 271, with an average per-year filing number of 190.[10] But in 2017, filings increased to 412—a 122% jump over the per-year average—and will stay at that unprecedented level for 2018.[11]

The four hundred-plus cases filed in 2017 may not seem like a large number on its face. But securities class actions are not ordinary cases; they are the litigation equivalent of aircraft carriers. One metric used to measure the size of these cases—change in target companies' market capitalization over the class period—amounted to $131 billion for 2017 cases, the highest since the 2008 financial crisis and greater than the average for 1997-2016.[12] And for cases filed in just the first half of 2018, the amount is $157 billion—nearly triple the half-year average for 1997-2017 (which is $60 billion).[13] Although this is not a measure of damages, it is used by plaintiffs' lawyers in settlement negotiations, and certainly demonstrates the huge and growing amounts of money at stake in these cases.

The gargantuan size of these cases is confirmed by the amounts of money paid in settlements: over $93 billion dollars since 1996, and $7.5 billion in just the last two years.[14] Draining these huge sums from the economy, with little or no benefits for actual investors—plus the additional billions of dollars in defense-side attorneys' fees and other costs inflicted by these lawsuits—has serious adverse consequences for capital formation and economic growth.

Indeed, securities class action filings at the rate of 300 per year were sufficient to lead Congress to enact the PSLRA in 1995, based largely on the adverse consequences for capital formation and the harm to investors.[15] Today's 37% increase in filing frequency therefore plainly warrants immediate congressional attention.



"The gargantuan size of these cases is confirmed by the amounts of money paid in settlements: over $93 billion dollars since 1996, and $7.5 billion in just the last two years."

The Nature of Securities Class Action Litigation Has Changed Dramatically

Until a decade ago, or even five years ago, most securities class actions involved allegations of misstatements or omissions regarding financial matters, such as alleged false statements or omissions in the company's financial statements or allegedly false projections of future earnings.

As Columbia Law School Professor John Coffee put it: "Traditional securities class actions usually involve financial misrepresentations."[16]

From 2009 through 2013, between half and two-thirds of all filings fell into these two categories.[17] "A decade ago," in the words of one prominent plaintiffs' lawyer, "accounting fraud cases dominated the headlines, with investors suffering losses stemming from improper revenue recognition, delayed asset impairment, and revenue 'smoothing.'"[18]

> *"These new categories of claims are producing new abuses, which inflict serious harm on investors, companies, the capital markets, and America's economy."*

That characterization of the nature of securities litigation is no longer true. A huge proportion of securities class actions today are based on: (1) proposed merger or acquisition transactions (M&A claims); or (2) headline-grabbing events harming a company's underlying business, such as an oil well explosion, the filing of tort claims, a data breach, or the denial of a patent (event-driven claims).

These new categories of claims are producing new abuses, which inflict serious harm on investors, companies, the capital markets, and America's economy.

> *"Virtually every merger or acquisition with a value of $100 million or more that involves a public company is met with a lawsuit alleging that the disclosures to shareholders relating to the transaction were false and deceptive."*

Merger & Acquisition Claims

The last eight years have seen a remarkable surge in lawsuits challenging merger and acquisition transactions—what has come to be known as "M&A litigation." Virtually every merger or acquisition with a value of $100 million or more that involves a public company is met with a lawsuit alleging that the disclosures to shareholders relating to the transaction were false and deceptive.[19]

These lawsuits were formerly brought under state law in state courts and paired with other state law claims alleging breaches of fiduciary duty relating to the sale price. In 2015, for example, 60% of deals produced lawsuits in Delaware courts.[20] But when the Delaware Chancery Court cracked down on abusive M&A claims in January 2016, plaintiffs' lawyers moved their business to federal court:

- In 2009, only 15% of these M&A deals triggered federal court lawsuits.[21]
- In 2017, 74% of M&A deals over $100 million triggered federal securities suits, a 500% increase from 2009.[22]

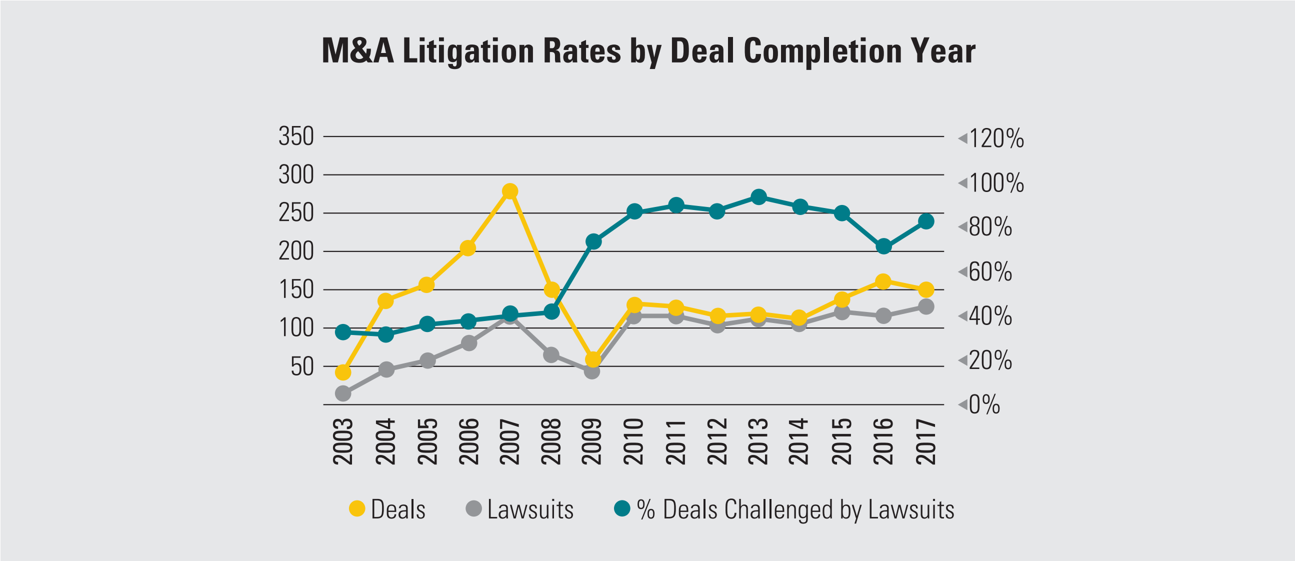
As explained below, M&A litigation is universally recognized as a category of class action rife with illegitimate claims. The migration of these cases to federal court, in direct response to the Delaware Chancery Court's thoughtful and necessary crack-down on unjustified lawsuits, highlights the need for reforms that will stop abusive claims from proceeding at that level.

HOW M&A CLAIMS WORK

When a merger or acquisition is announced and disclosure information is provided to the participants' shareholders, plaintiffs' law firms rush to file suit, claiming that the disclosures are inadequate and/or misleading and seeking a preliminary injunction to put the transaction on hold until the lawsuit is resolved. There is heavy pressure on the defendants to settle even meritless claims quickly, because they want to be able to close the deal and reap the economic benefits of the merger or acquisition.

Thus, a "positive factor for plaintiffs is the urgency with which the companies involved wish to close the transaction and, if a large deal, the incremental costs of settling the litigation are not significant relative to the overall transaction."[23] One law school professor put it succinctly: "'If [the companies] want their deal to go through, they don't have time to win.'"[24]

Undisputed facts regarding these lawsuits demonstrate that M&A claims are rife with abuse:



- **Skyrocketing percentage of deals triggering lawsuits**

  From 2003 through 2008, less than half of deals valued at $100 million or more were met by a lawsuit. In 2009, that almost doubled—to 76%. From 2010 through 2014, more than 90% of all such deals attracted a lawsuit—with a high of 96% in 2013. Last year, suits targeted 85% of deals.[25]

  No one could seriously contend that virtually every single large transaction involving a public company involves fraud. By itself, the huge percentage of deals targeted demonstrates that suits are filed without any regard to the underlying merits. For some plaintiffs' lawyers, the filing of a lawsuit has become a Pavlovian response to the announcement of a deal.

- **Short time from deal announcement to settlement and attorneys' fee award**

  M&A cases proceed quickly. A suit is usually filed "within days of the public announcement of the merger. Most of the litigation effort, motions practice, and expedited discovery takes place during the relatively brief window between the merger filing and its closing."[26] And, "[b]ecause claims that are not resolved on motions or settled prior to closing can theoretically be litigated long after closing, creating a potentially significant contingent liability, defendants have a strong incentive to resolve merger claims before the merger closes."[27]

  This quick timeline incentivizes the filing of lawsuits without regard to a claim's

> *"[A] study of M&A cases from 2003-2011 found that the overwhelming majority of cases were settled (72%) and 77% of settlements provided for disclosure only."*

underlying merit. As one law school professor explained, "'[t]he quicker the suit, the less thoughtful the suit. You're striking on the mere announcement of the merger,' with little information about its fairness."[28] "The limited time between the deal being announced and litigation being filed prompted many commentators in this area to question the legitimacy of the lawsuit and the plaintiff's ability to conduct sufficient inquiries to have good cause to believe that the board had breached its fiduciary duty to its shareholders."[29]

- **Disclosure-only settlements with substantial attorneys' fees for plaintiffs' lawyers**

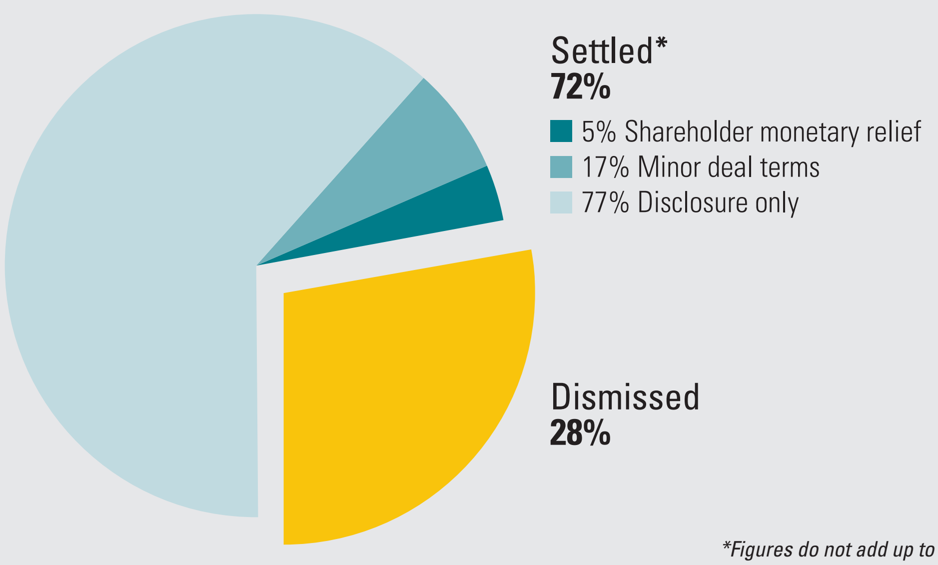
  Studies repeatedly find that "these lawsuits rarely result in a monetary recovery for the plaintiff class. Rather, the vast majority end in settlement or dismissal. In most settled cases, the only relief provided to shareholders consists of supplemental disclosures in the merger proxy statement"—accompanied by a fee award to the plaintiffs' lawyers.[30]

  For example, a study of M&A cases from 2003-2011 found that the overwhelming majority of cases were settled (72%) and 77% of settlements provided for disclosure only. Yet the average attorneys' fee for these cases was $749,000.[31] Another 17% of settlements involved changes in relatively minor deal terms that were unrelated to the amount of monetary consideration.[32] Only five percent of cases resulted in an increase in consideration for shareholders.[33] The 28% of cases that were not settled were dismissed.[34]

- **No benefit to shareholders from disclosure-only settlements**

  An empirical study of disclosure-only settlements found that the additional disclosures "do not seem to affect shareholder voting on the merger. Insofar as disclosure-only settlements do not provide shareholders with useful

M&A Lawsuit Settlements: 2003-2011



**Figures do not add up to 100% due to rounding* information, they are wasteful, clogging the courts and increasing transaction costs for no reason."[35] "Moreover, the illusory benefit of supplemental disclosure must be weighed against the clear cost of merger litigation—including litigation expense as well as delay and uncertainty."[36]

Thus, as Professor John Coffee of Columbia Law School has explained, "'[t]he greatest benefit is for the plaintiffs' attorneys' in [this] litigation."[37]

Indeed, shareholders lose because they foot the bill: "'If you can get $500,000 for increased disclosures and not one nickel for shareholders, who's paying that?' [Professor Jennifer] Johnson said. 'It's coming out of shareholders' pockets because the companies pay the lawyers' bills."[38]

DELAWARE INSTITUTES REFORMS

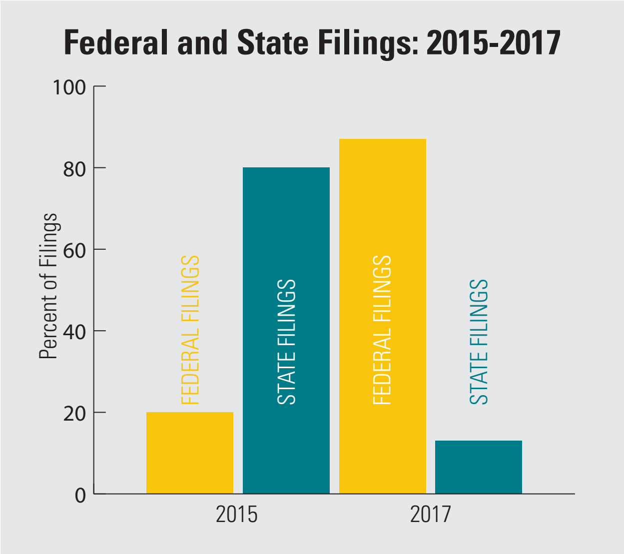
The Delaware Chancery Court responded to concerns about abusive M&A claims in its January 2016 decision in *In re Trulia*.[39] The court began by describing the problem it confronted:

> *"Thus, as Professor John Coffee of Columbia Law School has explained '[t]he greatest benefit is for the plaintiffs' attorneys' in [this] litigation."*

> *"They therefore adapted by leaving Delaware and shifting to federal securities law claims and filing their cases in federal court, where the abuse continues."*

> Today, the public announcement of virtually every transaction involving the acquisition of a public corporation provokes a flurry of class action lawsuits alleging that the target's directors breached their fiduciary duties by agreeing to sell the corporation for an unfair price … [F]ar too often such litigation serves no useful purpose for stockholders. Instead, it serves only to generate fees for a certain group of lawyers, who wait for the public announcement of a deal to file a hastily drafted complaint on behalf of stockholders, and use the time pressure to settle quickly on terms that yield no monetary compensation to the stockholders they represent.[40]

Because of "the rapid proliferation and current ubiquity of deal litigation" and "the mounting evidence that supplemental disclosures rarely yield genuine benefits for stockholders," the court decided to "reexamine[]" its "historical predisposition toward approving disclosure settlements."[41] The Delaware court gave notice that disclosure-only settlements would no longer be approved: "disclosure settlements are likely to be met with



continued disfavor in the future unless the supplemental disclosures address a plainly material misrepresentation or omission."[42]

PLAINTIFFS' BAR RESPONDS BY LEAVING DELAWARE

The reaction to the Delaware Chancery Court's announcement was immediate. Plaintiffs' lawyers decided that they had to find a new venue in which they could continue their abusive practices. They therefore adapted by leaving Delaware and shifting to federal securities law claims and filing their cases in federal court, where the abuse continues.

Federal filings targeted only 20% of litigated deals in 2015—but federal cases more than quadrupled in 2017 to target 87% of such deals.[43] State court filings witnessed a corresponding reduction: they constituted 80% of the litigated deals in 2015, but only 13% in 2017.[44]

As one academic study found, "[t]he drivers of merger litigation are shareholder plaintiffs' attorneys' firms. For these firms, shareholder litigation is a business and attorneys' fees drive their conduct."[45] "Attorneys act in their self-interest to file opportunistic complaints in pursuit of settlement and payment of attorneys' fees."[46]

When plaintiffs' lawyers saw that awards of attorneys' fees would become more uncertain in Delaware, they moved their cases to maintain that cash flow. "The reasons for this migration seem clear," explains Professor Coffee. "Delaware grew increasingly disgusted with such suits" given their lack of any benefit to shareholders, and "federal court has become the preferred forum."[47]

The federal court gambit is working out well for the plaintiffs' bar: they have been able to replicate their pre-*Trulia* practice of quick resolutions accompanied by payments of attorneys' fees, although the mechanism is slightly different.

Rather than entering into a disclosure-only settlement, the new wave of suits requires the defendant to unilaterally add new disclosures to address the supposed "deficiencies" alleged in the class action complaint—which moots the claim—and pay a "mootness fee" to the plaintiffs' lawyers in return for dismissal of the case. Once again, the principal beneficiaries are the lawyers.

In 2017, 89% of all cases were dismissed—and 75% involved payment of a "mootness fee" to the plaintiffs' lawyers.[48] The plaintiffs' bar thus succeeded in replicating in federal court the very same abusive system that the Delaware Chancery Court sought to eliminate.

And the median fee for plaintiffs' lawyers in these cases is $265,000.[49] That is more than a quarter of a million dollars simply to file a complaint, which is then dismissed after the defendants issue inconsequential additional disclosures. That is a rather hefty return on very little work.

The reason plaintiffs' lawyers have adopted the dismissal/mootness fee approach is clear: it avoids the risk that federal courts might follow Delaware's lead and reject both disclosure-only settlements and the associated fee awards. Indeed, the Seventh Circuit did just that in an opinion written by Judge Posner, which stated:

> The type of class action illustrated by this case—the class action that yields fees for class counsel and nothing for the class—is no better than a racket. It must end. No class action settlement that yields zero benefits for the class should be approved, and a class action that seeks only worthless benefits for the class should be dismissed out of hand.[50]

Typically, the payments are made without court approval. Federal courts are considering whether they have authority to oversee such payments. The issue is far from clear.[51] Thus, by using dismissals rather than settlements, plaintiffs' lawyers hope they can avoid any judicial scrutiny of their claims—and can continue their M&A "racket" unchecked.

Event-Driven Claims

The second major trend in securities class actions is the dramatic growth in the new category of event-driven claims. "Increasingly," Professor Coffee has explained, "an adverse event will trigger a securities class action: an explosion, a crash, a mass torts episode."[52]

The plaintiffs' lawyers filing these securities class actions typically contend that the defendant company's statements before the adverse event occurred misrepresented the risk that an oil platform would explode, that its products would be the subject of tort litigation, or that its systems containing employee or customer information would be hacked. Alternatively, the complaint may assert that the company was obligated to disclose the risk of the adverse event and failed to do so.

There has been a parade of such claims, with many more on the horizon:

- The company that manufactured building material used in Grenfell Tower, the site of a serious fire in London, was sued on the theory that it knew of the material's flammability but failed to disclose that fact to investors.[53]
- A pharmaceutical company, which faces a number of product liability lawsuits based on the claim that talc present in baby powder caused cancer, has been sued for failing to disclose that risk.[54]
- A Chinese education company was sued on the theory that it knew of, but failed to disclose, pervasive child abuse at its schools.[55]

> *"In 2017, 89% of all cases were dismissed—and 75% involved payment of a 'mootness fee' to the plaintiffs' lawyers."*

- Several companies have been subjected to securities class actions based on sexual harassment claims asserted against the company and/or its officers or other employees, on the theory that they knew of the risks of such liability but failed to disclose them to investors.[56]
- Businesses that have been victims of data breaches have been named as defendants in securities class actions alleging that the defendants knew of cyber security risks but failed to disclose them.[57]

A company already faces liability for the underlying event on which these cases are based: products liability lawsuits, or claims seeking compensation for cyber breaches and other alleged wrongful conduct. The question is whether there is any basis for another set of class action lawsuits under the securities laws.

The only legitimate justification for such a claim would be that: (1) the company knowingly or recklessly made false statements in the past regarding the possibility that those adverse events would occur; and (2) that investors relied on those statements. But these events by their nature are unpredictable; companies typically make only general statements regarding their efforts to comply with other laws—no company could or would guarantee that adverse events will not happen. Indeed, the circumstances surrounding the sudden spike in event-driven cases, and the nature of the suits themselves, make clear that the merits of the underlying securities claims have little to do with the wave of event-driven lawsuits.

Thus, as Professor Coffee has explained, "the cases filed in 2017 push the envelope on this principle to the limit."[58] For example, he cites "the claim … that Johnson & Johnson 'knew for decades' that cancer-causing asbestos 'was present in the talc in its Johnson's Baby Powder,'" and asks:

> [h]ow does one plead this allegation with sufficient particularity to survive a motion to dismiss? Answer: The complaint quotes from a press release issued by the personal injury lawyers suing Johnson & Johnson.[59]

Similarly, "it might be doubted that BP knew that the Deepwater Horizon was likely to explode or that it acted with scienter to conceal this remote risk."[60]

These lawsuits reprise the precise practices that Congress enacted the PSLRA to prevent—the rapid filing of claims with little or no investigation, all designed to force defendants into settlements regardless of the underlying merits. "The trend in 'event-driven' litigation," explains Professor

"These lawsuits reprise the precise practices that Congress enacted the PSLRA to prevent: rapid filing of claims with little or no investigation, all designed to force defendants into settlements regardless of the underlying merits."

Coffee, "appears to be to file early, soon after the stock drop, and without the more elaborate investigation that the larger established plaintiffs' firms today employ in securities litigation."[61]

A significant and growing number of these cases target biotech, pharmaceutical, and other medical companies. Eighty-eight securities class actions were filed against these companies in 2017—a 225% increase from the 27 cases filed in 2012.[62] That increase is also greater in percentage terms than the overall increase in securities class action filings. And the filings increasingly target new smaller companies[63]—the very entrepreneurial businesses that help grow our economy.

PLAINTIFFS' BAR DRAWN TO EVENT-DRIVEN CLAIMS

Event-driven litigation attracts plaintiffs' lawyers for reasons that have nothing to do with the merits of the securities claims.

First, the "event" invariably causes a very large drop in the company's stock price. Of course, all or most of that drop will be attributable to the adverse event itself, and the consequences for the company's future profitability. But the securities class action complaint will assert that the price drop resulted from the supposed "correction" of prior false statements or material omissions. And it will argue that the potential damages in the securities case are tied to that very large price drop, which the plaintiffs' lawyers will use to argue for a large settlement, if the case proceeds past the motion to dismiss.

Second, litigation of the securities class action threatens the company with continuing harm substantially more damaging than the typical financial reporting securities claim. The plaintiffs' lawyer will focus on the underlying adverse event—and only tangentially on the alleged false statement or omission that occurred months or years earlier—which will keep the adverse event in the public eye, even if the company has settled any legal claims arising out of that event. That creates significant additional pressure to settle the securities claim, regardless of the merits.

And the merits of these claims are highly suspect. Event-driven lawsuits "often lack merit (for example, they often are fatally deficient on scienter [the requirement that the defendant act recklessly or intentionally in making the alleged false statement or omission] or causation allegations)."[64] Professor Coffee agrees that the requirement that a securities plaintiff prove "loss causation"—that the claimed misrepresentation or omission caused the stock's loss in value—"could be fatal to the[] action (unless they settle cheaply)."[65]

With courthouse doors wide open to event-driven claims, Professor Coffee and Kevin LaCroix—two of the most experienced observers of securities litigation trends—predict that the "scope of 'event-driven' litigation could expand rapidly."[66]

> *"And the filings increasingly target new smaller companies—the very entrepreneurial businesses that help grow our economy."*

EVENT-DRIVEN CLAIMS FILL GAP LEFT BY TRADITIONAL FINANCIAL REPORTING CASES

Event-driven claims are growing rapidly for the additional reason that they solve a major problem for plaintiffs' law firms: the shortage of traditional securities claims relating to financial reporting.

Financial reporting claims are typically based on a company's announcement that it was going to restate its financial results. But financial restatements have declined significantly in recent years, dropping from 1,859 in 2006 to 533 in 2017—a decline of 71%.[67] The change is so dramatic that one leader of the plaintiffs' bar cited the scarcity of viable financial reporting claims as his reason for leaving the securities class action business.[68]

But plaintiffs' lawyers still must file new lawsuits—their business model depends on maintaining an "inventory" of pending cases—so new ones must be filed as old ones are resolved. Therefore, as one experienced observer of securities class actions has explained, "[a]s restatements have become less common than in prior years, the plaintiffs' lawyers (or at least some of them) have shifted their focus to adverse developments in company operations. Something goes wrong at the company, its share price declines, and the company gets hit with a securities suit."[69]

These lawsuits are also a consequence of new plaintiffs' firms entering the securities class action business and needing cases to litigate:

> Securities litigation has recently seen a number of new plaintiffs' firms enter the field. These new entrants have little hope of wresting control of a major securities class action involving financial irregularities … because they do not have relationships with the major institutional investors who could serve as lead plaintiff. Thus, they need to focus on smaller cases or cases involving [event-driven] claims … that larger institutional investors might feel uncomfortable asserting … [T]he newer entrant must fear that an established plaintiffs' firm will wrestle control of a case from it (through its association with large institutional clients). As a result, the new entrant needs to move quickly and generally focus on smaller defendants.[70]

The effect of this phenomenon is that "a two-tier plaintiffs' bar is emerging, in which the older tier will continue to focus on financial irregularity cases, because they can win control of these cases. The new entrants are likely to focus on 'event-driven' cases because that is what is left to them."[71]

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Meritless Class Actions are Increasing

Securities class actions are almost never resolved by a decision on the merits of the underlying claim. Cases that are not dismissed are virtually always settled—because the costs of litigation are high and these cases threaten hundreds of millions, if not billions, of dollars in possible liability.

From 1997 through 2014, only 14 cases went to trial—compared to 3,938 cases resolved by dismissal or settlement over that period.[72]

Notwithstanding the absence of merits-based decisions by courts, it is still possible to assess the relative merits of cases filed in recent years compared to the merits of cases filed in earlier periods. When more cases are dismissed or settled for relatively small amounts that are equivalent to the costs of defending the matter through trial, then it is clear that the number of abusive claims is increasing and the number of possibly legitimate claims is dropping.

That is precisely what is happening in securities class action litigation today. As explained above, M&A cases result in little real benefit for shareholders, demonstrating the lack of merit in that entire category of cases. The same is true of other types of securities class actions where dismissals have increased significantly:

- Cases filed from 2000 to 2004 were dismissed at rates of 32% to 44%. But from 2008 to 2011, the last years for which most cases have been resolved, dismissal rates rose significantly, ranging from 48% to 53%, and could be even higher once all cases are resolved.[73]
- Moreover, in the last two years, 56% (for 2016) and 58% (for 2017) of the cases resolved in those years—no matter when the cases were filed—were resolved through dismissal rather than settlement.[74]

The increase in dismissals confirms that plaintiffs' lawyers are filing more legally-unjustified cases, which is presumably a result of their struggle to find new kinds of cases to fill the void left by the decline in accounting restatements and other types of financial statement-related litigation. Because the plaintiffs' bar business model requires an inventory of cases, these firms must file new complaints to maintain their profit flow. That imperative appears to be forcing them to file an increasing number of unjustified claims.

One leading plaintiffs' lawyer who decided to retire in 2018 confirmed the trend: "If you go back five, 10, 15 years ago, we

> *With more than half of all cases dismissed, and approximately 60% of the remaining cases settling for the equivalent of the cost of defending at trial, that leaves less than 20% of securities class actions with any indicia at all that the claim has underlying merit.*

were winning 90 to 95% of our cases. I liked that. In the last year and a half, we've probably lost more than we've won. I'm not used to that."[75] He added that there are simply fewer promising cases.[76]

Securities class action settlement data tells the same story. In three of the last five years, the vast majority of cases—58% or 61%—settled for less than $10 million.[77] And the median settlement amount for all cases for the last four years was less than that: $7 million in 2014 and 2015 and $6 million in 2017.[78] Given the high cost of defending these cases, the small size of settlements leaves no doubt that these settlements represent a decision by the defendants to settle for close to the cost of defending the case through trial—costs that a defendant cannot recover—rather than a payment based on perceived merit of the underlying claim.

With more than half of all cases dismissed, and approximately 60% of the remaining cases settling for the equivalent of the cost of defending at trial, that leaves less than 20% of securities class actions with any indicia at all that the claim has underlying merit.

In sum, objective evidence makes clear that the number of meritless securities class actions is increasing rapidly—both M&A claims and other types of claims as well. That growing abuse of the litigation system inflicts significant costs on investors and on society at large.

Unjustified Securities Class Actions Hurt Investors and Enrich Lawyers

Today's unprecedented expansion of abusive securities class actions is hurting investors, not benefiting them.

FIRST

A recently-issued pathbreaking study of securities class action costs conducted by Chubb documents the deadweight loss to shareholders.

For M&A class actions from 2012-2016:

- Lawyers got nearly two-thirds of the total payments in cases settled or dismissed (both plaintiffs' and defense lawyers), with only 39% going to shareholders—of course, the overwhelming majority of cases resulted in disclosure-only settlements with only a few cases with shareholder awards responsible for the 39%.
- The average cost of these cases grew 63% during that period.[79]
- The average cost of dismissed M&A cases—which provide no benefit at all to shareholders—rose 162% from 2012 levels to reach $2.3 million in 2016.[80]

This data confirms the abusive character of these cases, draining funds from shareholders (through direct payments by companies, increased D&O costs, or both) and overwhelmingly benefiting lawyers.

For all securities class actions during that period the results were not much better:

- Lawyers continued to do well, reaping 43% of the total payments, with shareholders getting 57%.[81]
- The average cost per case was $11.9 million. Plaintiffs' lawyers got $2.3 million and defense lawyers $2.9 million.[82]

> *"The costs of the litigation and of any settlement are borne by the corporation, and its existing shareholders, even though they did not realize gains from the alleged fraud."*

SECOND

Even the relatively small percentages of funds that are paid to shareholders provide no net benefit to investors, because the undisputed reality of securities class actions is that they typically accomplish nothing more than shifting money from one innocent investor to another—with huge transaction costs paid to lawyers. Professor Adam Pritchard explained the phenomenon well:

> Securities fraud class actions are a "pocket-shifting" exercise for shareholders … [T]he dollars paid in these suits come from the corporation, either directly in the settlement or indirectly in the form of premiums for insurance policies … Shareholders effectively take a dollar from one pocket, pay about half of that dollar to lawyers on both sides, and then put the leftover change in their other pocket.[83]

This shift occurs because securities class actions are unusual in that the parties who allegedly profited from the claimed "fraud"—the investors who sold stock in the open market at an allegedly inflated price—are permitted to retain those gains (unless a corporate officer or director was a seller, which does not usually occur). The costs of the litigation and of any settlement are borne by the corporation and its existing shareholders, even though they did not realize gains from the alleged fraud.

Numerous academic observers have therefore concluded that "recovery via class action is an expensive rearrangement of wealth from one pocket to another—minus a cut for the lawyers."[84] "[T]he plaintiff class recovers from the other shareholders, with the result that secondary market securities litigation largely generates pocket-shifting wealth transfers among largely diversified shareholders" and therefore "the odds are high that shareholders are made systematically worse off by securities class actions."[85]

THIRD

Shareholders suffer an additional harm from these cases. The mere filing of lawsuits like securities class actions wipes out, on average, 3.5% of the defendant company's equity value.[86]

In sum, the number of these gigantic cases is skyrocketing—and so is the number of abusive unjustified cases. That fact confirms the critical need for congressional attention, and reform.

Abusive Practices Further Enable the Filing and Prosecution of Meritless Claims

The same sort of abusive practices that spurred enactment of the PSLRA are again in full flower and require Congressional attention on securities class actions.

Congress found in 1995 that the initiative for filing these lawsuits came "almost entirely from the [plaintiffs'] lawyers, not from genuine investors," and that "[l]awyers typically rely on repeat, or 'professional,' plaintiffs who, because they own a token number of shares in many companies, regularly lend their names to lawsuits."[87] Congress therefore sought to "transfer primary control of private securities litigation from lawyers to investors" by establishing a new procedure for selecting a "lead plaintiff" that was designed to "increas[e] the role of institutional investors in securities class actions," in the belief that those investors would have the interest and resources to ensure that plaintiffs' lawyers acted in the interest of the class members.[88]

The "lead plaintiff" process has not solved the problem. To begin with, many institutional investors—in particular mutual funds and hedge funds—have stayed on the sidelines, declining to get involved in overseeing securities class actions. Public employee pension funds and union pension funds have been the principal institutional investors to engage with the litigation process.

Studies have found that institutional investor involvement correlates with higher settlement values—but, as one recent study concluded, "[t]here is obviously a selection effect at work here" because these investors typically choose to participate only in cases involving large potential damages and other indicia of potential merit, such as accounting restatements and ongoing SEC investigations.[89] There is some evidence that cases with institutional investors as lead plaintiffs are marked by lower fee requests from plaintiffs' lawyers, but the most recent review found that courts, rather than lead plaintiffs, may be responsible for the reduction in fees.[90]

Most concerning are the frequently-recurring instances in which public pension funds—which typically are controlled by elected officials—select plaintiffs' law firms whose partners and employees have made campaign contributions to those officials.

> *"The 'lead plaintiff' process has not solved the problem. To begin with, many institutional investors—in particular mutual funds and hedge funds—have stayed on the sidelines, declining to get involved in overseeing securities class actions."*

"Numerous studies have documented the relationship between these public officials and the law firms selected to file securities class actions."

Numerous studies have documented the relationship between these public officials and the law firms selected to file securities class actions.[91]

Professor Coffee described the practice as "the equivalent of hanging a 'for-rent' sign out over the pension fund."[92]

> The political influence over these funds raises the question of whether law firms are making campaign contributions to politicians to enhance their chances of being selected to represent the funds. The available evidence raises suspicion that at least some class action law firms are buying lead counsel status with campaign contributions, i.e., lawyers are paying to play. Not surprisingly, government officials receiving campaign contributions appear to be less vigorous overseers of class action counsel.[93]

Indeed, one study found that plaintiffs' lawyers receive lower fees when institutional investors serve as lead plaintiffs, compared to cases in which an individual is the lead plaintiff. But "[t]his differential disappears … when [the study controlled] for campaign contributions to officials with influence over state pension funds."[94]

A recent investigation by a court-appointed special master of a state pension fund's involvement in a non-securities class action identified a new variant on the payment of campaign contributions. One observer summarized the significance of the special master's findings:

> [A]n active market may exist today in which politically-connected attorneys charge extraordinary contingent fees, requiring payments in the millions of dollars, for introducing and connecting prominent plaintiff law firms with public pension funds and other institutions capable of serving as lead plaintiffs in major class actions. The attorney who plays this hidden brokerage role does not work on the case, makes no appearance in court, and may not be known to the client, most of the class counsel in the case, the class representatives, or the court.[95]

The special master found agreements to make such payments in the class action under investigation; the implications of these payments for the approval of the fee award in that case have not yet been decided by the federal district court. And no one knows how prevalent this practice may be—if it extends beyond this case, it could "be a legal 'Watergate'… that could reshape class action practice."[96]

When the lead plaintiff is an individual, the situation is worse. A recent study found that the median settlement value in such cases was $2.7 million—less than half the $6.1 million median value for all securities class actions.[97] Two law professors concluded that "[t]his finding suggests that individuals serving as lead plaintiffs are primarily associated with nuisance-value settlements."[98]

Unfortunately, an increasing number of cases are being brought by individuals rather than institutional investors. One leading plaintiffs' lawyer recently observed that "[t]here's definitely been a shift of who's been bringing these cases. A lot of the big funds don't want to bring them anymore … Maybe the top five or six cases will have these really huge funds," but the vast majority of cases will not.[99] That is particularly true of the M&A cases. One press report highlighted Hilary Kramer and her husband, who filed 46 such lawsuits.[100] The individuals challenging the recent Time Inc. deal had been involved in nine and 12 securities lawsuits, respectively.[101]

The PSLRA's lead plaintiff process clearly is not working. As law professors Stephen Choi and Adam Pritchard concluded in their 2017 study, "[t]he law expects representative plaintiffs to serve a gatekeeping function in entrepreneurial litigation, yet currently does little to ensure that plaintiffs meet this expectation … Shareholders with little at stake, or who have been bribed to serve as shareholder, have little incentive to perform this monitoring function."[102] There is a "missing monitor in many shareholder lawsuits, which in turn may help explain why plaintiffs' lawyers are able to file so many lawsuits that are dismissed or settled for nuisance value. Either way, they are imposing a cost on the system and ultimately, shareholders, who are its intended beneficiaries."[103]

> *"The PSLRA's lead plaintiff process clearly is not working."*

Conclusion

The securities class action system today is plagued by abuses just as serious, and indeed more so, than those that led Congress to enact the Private Securities Litigation Reform Act by overwhelming votes in both the House and Senate.

The number of cases is at an all-time post-PSLRA high—and not just for one year: it is sticking at that extremely high level. The fact that more than eight percent of all public companies were sued last year—and that the same percentage will be sued again this year—demonstrates that the class action system is out of control.

The financial reporting cases that formerly were the bread-and-butter of securities litigation have been supplanted by two new types of claims. The changing nature of these lawsuits demonstrates that abusive lawsuits have taken over.

"The number of cases is at an all-time post-PSLRA high—and not just for one year: it is sticking at that extremely high level."

First

It is beyond reason to think that 85% of merger and acquisition deals over $100 million involve fraud or misrepresentations. But that is the number of mergers and acquisitions subjected to lawsuits each year. And the results of these cases confirm their lack of merit: they are typically resolved by disclosure-only settlements that provide no real benefit to shareholders, but they are always accompanied by hundreds of thousands of dollars in fees for the plaintiffs' lawyers who filed the suit.

Second

The new event-driven claims are designed to maximize settlement leverage by threatening to prolong brand damage resulting from negative events in a company's business. The underlying merits of these claims are typically weak, but the threat of adverse publicity and high defense costs can be sufficient to extort a large settlement.

The fact that these new types of lawsuits lack merit is confirmed by the increase in dismissals and the decline in median settlement value. Indeed, the overwhelming majority of claims are either dismissed or settled for an amount close to defense costs.

Finally

The abusive litigation practices that Congress cited when it enacted the PSLRA have returned in full force. A key flaw in securities class actions, Congress found, was that the lawsuits were controlled by plaintiffs' lawyers and not by the actual plaintiffs. That is again true today: plaintiffs' lawyers use campaign contributions to "capture" public pension funds. And an increasing number of cases are brought by individuals, not the individual investors that Congress believed would screen out unjustified claims—apparently because institutional investors are unwilling to associate themselves with these claims.

In sum, the current securities class action litigation racket is plainly inflicting serious harm on investors, companies, capital markets and our entire economy. Congress should enact reforms that will:

- Deter the filing of meritless cases and encourage the filing of cases involving real fraud;
- Ensure that cases are brought because investors injured by fraud seek redress, not because plaintiffs' lawyers need additional "inventory" that will pressure defendants to enter into unjustified and unwarranted settlements; and
- Prohibit abusive practices that undermine the ability of parties and the courts to address the merits of securities class action claims.

> *"A key flaw in securities class actions, Congress found, was that the lawsuits were controlled by plaintiffs' lawyers and not by the actual plaintiffs. That is again true today."*

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U.S. CHAMBER
Institute for Legal Reform

202.463.5724 main
202.463.5302 fax

1615 H Street, NW
Washington, DC 20062

instituteforlegalreform.com