



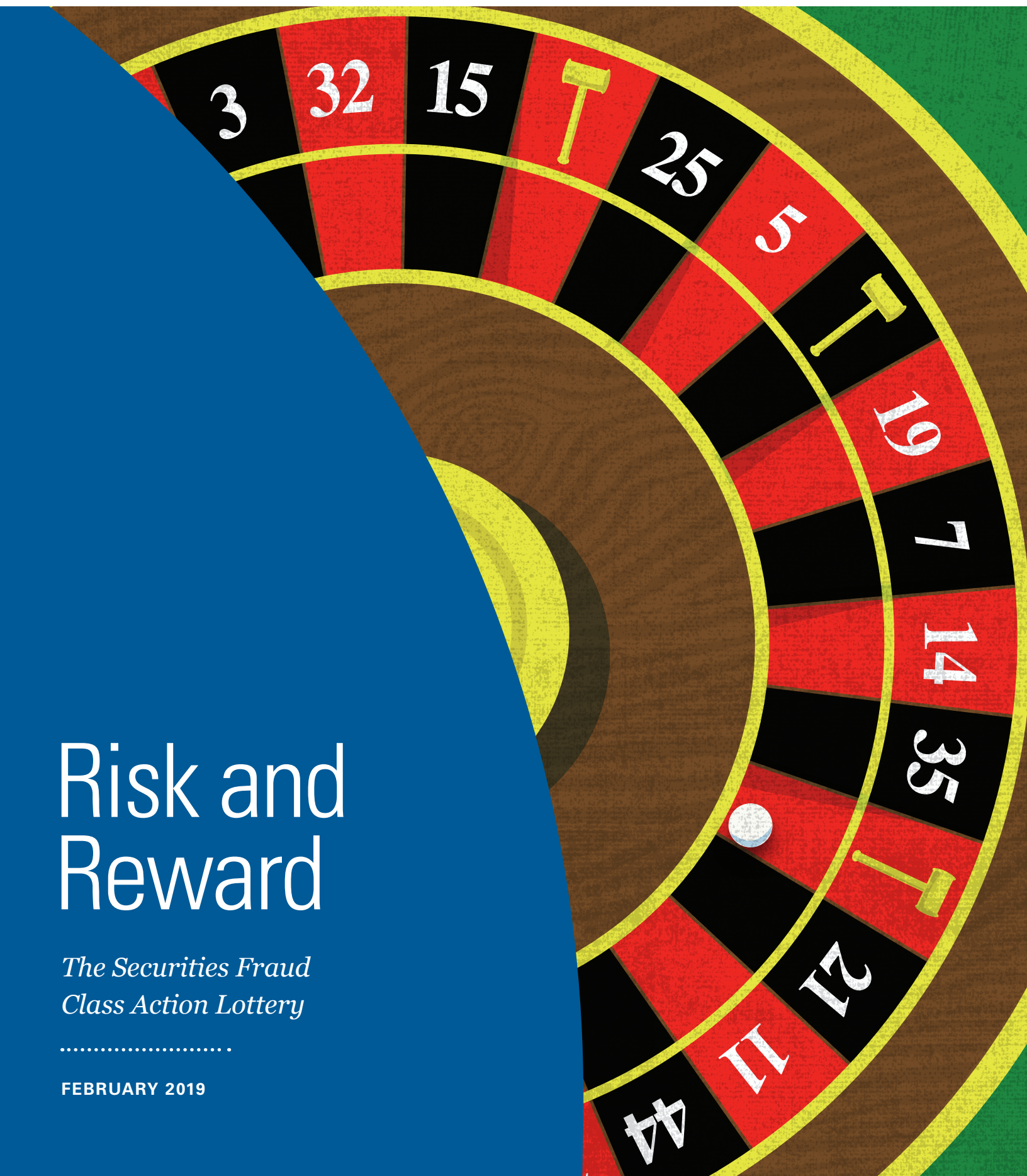
U.S. CHAMBER

Institute for Legal Reform

Risk and Reward

*The Securities Fraud
Class Action Lottery*

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FEBRUARY 2019





U.S. CHAMBER
Institute for Legal Reform

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Executive Summary

Securities fraud class actions against public companies have been hotly debated since the Supreme Court unleashed them in *Basic Inc. v. Levinson* in 1988.¹ In 1995, Congress responded to the concerns about the costs that securities fraud class actions impose on public corporations by stiffening the requirements for these suits in the Private Securities Litigation Reform Act (PSLRA).²

The PSLRA imposes heightened pleading standards requiring particularized facts for complaints alleging securities fraud,³ along with a mandatory sanctions inquiry after every dismissal.⁴ In addition, the PSLRA stays discovery while a motion to dismiss is pending,⁵ so plaintiffs' lawyers cannot file suit with a barebones complaint in the hope that discovery will turn up incriminating evidence.

Notwithstanding these reforms, critics of securities class actions contend that weak cases are still being filed.⁶ The number of cases filed today is no less than when the PSLRA was adopted,⁷ despite the sharp drop in the number of public companies in the U.S.,⁸ so the percentage of companies being sued in any given year has increased dramatically: the number was 8% in 2017.⁹ More damning, the high dismissal rate in such cases—roughly half—along with the high incidence of “nuisance settlements”—cases settled for less than defense costs—suggest that the plaintiffs' bar brings cases that are either meritless or not cost

justified.¹⁰ These data leave open the possibility that these cases are being filed purely for extortion value.

Filing meritless cases, however, makes little sense as a business model, absent substantial nuisance value. Plaintiffs' lawyers work on a contingency fee basis in securities fraud class actions, meaning they only get paid if they win.¹¹ Moreover, plaintiffs' lawyers typically bear the expenses of bringing the actions, including the cost of discovery and experts.¹² Those expenses will only be reimbursed if the plaintiffs secure a settlement. This downside suggests that the securities class action bar has incentives to screen potential cases for indicia of merit; it makes no sense to invest resources in cases that are likely to turn out to be dry holes. The economics pose a puzzle. Why do plaintiffs' lawyers file so many securities fraud class actions that produce little or no return?

This research attempts to shed light on that question by taking a closer look at the incentive structure faced by the plaintiffs'

lawyers who specialize in securities fraud class actions. To facilitate this analysis, we collected data from virtually all securities fraud class actions filed in federal court between 2005 and 2016, including the allegations, lead plaintiff motions, dismissals, settlements, fee applications, settlement awards, and federal district court dockets. This effort produced a data set with over 1700 cases, providing a comprehensive picture of the securities fraud class action industry.

Our analysis yields important insights into the business of securities fraud litigation. We find that securities class actions resemble a lottery for plaintiffs' attorneys. Although the median settlement in a securities class action is \$6.4 million, the mean settlement in the top decile of settlements is nearly \$300 million. We refer to the settlements in the top decile of settlements as the "mega" settlements. Winning the lottery—getting picked as lead counsel in a case that is likely to result in a mega-settlement—leads to considerably higher settlements, hours worked, and fees.

These mega-settlements differ from their more run-of-the-mill counterparts in two important ways. First, these settlements are more likely to involve obvious indicia of fraud, such as a parallel Securities and Exchange Commission (SEC) investigation or an officer termination. Second, these settlements involve corporations with much larger market capitalizations. Typically, these factors are publicly known before the securities class action is ever filed. As a result, plaintiffs' attorneys can predict which cases are more likely to end with large settlements before they ever file suit. Put another way, these lawyers are

packaging publicly-available information into a complaint that is highly likely to generate a settlement. Thus, they can predict which cases will lead to higher expected attorney fees.

Notwithstanding the lower risk in these mega-cases (particularly those with obvious indicia of fraud prior to the filing of the complaint), these attorneys are handsomely rewarded for their efforts. The attorneys' fees in cases with the largest settlements average \$39.5 million, approximately 20 times higher than the median fee award in our study. Our study finds that courts use a higher multiplier in these mega-cases, increasing the lodestar figures by a far greater percentage than in the cases with smaller settlements. Multipliers are intended to compensate plaintiffs' attorneys for the risk of non-settlement.

A higher multiplier would make sense if these plaintiffs' attorneys were digging up the evidence needed to prove the claims and ran the risk of failing to find such evidence. But, as noted above, the large settlements correspond to cases where facts relating to the egregiousness of the underlying securities law violations and the potential for a mega-settlement are publicly available before the case is ever filed. As a result, our study suggests that these attorneys receive a multi-million dollar windfall—a winning lottery ticket—when they are appointed as lead counsel in cases that are predictably likely to result in a mega-settlement.

We also offer potential reforms to curtail the lottery aspect of securities fraud class actions. Specifically, we suggest that courts review fee requests with far more skepticism. Currently, courts appear to focus on the overall egregiousness of the

securities law violations, which often are publicly known even before the plaintiffs' attorneys start working on the case, and the size of the recovery for the class. Although imposing damages on more egregious securities law violations and obtaining large recovery for the class may be socially beneficial, to the extent plaintiffs' attorneys do not contribute much to this outcome, plaintiffs' attorneys should not get an outsized fee award simply by association.

In conducting their review, courts should instead closely examine the marginal contributions of the attorneys. The examination of marginal contributions could include an analysis of whether the plaintiffs' attorneys uncovered evidence that government investigations missed or advanced innovative legal or factual arguments. Legislatures can also help curb inflated fee awards by setting presumptive limits on fees in the largest cases where windfalls and abuse seem to be more common.

In addition, lawmakers should look more closely at the lead plaintiff selection process. Getting selected as lead counsel in a mega-case depends in large part on a plaintiffs' law firm's ability to amass a

stable of institutional investors as clients. These clients provide the winning lottery ticket into these cases. Although skill and past track record in litigation may be part of the equation, factors unrelated to expertise also play a prominent role.¹³ Law firms spend significant money and energy to attract these clients either directly or through intermediary law firms. Wooing institutional investors does little to promote deterrence. We suggest that Congress should amend the PSLRA to prohibit lead counsel from paying referral fees to other law firms that do nothing other than provide an institutional client. We also recommend prohibiting lead counsel from sharing its fee with other law firms that do not perform actual legal work in the case.

Finally, we suggest that Congress adopt sliding-scale damages caps to rein in the biggest mega-settlements. Settlement awards in the hundreds of millions are not necessary to induce plaintiffs' attorneys to file suit. Moreover, the lure of the jackpot case deflects resources away from cases against smaller companies that have engaged in more egregious fraud. Limits on damages would curtail the lottery aspect of securities class actions without materially undermining deterrence.

Background

In theory, securities class actions have two goals: (1) to compensate defrauded shareholders; and (2) to deter securities fraud in the future.¹⁴ Yet securities class actions have long fallen short on their compensatory goal.¹⁵

Most securities class actions return only pennies on the dollar to injured investors.¹⁶ Perhaps unsurprisingly, many investors fail to claim their share of the settlements.¹⁷ Adding insult to injury, most settlement dollars are paid by the corporation's directors and officers insurance.¹⁸ The premia that the corporation pays for those insurance policies reduce the returns for shareholders. Consequently, the compensatory morsels provided by securities fraud class actions are ultimately paid by other shareholders. In a world of diversified investors, shareholders are compensating themselves (after deducting a big slice for the lawyers). This "circularity" problem undermines the compensation rationale for securities fraud class actions.¹⁹

Given the circularity of compensation, the justification for securities class actions must rest on deterrence.²⁰ Without the threat of these suits, the theory goes, corporate managers will be tempted to lie to the market. Note that deterrence is a public good; all shareholders of public companies potentially benefit from the deterrent effect of securities fraud class actions, not just the shareholders of the

company forced to defend the suit (for which the costs certainly outweigh the benefits).²¹ The costs of the legal regime can be characterized as a "deterrence tax" born by all public companies and, ultimately, their shareholders.

Like most taxes, the good intentions mask considerable inefficiency built into providing the promised services—deterrence is not cheap. Securities class actions are expensive to litigate, requiring many

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lawyers and high-priced experts.²² The costs to process these suits ultimately are passed on to shareholders, increasing the corporation's cost of capital. Many of the issues contested in the lawsuits, such as market efficiency and loss causation, have no bearing on the question of whether fraud was committed. These expenditures do little to enhance deterrence because they do nothing to distinguish business reversals from intentional misstatements, the principal goal of an adjudicative system for assessing alleged fraud.

The larger objection to the deterrence rationale lies in the fact that securities class actions exist within a network of other enforcement options. Securities fraud by public companies can be addressed by individual lawsuits and arbitrations, civil enforcement suits by the SEC and state securities regulators, and criminal enforcement by the Department of Justice.²³ The marginal benefit of an additional enforcement mechanism must be balanced against its costs. The value of securities class actions therefore rests on whether these suits generate enough marginal deterrent impact to offset the considerable costs that they impose on public corporations and their shareholders.

Deterrence and Agency Costs

Securities class actions are intended to curb wayward behavior imposed by corporate officers, but they suffer from their own brand of agency costs. Securities class actions are representative lawsuits, which means that the lead shareholder plaintiff represents a much larger class of shareholders; those shareholders typically sit on the sidelines during the litigation. In theory, the lead plaintiff should negotiate with class counsel and monitor the litigation on behalf of the class. In practice, the lead plaintiff may not have enough at stake in the litigation to justify the individual costs of close monitoring.²⁴ Even lead plaintiff shareholders with a significant stake in the litigation may not invest sufficient time in monitoring given that they will have to incur all of the costs of negotiating with and supervising the attorney for the class, while receiving only a fraction of the benefits.

This mismatch between the individual costs and benefits for the representative plaintiff means it is entirely rational for an individual shareholder to defer to his or her attorney's decisions regarding the litigation. That deference generates predictable consequences for the attorney-client relationship. As one well-known plaintiffs' attorney remarked in the mid-1990s, "I have the greatest practice of law in the world. I have no clients."²⁵

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These agency costs create a substantial risk that plaintiffs’ attorneys will make litigation decisions that benefit themselves at the expense of their shareholder clients in both meritorious and non-meritorious suits. Absent vigorous bargaining from the lead plaintiff, plaintiffs’ attorneys may take advantage of the contingency fee model by seeking a higher percentage of the recovery for their fee, even in cases that pose minimal risk. As scholars have observed, “once the client becomes only a distant bystander to the litigation,” the plaintiffs’ attorney can find “a variety of means by which to trade a low settlement for a high attorney’s fee.”²⁶ In addition, plaintiffs’ attorneys may file frivolous lawsuits, which generate no deterrent benefit, if they believe the suits can be settled for nuisance value with a modest fee for the attorneys.²⁷ Such suits benefit the lawyers, keeping the lights on at least, but do little for the shareholder class or investors generally.

These concerns substantially undercut the deterrent rationale for securities class actions. Frivolous litigation undercuts the stigma associated with being a defendant in a securities class action.²⁸ If corporate directors commonly view securities class actions as meritless, corporate managers may be able to persuade their boards that the filing of a securities fraud class action against the company reflects bad luck rather than bad conduct.²⁹ The value of deterrence is undercut if companies think they are going to be sued regardless of their investment in precautions. At the same time, nuisance settlements impose substantial costs in the aggregate on public companies, and ultimately, shareholders. Thus, curbing frivolous litigation and minimizing agency costs in shareholder litigation is central to the goal of deterrence in these lawsuits.

PSLRA Takes Aim at Agency Costs

These concerns about agency costs in securities class actions are far from theoretical. In the early 1990s, companies claimed that plaintiffs were filing securities class actions armed with little more than suspicion of bad business decisions. Faced

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with these suits, companies paid nuisance settlements rather than incur the high costs of litigation. These problems were exacerbated by professional plaintiffs who filed dozens of suits but played little or no role in directing the litigation.

Congress concluded that these problems could “wreak havoc on our Nation’s boardrooms and deter capital formation.”³⁰ Over President Clinton’s veto,³¹ Congress passed the Private Securities Litigation Reform Act (PSLRA) of 1995,³² intended to promote better screening and monitoring of these claims in a variety of ways. First, the PSLRA enacted heightened pleading standards that increased the detail a plaintiff must provide in the initial complaint. In pleading scienter, for example, the plaintiff must allege with particularity facts giving rise to a strong inference that the defendant acted with an intent to deceive (e.g., the defendant had a motive to lie).³³ The plaintiff must also allege particular facts establishing the falsity of the challenged statements,³⁴ as well as loss causation (i.e., a theory connecting the alleged misstatement(s) to the losses suffered by the plaintiff).³⁵ To bolster these pleading requirements, the

legislation prohibits discovery until after the plaintiff has survived a motion to dismiss.³⁶ This stay of discovery discourages plaintiffs from filing cases “with only faint hope that the discovery process might lead eventually to some plausible cause of action.”³⁷

To curb agency costs imposed on the class, the PSLRA also sought to give large institutional shareholders more control over these cases. Congress created a rebuttable presumption that the lead plaintiff will be the shareholder applicant with the largest financial interest in the litigation.³⁸ To discourage “professional plaintiffs,” it also capped the number of securities class actions in which a given shareholder can serve as a lead plaintiff over a three-year period.³⁹ These provisions sought “to encourage the most capable representatives of the plaintiff class to participate in class action litigation and to exercise supervision and control of the lawyers for the class.”⁴⁰

Finally, the PSLRA limits attorneys’ fees. Congress did not want courts using a pure lodestar approach, which sets fees based on the hours worked by plaintiffs’ counsel multiplied by their hourly rate.⁴¹ The lodestar, Congress feared, encouraged attorneys to run up their hours by spending time on unnecessary or inefficient work.

The PSLRA sought to limit fees by mandating that the fee award could not exceed a “reasonable percentage” of the damages and prejudgment interest paid to the class.⁴² Courts could use lodestar figures as a cross-check,⁴³ but the fee itself could not be unreasonable, regardless of how many hours the plaintiffs’ attorneys spent litigating the case.⁴⁴ A contingent percentage would ensure that class members received more of the settlement

fund, especially in smaller cases where there may not be as much money to go around.⁴⁵ The reasonableness cap on fees was meant to discourage plaintiffs' attorneys from running up large bills while their investor clients recovered little. At the same time, the lead plaintiff provisions were intended to encourage institutional investors to exercise a more watchful eye over the suits.

PSLRA's Impact on Low-Value Lawsuits

The PSLRA's pleading reforms were primarily aimed at frivolous suits. The PSLRA's heightened pleading requirements made it far more difficult for these suits to survive a motion to dismiss. By screening out nuisance suits, the goal was to enhance the deterrent effect of the securities class actions that survive.

The PSLRA had some modest success in screening out meritless suits. The heightened pleading requirements reduced the number of frivolous cases, but they also reduced the number of non-frivolous cases. Moreover, there are still a significant number of low-value suits. According to Cornerstone Research, the median settlement in 2017 was \$5 million.⁴⁶ That number is likely less than the amount that defendants would have to pay to defend against these claims at trial. Moreover, many suits settled for less than \$2 million.⁴⁷ In short, even though

low-value suits were Congress's particular focus in enacting the PSLRA, the evidence is unclear on whether it effectively screened out frivolous cases.

PSLRA's Impact on High-Value Cases

The PSLRA was largely silent with respect to another category of cases: high-value cases filed against companies that had engaged in more obvious fraud or other misconduct. These cases were subject to the PSLRA just like other securities class actions, but the legislation was not aimed at perceived problems with these suits.⁴⁸ The PSLRA's stated goal was to eliminate abusive litigation, and its reforms focused on the bottom-feeder suits that settled for nuisance value. No one in Congress seemed to doubt that higher-value claims should continue without undue barriers.

And they have in fact continued. The average settlement in securities class actions from 1996 to 2016 is nearly \$50 million,⁴⁹ and many settlements are far higher. Since 1995, there have been thirteen settlements in securities class actions of more than \$1 billion,⁵⁰ and another fourteen that settled for between \$500 million and \$1 billion.⁵¹ Many of these settlements involved high-profile cases that made the front pages of the national newspapers. The securities class action filed against Enron, for example, settled for

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more than \$7 billion,⁵² while the securities class action against WorldCom settled for more than \$6 billion.⁵³ More recently, the Brazilian company Petrobras agreed to settle a securities class action related to the company’s alleged kickback scheme for \$3 billion.⁵⁴

Commentators have lauded the fact that the PSLRA left these high-value cases mostly untouched. The PSLRA was followed by revelations about major corporate frauds at companies such as Enron and WorldCom in the early 2000s, and securities class actions were seen as a key tool in addressing these frauds. Scholars have argued that the billion-dollar settlements against these companies were a “success” that “likely secured the survival of the securities class action for another generation.”⁵⁵ The securities fraud class action industry has not only survived the PSLRA, it has thrived, fueled by this steady stream of mega-settlements.

Plaintiffs’ lawyers remain eager to participate. As discussed above, the PSLRA awards lead plaintiff status to the shareholder applicant with the largest

financial stake in the litigation. The lead plaintiff proposes the lead counsel for the class, so for plaintiffs’ attorneys, having large institutional investors as clients is the entrance ticket to participate in securities class actions. Conversely, without these clients, law firms have little hope of being named lead counsel except in small-stakes cases that involve little competition for the lead plaintiff spot. In high-value securities class actions, there will frequently be a scramble of investors competing to serve as lead plaintiff. In the recent lawsuit arising out of Elon Musk’s ill-advised proposal to take Tesla private, a dozen law firms stepped forward representing proposed lead plaintiffs.⁵⁶ In response to the vigorous competition in the highest profile cases, many firms will go to great lengths to attract these clients, as we documented in an earlier research paper.⁵⁷

The law firms that successfully recruit these clients can be rewarded with hefty fees. In the Enron litigation, for example, the plaintiffs’ attorneys received nearly \$700 million.⁵⁸ In the more recent Petrobras lawsuit, the court awarded the plaintiffs’ attorneys \$186.5 million.⁵⁹ Overall, the fees awarded in securities class actions average around 25 percent of the settlement amount, although the percentage tends to decrease for the largest settlements.⁶⁰

Federal law contemplates that these fee awards will be closely scrutinized, but this oversight often falls short. As part of their responsibility to select lead counsel, investors can negotiate with law firms ex ante to determine the percentage and terms of the firms’ compensation.⁶¹ Judges are supposed to supplement these ex ante negotiations with their own ex post review

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of fee requests to ensure that the fees are reasonable.⁶² Yet empirical studies have found that neither lead plaintiffs nor judges

do a very good job in pushing back on fee requests.⁶³ Lead plaintiffs only negotiate ex ante with lead counsel in approximately 11 percent of cases, and even when they do, judges rarely seem to consider these ex ante agreements in setting fees.⁶⁴ Instead, judges typically rubber-stamp the lead counsel’s fee request, granting it without modification in approximately 85 percent of cases, regardless of settlement size.⁶⁵

This lax oversight is troubling in light of the agency costs in the securities fraud class actions previously outlined. If fee requests go without serious scrutiny, there is little to stop plaintiffs’ law firms from requesting an unnecessarily high percentage of the settlement for themselves. Exorbitant fee awards obviously diminish the amount of money returned to injured investors, further undermining the compensatory rationale for the litigation. But home run fee awards also undermine deterrence by skewing litigation incentives for plaintiffs’ attorneys, creating an incentive for law firms to pursue a wider array of cases in the hopes of hitting the fees jackpot if the case settles.

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Methodology & Findings

As this discussion suggests, the PSLRA addressed some of the problems with securities class actions, but it left some questions unanswered. Was the PSLRA successful in screening out most nuisance suits? At the opposite end of the spectrum, how did the PSLRA affect the highest-value securities class actions? And what do the cases at the two extremes tell us about the overall deterrent impact of these lawsuits?

Our study sought to answer these questions. We collected data on every securities class action filed in federal court between 2005 and 2016 that involved a disclosure claim.⁶⁶ We combed through court dockets and case filings to gather information on the contest for lead plaintiff, including the number of lead plaintiff applicants, the alleged losses of the appointed lead plaintiff, and the name of the law firm appointed as lead counsel. We also collected the types of allegations in the final consolidated complaint, as well as the dispositive motions filed in the lawsuits.

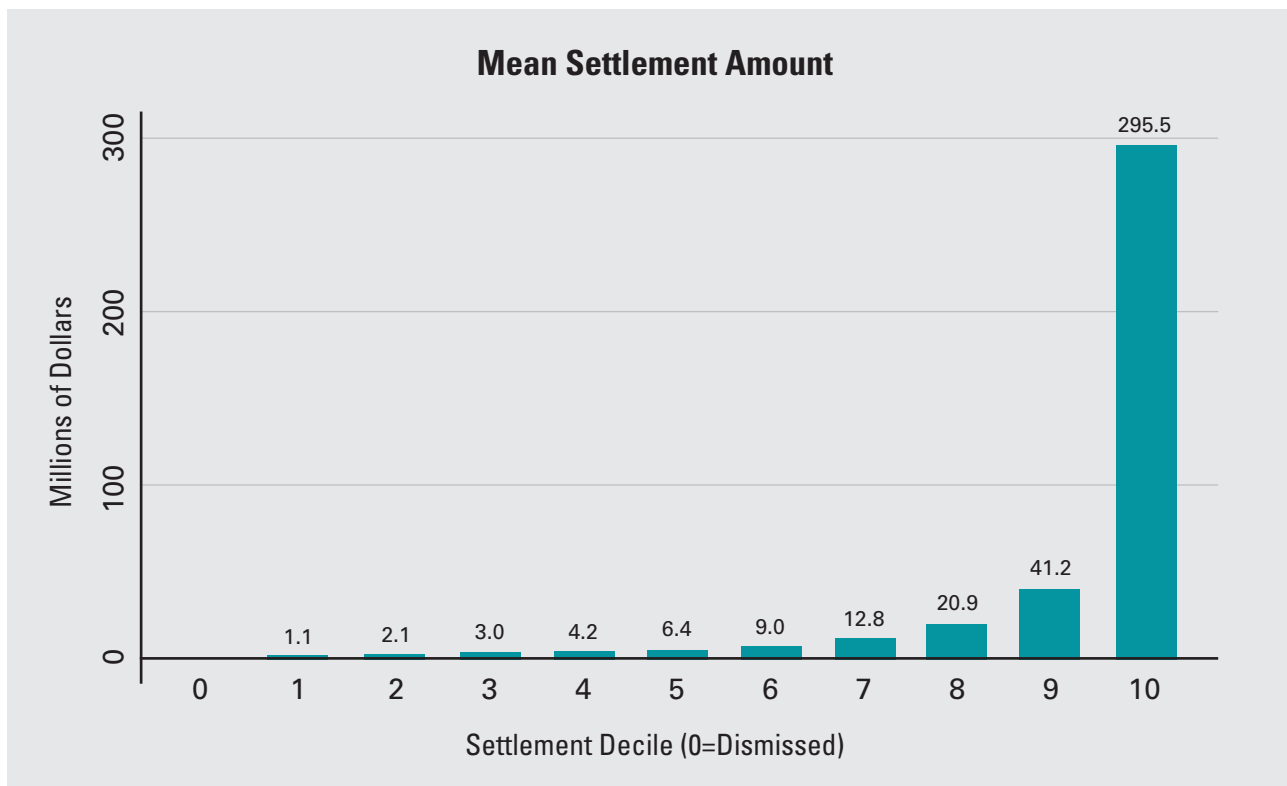
We then documented the final resolution of each case, and in every case that ended with a settlement, we collected detailed data regarding the terms of the settlement, the fees requested by lead counsel and awarded by the court, and the hours worked and lodestar data. Finally, we supplemented the litigation data with the defendant corporations' market

capitalization measured on the first trading day after the start of the class period.

Risks and Rewards in Securities Fraud Class Actions

We begin by looking at the distribution of settlements. For our sample period, the mean settlement was \$39.5 million, and the median was \$7.5 million. These overall statistics, however, mask an important aspect of the distribution of settlements: a small percentage of settlements make up the lions' share of overall recoveries in securities class actions. The chart on the next page presents the distribution of settlements in our sample, with the average for each decile. In all the charts that follow, dismissed cases are represented by the bar designated as 0.

The settlement chart shows that half of all settlements are for relatively insignificant amounts, ranging from \$1.1 million in the



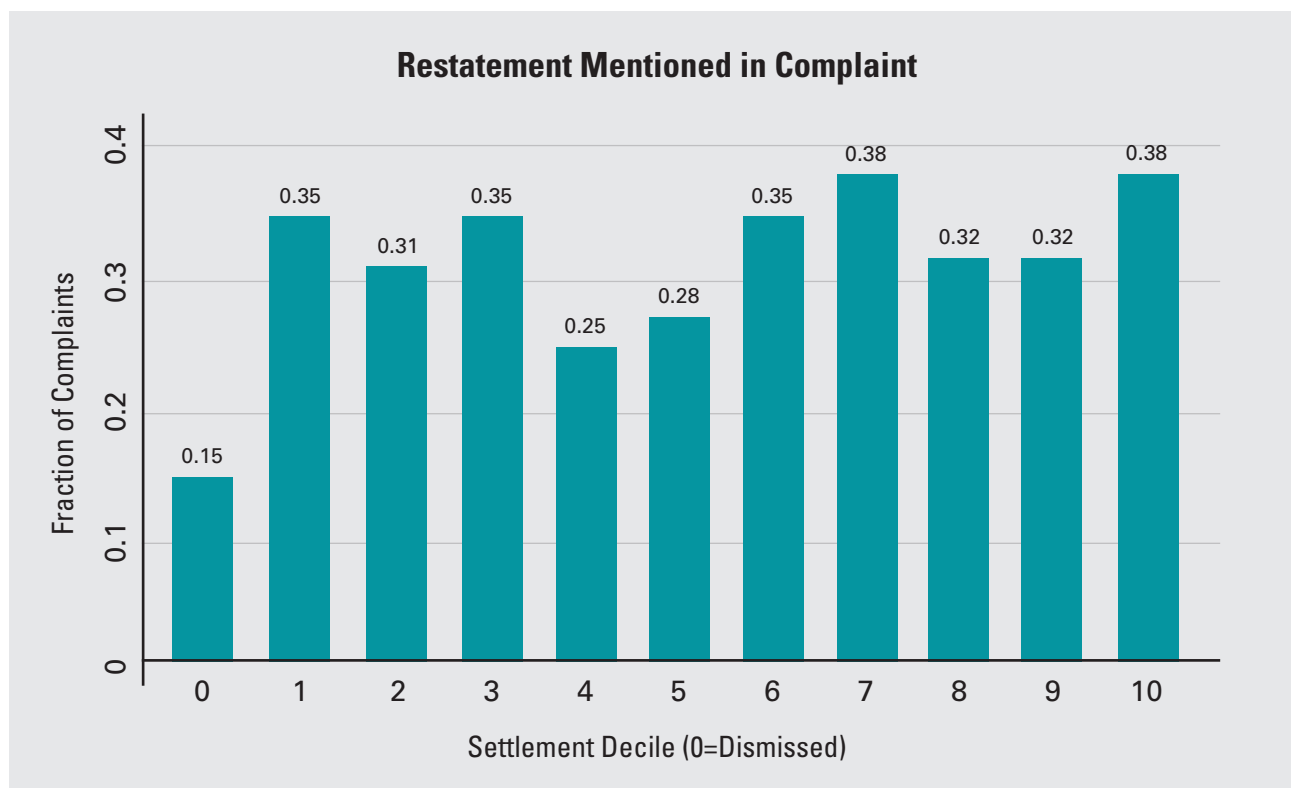
bottom decile to \$6.4 million at the fifth decile. These numbers may reflect minimal provable damages or defendant companies with solvency issues, but they are also consistent with defendants paying purely to avoid defense costs and distraction from these lawsuits. The numbers gradually increase in the top half of the distribution before increasing sharply in the top 10 percent of the distribution. The numbers in that top decile are striking, with a mean of nearly \$300 million. This huge leap suggests that a small number of outliers have outsized importance in the aggregate figures among securities class actions and in the aggregate compensation for securities class action plaintiffs' attorneys.

Accordingly, plaintiffs' attorneys will have a disproportionate incentive to obtain the lead counsel position in the mega-class actions and to put in hours litigating such actions.

But do the eye-popping settlements at the top end reflect the most egregious cases of fraud?

Do the Merits Matter?

To assess the relation between recovery and merit, we will present figures showing the distribution of objective indicia of fraud by settlement decile. We show four types of allegations commonly found in prior studies to correlate with recovery in securities fraud class actions: financial restatements; SEC investigations; other government investigations; and termination of top officers (e.g., CEO or CFO). We only track those allegations mentioned in the securities class action complaint. Our analysis reflects the information that plaintiffs' attorneys typically have access to at the time of their decision to file suit or early in the litigation prior to discovery.



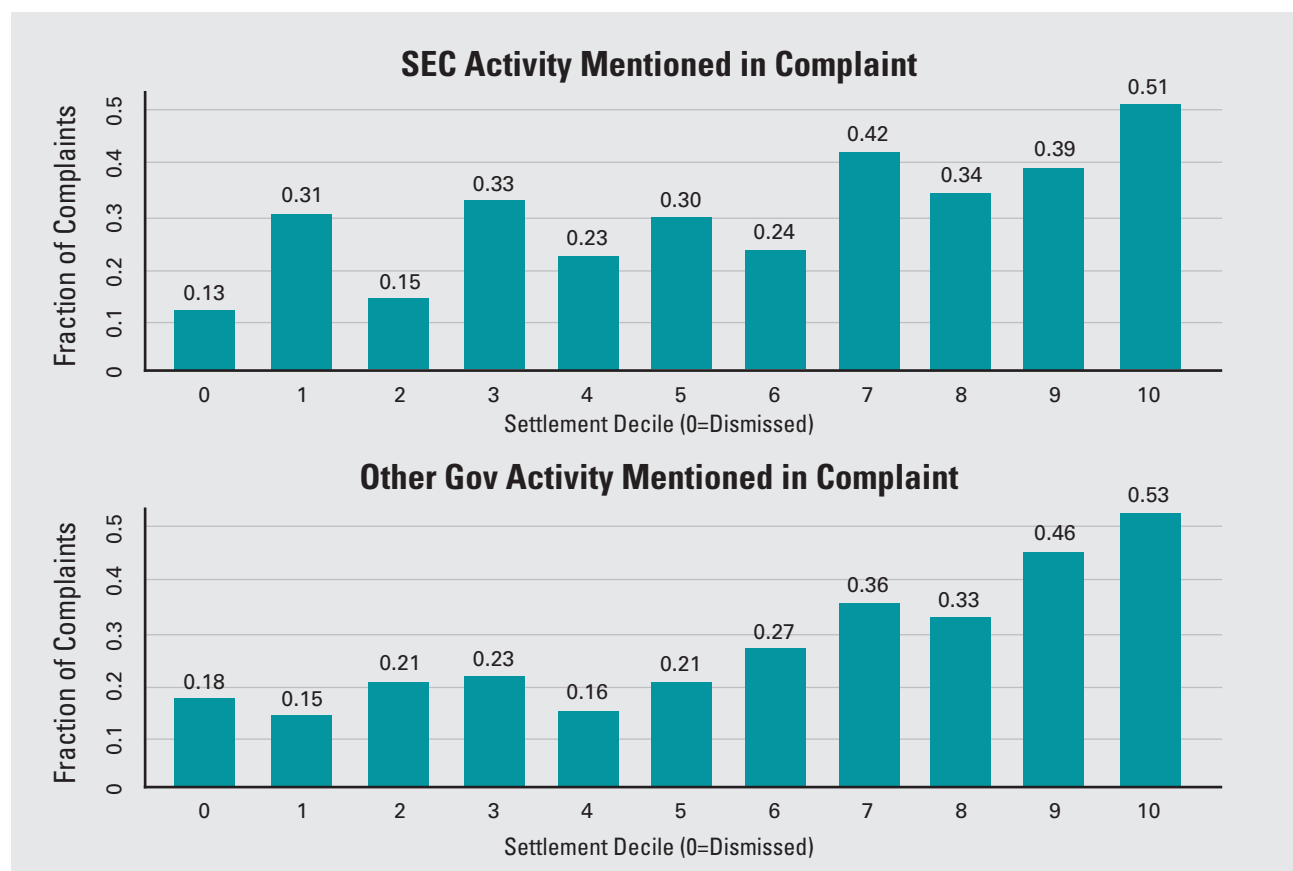
With regard to restatements, only one column stands out in this chart; the dismissed cases (column 0) have notably fewer restatements. Restatements make it much easier for plaintiffs to plead their cases because the corporation has

conceded that it made a material misstatement—a key element of a fraud claim.⁶⁷ The restatement will typically have been made under pressure from the company’s external auditor. Auditors have the power to withdraw their audit opinions or refuse to certify subsequent financial statements, either of which would be even more damaging to the company’s credibility than making the restatement. Typically, plaintiffs’ attorneys do no work in turning up this evidence of fraud. This is particularly the case for restatements that are mentioned in the initial complaint, when plaintiffs have not yet had access to discovery. Also interesting is the lack of an appreciable difference between deciles 1 and 10: both the smallest settlements and the largest have an allegation of a restatement in a little over a third of the cases.

“Also interesting is the lack of an appreciable difference between deciles 1 and 10: both the smallest settlements and the largest have an allegation of a restatement in a little over a third of the cases.”

Plaintiffs' attorneys may also benefit from investigations conducted by the SEC or other government agencies (or both) prior to the filing of the complaint, which bolsters the credibility of the plaintiffs' allegations of fraud. The notable difference between private and public actions is that the SEC, criminal prosecutors, and state

regulators have subpoena authority, which will allow them to access a corporation's internal records before they decide to file a claim. As with restatements, private plaintiffs can piggyback on the work of government investigators in deciding to bring suit.

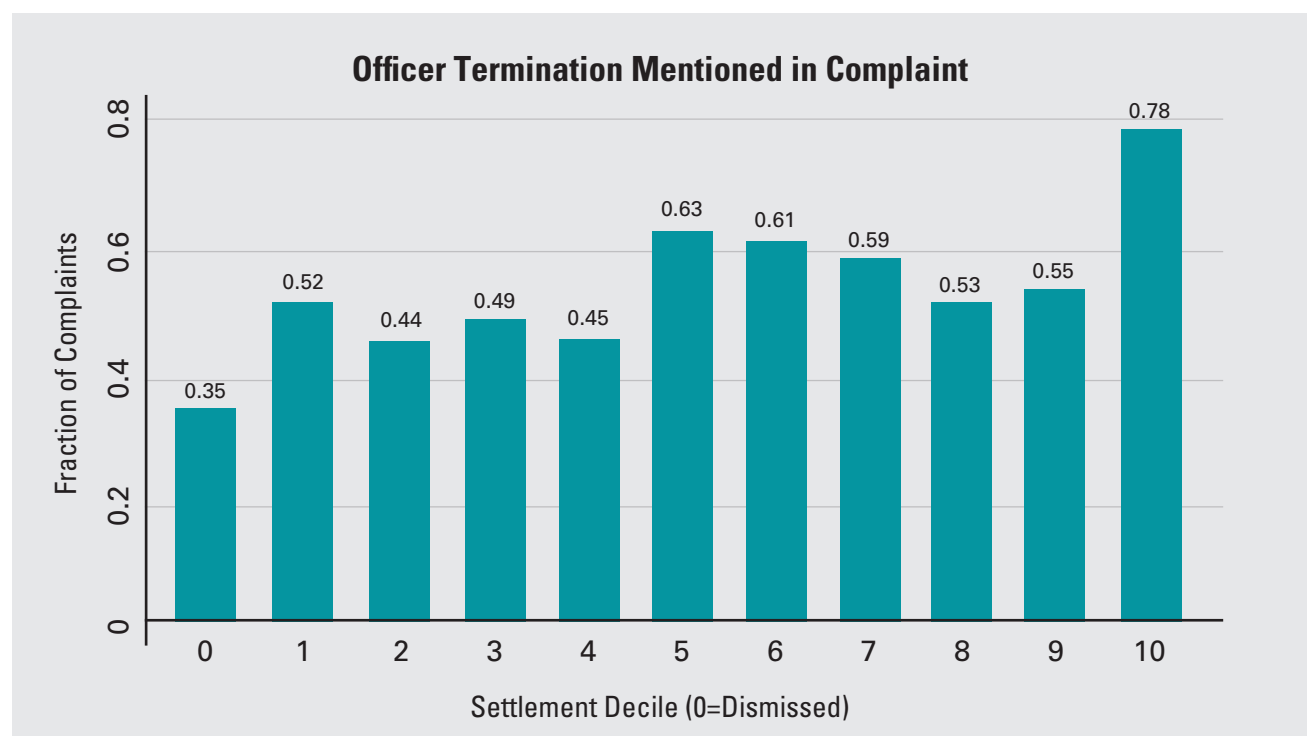


In these charts we see a pattern closer to what we might expect if settlement size correlates with the strength of the evidence of fraud. The largest settlements in decile 10 show a higher incidence of investigations by the SEC and other government regulators, with such investigations cited in more than half of the complaints. These categories of investigation frequently overlap; in 42 percent of the cases in which the complaint cited a government investigation (typically by the DOJ or a state attorney general or securities regulator), an

SEC investigation was also cited. Once again, the dismissed cases in decile 0 show a lower incidence of SEC and government investigations.⁶⁸ One outlier in these charts is the relatively high incidence of SEC investigations in the smallest settlements in decile 1 (albeit with a lower level of other government investigations). Overall, this pattern does not suggest that the smallest settlements reflect weaker cases on the merits, which we might expect if these cases are being filed for their extortion value.

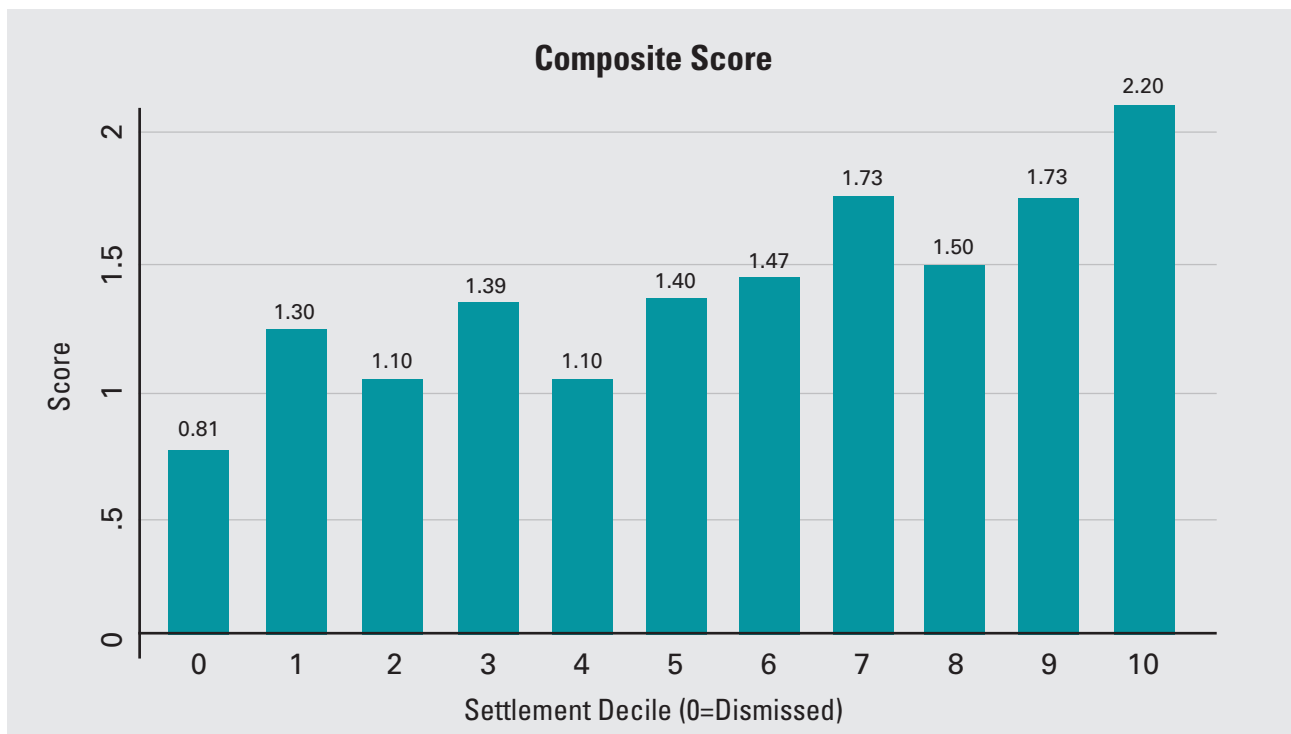
A final category of allegations that might suggest evidence of fraud is the termination/resignation of top officers. A common pattern in cases of fraud at public companies is the firing or resignation of a CEO or CFO announced simultaneously with an internal investigation supervised by the company's outside directors. The board of directors has access to the corporation's internal records; termination of employment is an obvious response if an officer has lost the trust of the board.

Termination may be a more ambiguous signal of fraud than our other categories, however, because boards of public companies frequently fire CEOs simply for poor performance unrelated to misconduct. A public confession of incompetence at the top can be just as damaging to a company's stock price as an admission of fraud, so either may well lead to the filing of a securities fraud class action. In either event, the termination or resignation of the officer is likely to be cited in the complaint.



Once again, we see that the incidence of officer terminations and resignations is significantly higher in the decile with the largest settlements, and significantly lower in the cases that are dismissed.⁶⁹ Also consistent with the prior charts, the incidence of officer terminations/resignations is not substantially lower in the cases that produce the smallest settlements in decile 1 compared with the other deciles with a settlement (other than the top settlement decile, decile 10).

To take into account restatements, SEC enforcement, other government enforcement and officer termination/resignation together, we assign each a value of 1 if mentioned in the complaint and 0 otherwise. We then sum the values to give each class action in our sample a score of 0 to 4 (referred to as the "Composite Score"). The next chart depicts the mean Composite Score for the securities class actions in our sample by settlement decile.



Consistent with the pattern for each separate proxy for the egregiousness of the securities law violation, we observe that settlement decile 10 has the highest average Composite Score, and the dismissed cases have the lowest. The figure for the smallest decile of settlements is not significantly different from the other deciles in the bottom half.⁷⁰

Taken together, these charts show that the cases producing the largest settlements also have the highest incidence of objective factors related to fraud. That is a good news/bad news message. The good news is that the merits seem to matter in

determining settlement amounts in securities fraud class actions. The bad news is that plaintiffs' attorneys do little to uncover information about the objective fraud factors documented above. In almost all cases, the information is publicly disclosed as a result of the compliance and governance systems that are standard operating procedure at public corporations in the U.S. Securities fraud class actions do little to nothing to generate this information. Instead, plaintiffs' lawyers are processing fraud-related information generated by others. Moreover, the reputational hit suffered by a company precedes the filing of these class actions. The stock price dropped when the company announced the restatement, government investigation, or the firing of an officer. The securities fraud class action merely adds insult to injury, piggy-backing on the problem that is already known to the market and investors. For public companies caught in a scandal, or even just a business reversal, when it rains it pours.

“ Instead, plaintiffs’ lawyers are processing fraud-related information generated by others. ”

Predicting Recovery

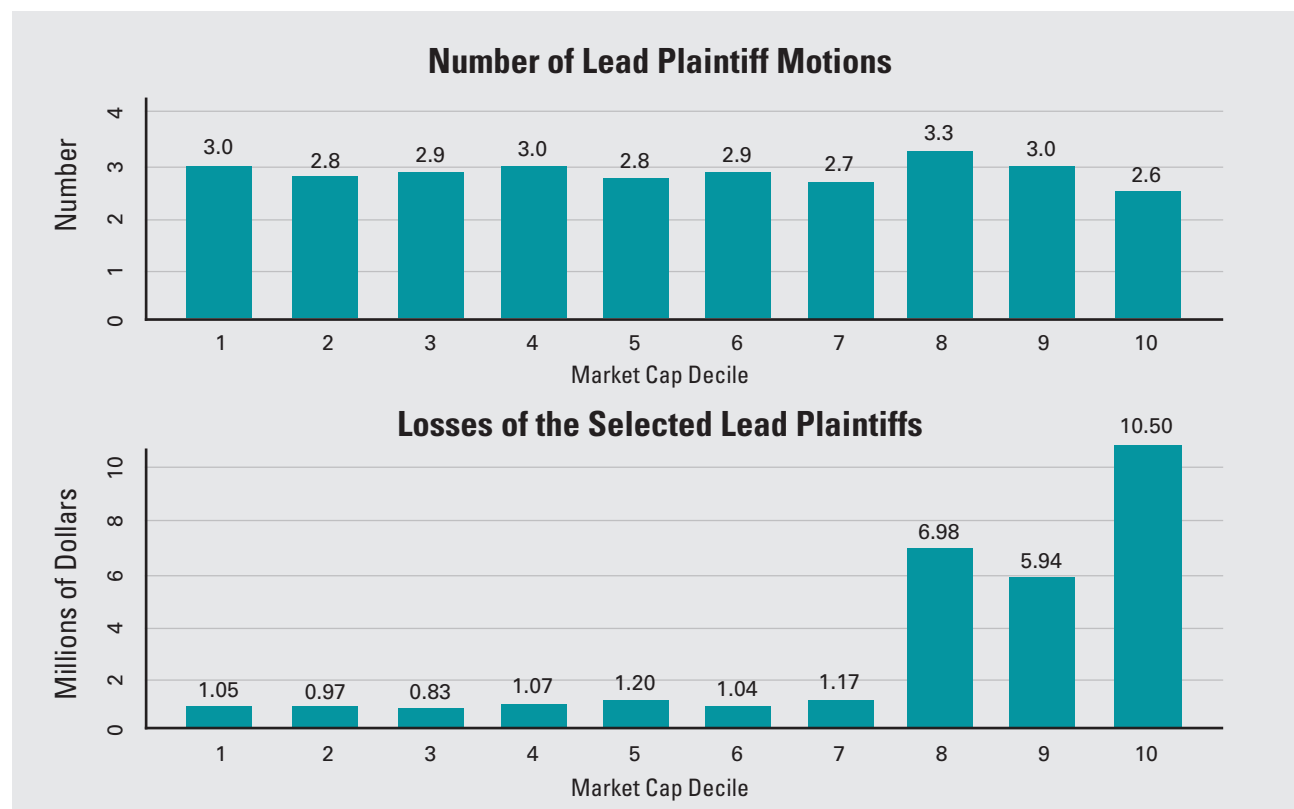
The previous charts suggest a correlation between public evidence of fraud and recovery in securities class actions, but the patterns are far from uniform. Notably we see evidence of indicia of fraud even in the smallest decile of settlements. And while the largest settlements stand apart in the strength of the allegations found in the complaints in those cases, there is considerable variation in the middle. That variation suggests that attorneys may face uncertainty when they file suit in a substantial percentage of cases.

One way of evaluating the uncertainty of recovery is to look at the competition to control a securities fraud class action. As discussed in the Background section, plaintiffs' attorneys compete in securities fraud class actions for the right to represent the class, with the attorney representing the plaintiff(s) with the biggest losses typically

winning that opportunity. Plaintiffs' attorneys are rational actors; we predict that competition will be stiffest in cases with the highest expected recovery.

To analyze how plaintiffs' attorneys make decisions about whether to compete, we divide our securities class actions based on the market capitalization of the defendant issuer measured at the end of the last day of the class period (typically the trading day before the last alleged corrective disclosure date). Market capitalization provides an objective metric of the potential stakes of the litigation known at the time of the filing of suit. Bigger market capitalization companies generally translate to bigger potential damages and thus higher stakes in the litigation.

The charts below show by market capitalization decile: (1) the mean number of lead plaintiff applicants for each of our settlement deciles; and (2) the losses suffered by the shareholder selected as lead plaintiff.

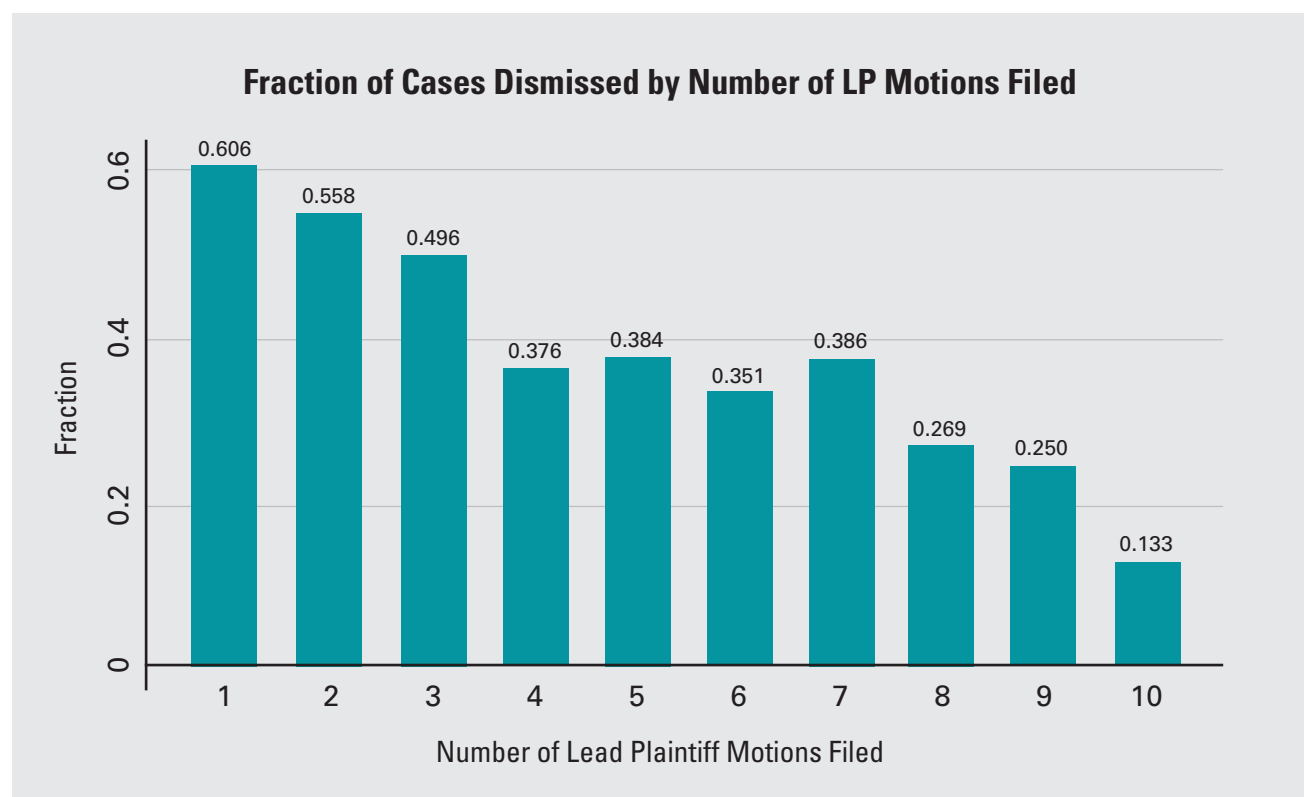


The competition for lead plaintiff is similar across all the market capitalization deciles in terms of the number of lead plaintiff motions. Who wins that competition? In the cases filed against the largest companies, it takes very substantial losses to be the shareholder(s) selected to represent the class, with over \$10 million of losses suffered by the representative shareholders on average in those cases. Losses of this magnitude suggest that these large market capitalization cases are purely the province of substantial institutional investors, such as state pension funds. The winners of the competition to represent the class are the law firms that are most successful in attracting the largest lead plaintiffs as clients. Consistent with lead plaintiffs with large losses mattering more for the higher stakes cases, we observe that the losses of the selected lead plaintiffs ascend sharply

“The winners of the competition to represent the class are the law firms that are most successful in attracting the largest lead plaintiffs as clients.”

for the top three deciles of market capitalization.

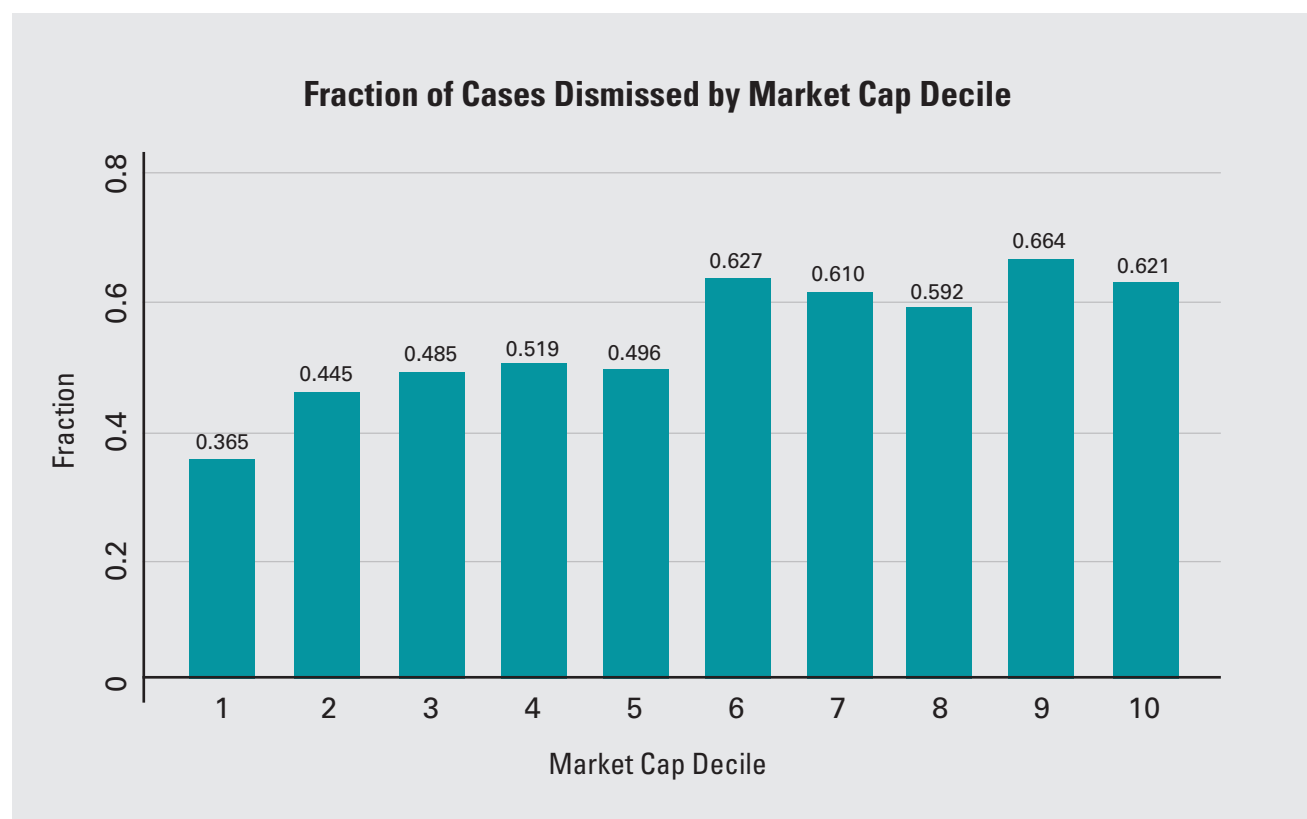
The competitive fervor seems to correlate closely with merit. The next table shows the percentage of cases dismissed broken down by the number of lead plaintiff motions filed.



Cases that generate a feeding frenzy among plaintiffs' lawyers to be appointed as lead counsel are unlikely to be dismissed. The risks of non-recovery are relatively low in the strongest cases and attorneys respond accordingly. The lead plaintiff contest occurs at the outset of the litigation, so the plaintiffs' lawyers in these cases are relying on publicly-available information when deciding to compete for the representation. The neat pattern showing a close connection between the level of competition for lead plaintiff status and likelihood of dismissal suggests that plaintiffs' lawyers have the capacity to evaluate outcomes in the securities fraud

class actions at the time that they file. If that is true, why do so many cases end up getting dismissed?

One clue: follow the money. Plaintiffs' attorneys are not only assessing the probability of recovery when they decide to file suit, but also the amount of recovery that is likely to be generated. Higher stakes, and thus the prospect of a bigger eventual settlement, lead plaintiffs' attorneys to file suits in cases with less substantial evidence of fraud. The following chart shows dismissal rates broken down by the market capitalization of the defendant companies.

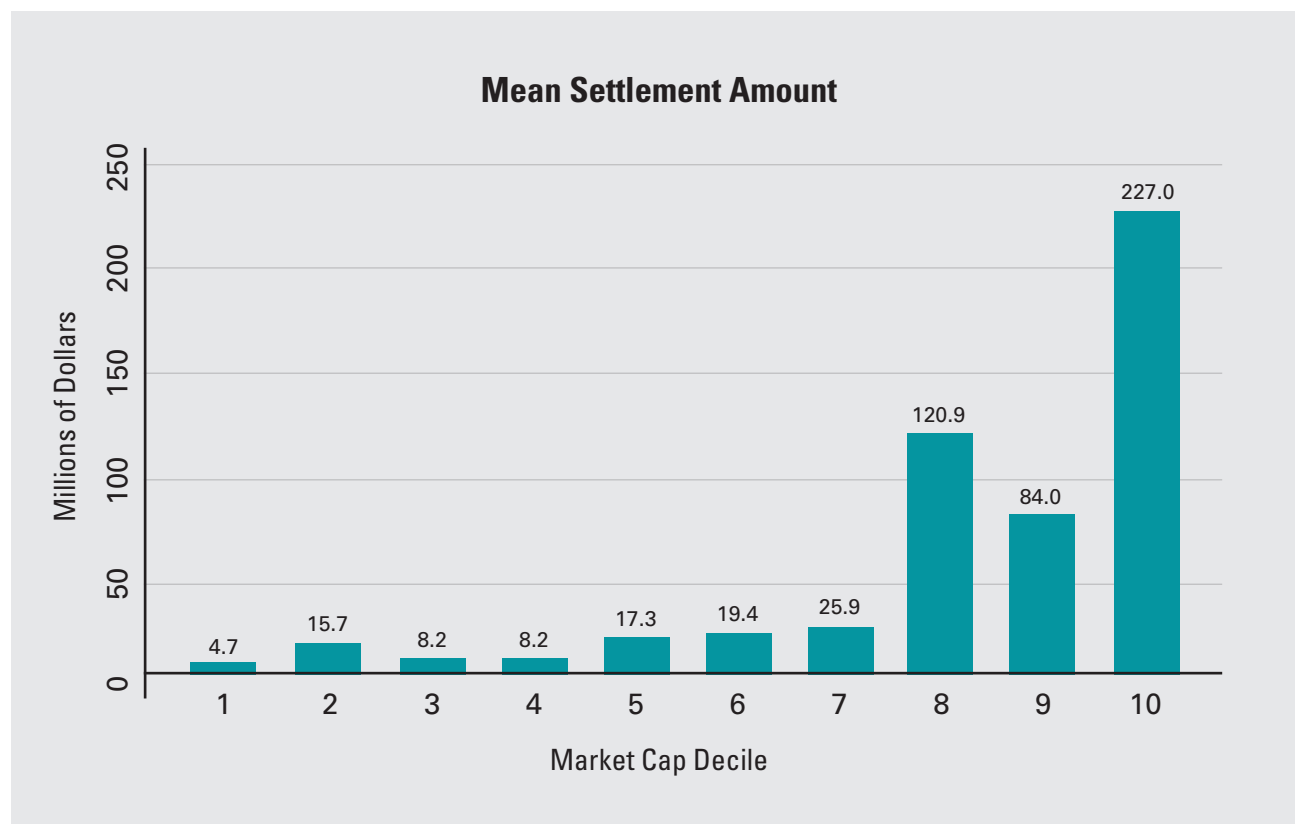


As predicted, the dismissal rate increases with the size of the company, which generally correlates with provable losses. Plaintiffs' attorneys are balancing risk and

return in their decision to file suit, and they are willing to take a chance on some cases with dubious merit if they think they have a chance of getting past a motion to

dismiss—and the potential damages are big. Smaller companies, by contrast, are unlikely to be sued unless plaintiffs’ attorneys believe that there is a good chance of

recovery. Compare the dismissal rate by market capitalization with the chart below showing settlement size by market capitalization decile.



Here we see the strong connection between market capitalization and settlement amount. It is unlikely, however, that there is a similar connection between market capitalization and fraud because larger companies tend to have more robust compliance systems and top-tier auditors. To assess this (lack of) connection, we compare the Composite Score for the top market cap decile (1.11) with the mean Composite Score for the other nine market

cap deciles (1.11). The lack of any appreciable difference in the mean Composite Scores is inconsistent with greater incidence of fraud among the larger market capitalization companies. Consequently, the high dismissal rate for suits against the largest companies is driven by the lure of the mega-settlement, the lottery ticket of securities fraud class actions.

“Consequently, the high dismissal rate for suits against the largest companies is driven by the lure of the mega-settlement, the lottery ticket of securities fraud class actions.”

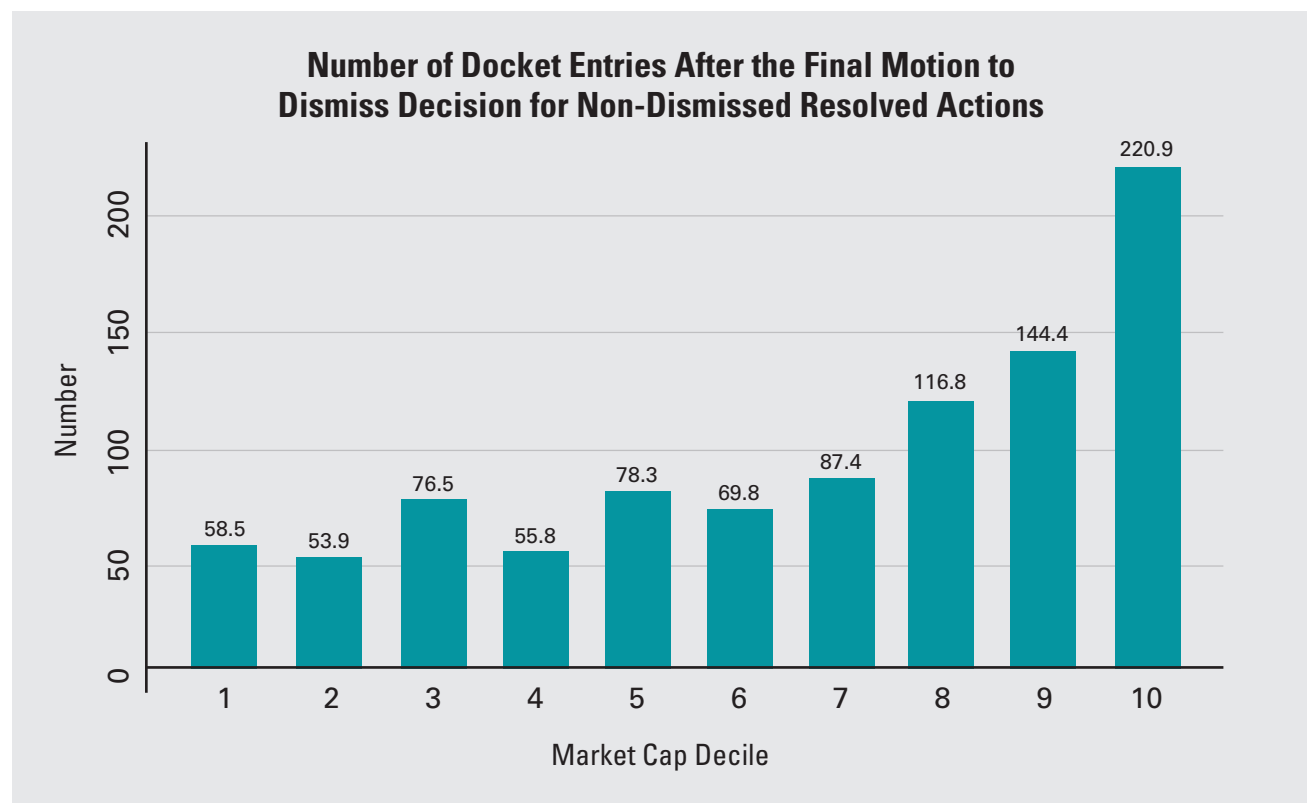
Working and Getting Paid

So far we have explored our class action data for insights into the ability of plaintiffs' lawyers to predict the likelihood of recovery and how that affects filing and litigation decisions. Likelihood of success only reflects a portion of the calculus faced by the plaintiffs' bar, however; equally relevant is the effort expended by lawyers and their share of the recovery. We turn to those questions in this section.

EFFORT

Insofar as plaintiffs' lawyers face uncertain recoveries at the time of filing for securities fraud class actions, that uncertainty seems driven in large part by willingness to take chances on cases of dubious merit. Filing marginal cases makes sense as a strategy only if two conditions hold: (1) law firms hold a diversified portfolio of claims, with the winning claims compensating for the

uncompensated expenses in the losing ones; and (2) law firms accelerate their hours expended in litigation after surviving the motion to dismiss (after which the risk of non-settlement diminishes and makes it less risky to expend hours in the matter). On the first point, the law firms in our study that served at least once as lead counsel served as lead counsel in an average of 15.7 cases during our sample period. The average firm obtained settlements in 41 percent of its cases. These numbers are consistent with a portfolio strategy. On the second point, the chart below shows that litigation activity after the final motion to dismiss court decision, as measured by the number of court docket entries,⁷¹ is heavily concentrated in the highest market capitalization cases, which we have seen are the cases with the greatest potential stakes.



This chart shows that cases against smaller companies generate substantially less litigation activity after the final motion to dismiss decision compared with cases against the top decile of market capitalization companies.⁷² This pattern is consistent with lawyers metering their effort to reflect the expected payout, devoting more time after the motion to dismiss for those cases with a higher expected settlement (those in the higher market capitalization decile). We see a similar pattern (untabulated) with the number of days between the final motion to dismiss decision and its final resolution. Non-dismissed cases involving the top market capitalization decile defendant companies take an average of 1,418 days from the final motion to dismiss decision to resolution, while all other cases take an average of 1,010 days.⁷³

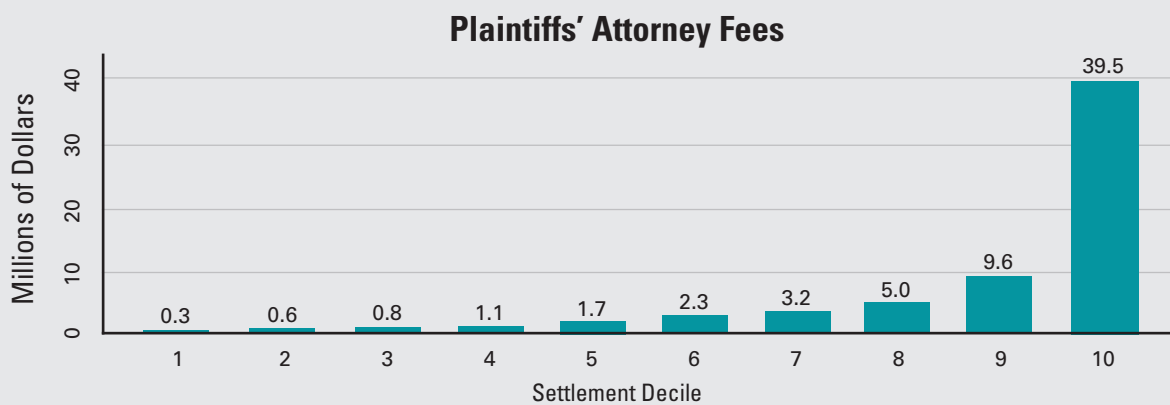
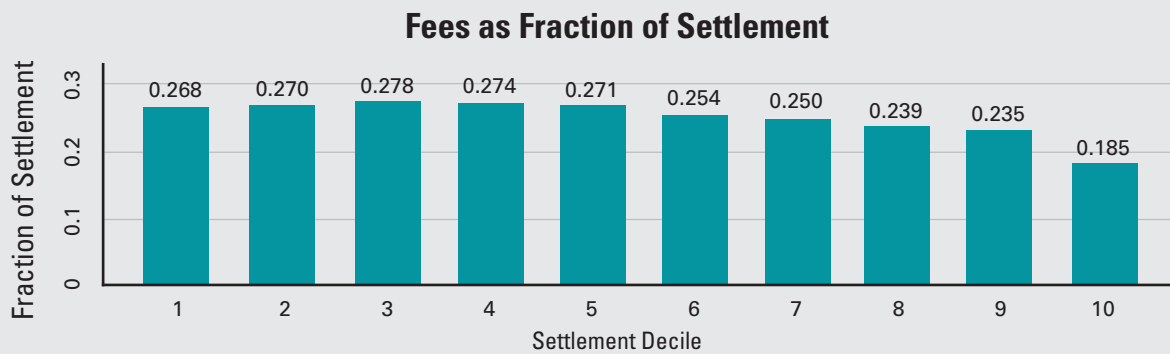
FEES

As discussed in the Background section, plaintiffs' lawyers are typically compensated with a percentage of the settlement that they negotiate on behalf of the class. (Defense lawyers typically are paid on an hourly basis paid by the company's D&O insurer. Defense-side fees are typically not contingent on outcome.) Trial judges determine the fee percentage

“ This pattern is consistent with lawyers metering their effort to reflect the expected payout, devoting more time after the motion to dismiss for those cases with a higher expected settlement (those in the higher market capitalization decile). ”

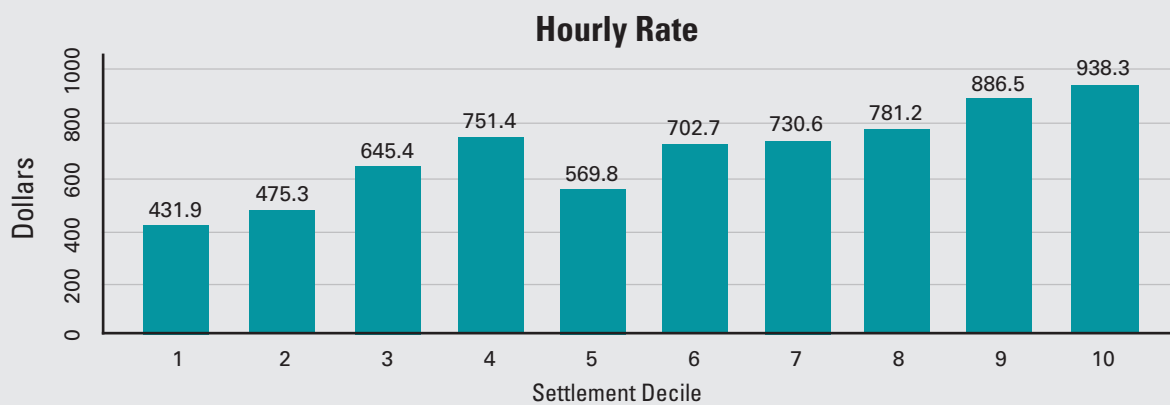
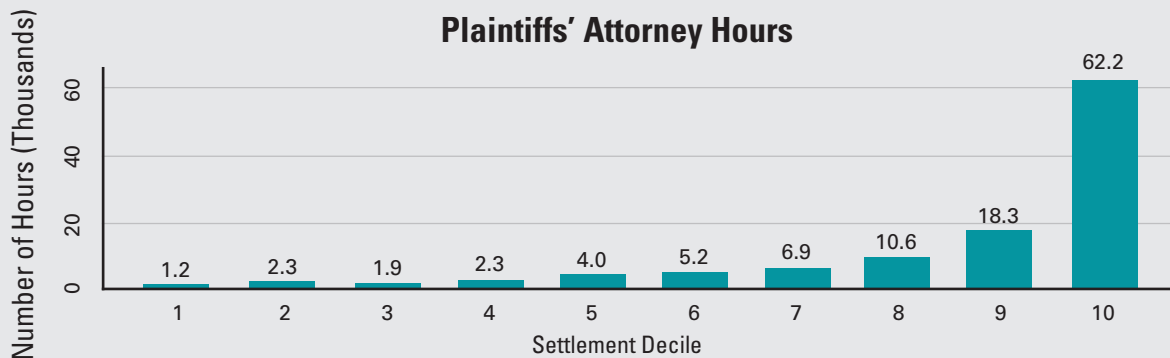
at the time the settlement is approved, typically based on circuit precedent regarding appropriate percentages. Most courts do a lodestar “cross-check” as well.

How do fee awards relate to the size of settlement and the risk of dismissal faced by plaintiffs' lawyers? In the cases with the largest settlements, fee awards are considerably smaller as a percentage of the settlement amount, but much greater in absolute terms. The next chart shows fee awards broken down by settlement decile both as a fraction of the settlement amount and as millions of dollars.



The fees in the largest cases are relatively small in percentage terms, averaging 18.5 percent of the settlement award, but are enormous in absolute dollars, averaging nearly \$40 million for the settlements in the top decile. The fees awarded in cases with smaller settlements, however, are much more modest, with the bottom third of settlements resulting in average fee awards of a little more than a quarter of the

settlement amount and below \$1 million in absolute dollars. What explains this vast disparity in fee awards for cases involving the same general subject matter? Two factors seem to be in play: (1) hours worked; and (2) the imputed hourly rate for that work. The following charts show those two factors broken down by settlement decile.



The number of attorney hours invested in the cases with the biggest settlements is staggering, averaging over 62,200 hours in the top decile. The smallest settlements receive the fewest hours, suggesting that attorneys do not overinvest in litigation with modest expected returns.

The focus on limiting attorney fees to a “reasonable percentage” after the PSLRA may also limit the incentive of attorneys to invest in litigation for smaller stakes. There exists a de facto cap on plaintiffs’ attorneys fees equal to one-third of the settlement

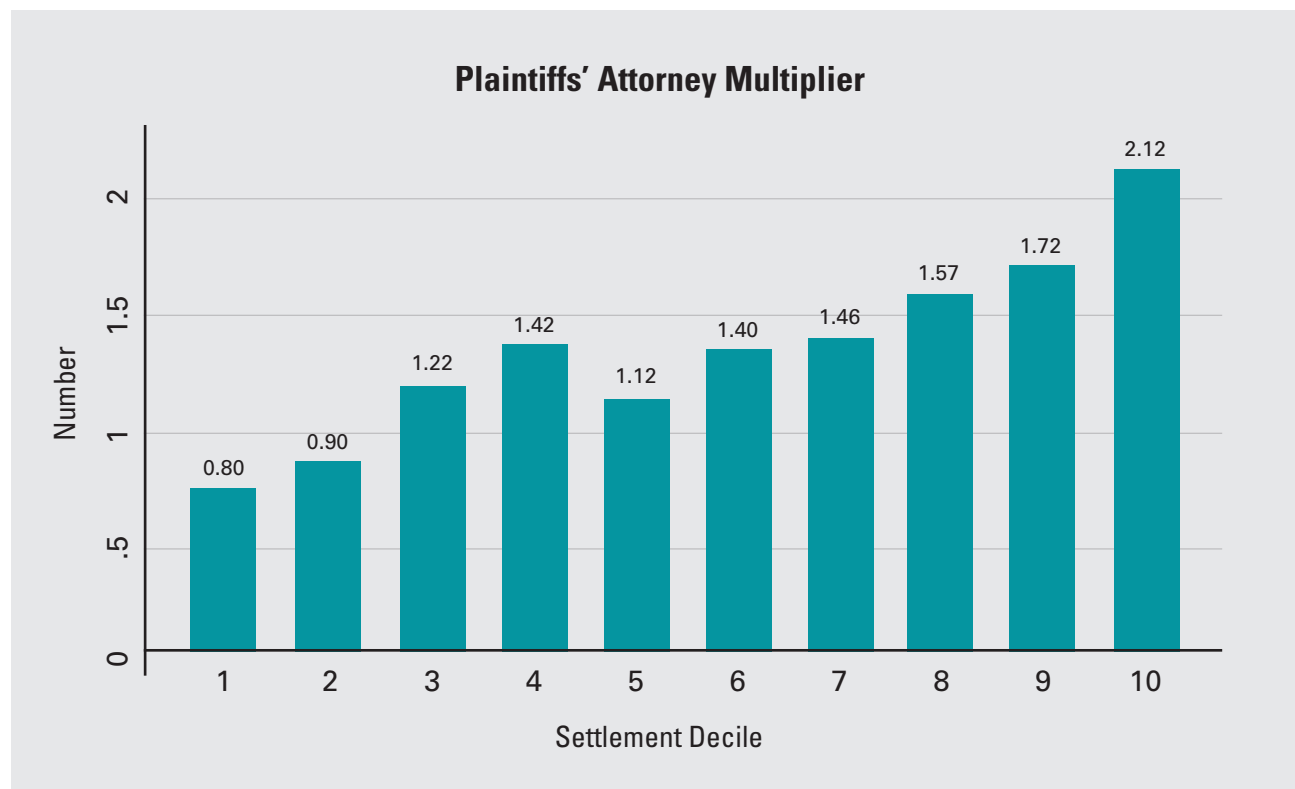
amount. Among the 713 settlements from 2005 to 2016 in our dataset for which we have data on attorney fee awards, 711 of the attorney fee awards were at one-third of the settlement amount or lower. The other two attorney fee awards were for 33.6 percent and 34 percent of the settlement amount respectively. Plaintiffs’ attorneys who expect a maximum of only one-third of the settlement amount will not have much incentive to work intensively on litigation where the expected settlement amount is low.

“ At the other end of the spectrum, the mega-settlements, judges appear to reward lawyers more for cases that result in large monetary recoveries, despite the evidence that the mega-cases tend to have stronger objective indicia of fraud publicly available to the attorneys at the time of filing suit.”

At the other end of the spectrum, the mega-settlements, judges appear to reward lawyers more for cases that result in large monetary recoveries, despite the evidence that the mega-cases tend to have stronger objective indicia of fraud publicly available to the attorneys at the time of filing suit. Stronger evidence of fraud at the outset means that lawyer skill and effort play less of a role in generating a settlement, even if that settlement is a substantial one. If a Fortune 500 company issues a restatement, the CFO resigns, and the SEC starts an

investigation, it is virtually certain that the D&O insurer will write a big check to resolve the securities fraud class action, regardless of the talent and effort of the lawyers filing the suit.

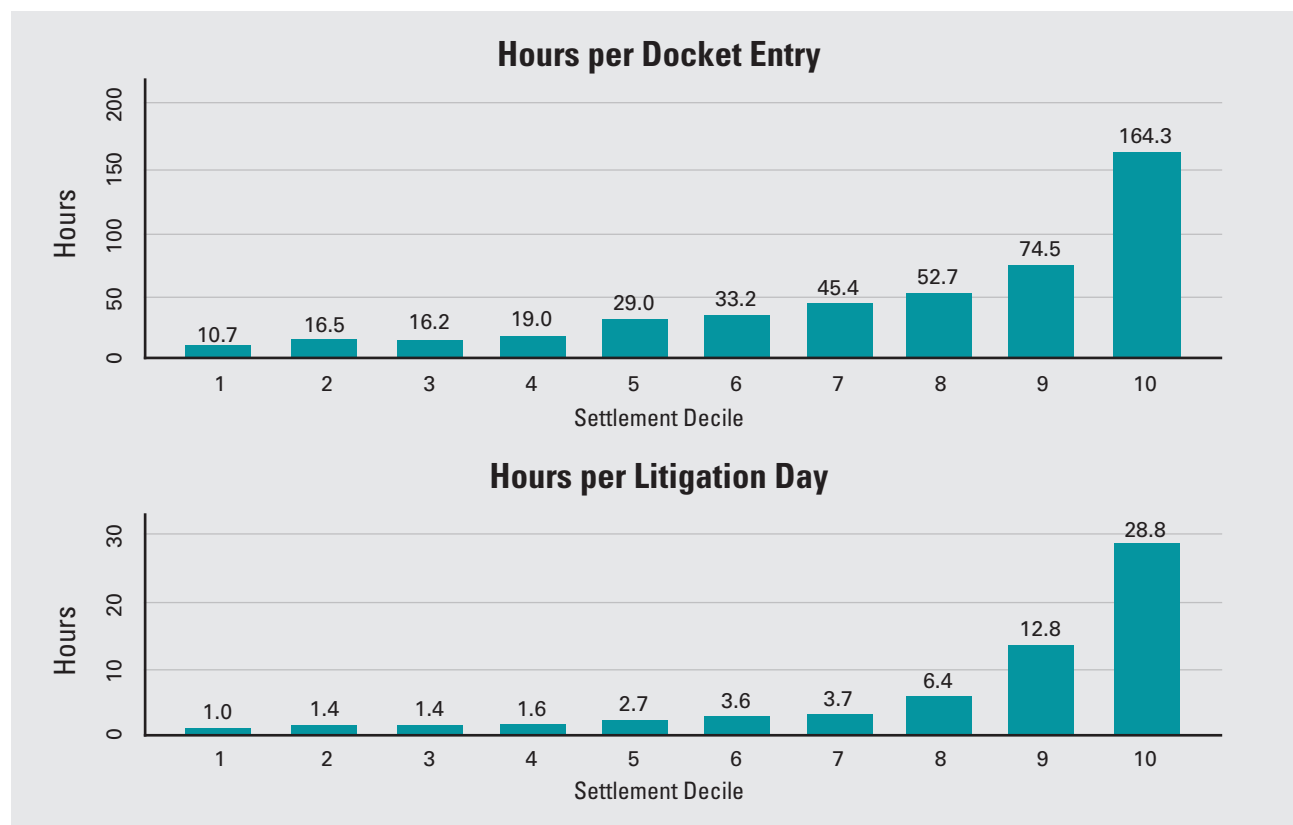
Another way of looking at the relation between settlement size and the compensation awarded to lawyers is the multiplier: the ratio of the fee award to the lodestar. The chart below shows the multiplier broken down by settlement decile.



Here we see a strong pattern of judges rewarding class action lawyers for the size of the settlement, despite the evidence already presented, which tends to show that the variation in settlement amounts is driven in large part by differences in market capitalization. Suits against bigger companies produce bigger settlements—and much bigger fee awards based on more generous multipliers. Plaintiffs’ lawyers are being rewarded for their success in the biggest cases, but that success is largely driven by factors already known prior to the filing of the plaintiffs’ complaint (such as a restatement, SEC enforcement action, other government enforcement action, and termination of a top officer). More to the point, lawyers are reaping huge paydays for suing the biggest companies. Plaintiffs’ lawyers win the representation in those cases by attracting institutional investors with the largest losses.

The enormous disparity in fee awards between the smallest and largest settlements becomes even more stark when one considers that none of these cases go to trial. All of the attorney effort, regardless of settlement size, is spent drafting/arguing motions, conducting discovery (document review, depositions, etc.), and negotiating the settlement. Is it plausible that the largest settlements take nearly 60 times as much lawyer effort as the smallest?

This disparity seems implausible. Without directly observing the work being done by plaintiffs’ lawyers, it is impossible to determine if make-work is being generated to justify the enormous fees paid in the mega-cases, but we do see some evidence consistent with this conjecture. The charts below show the numbers of hours worked divided by two alternative metrics of intensity of litigation: (1) number of docket entries; and (2) days in litigation. We again sort these numbers by settlement decile.



The two charts suggest a consistent story: attorneys are investing vastly more hours in the cases producing the largest settlements. One response to the make-work hypothesis is that more work is necessary in the mega-settlements for any given step in the litigation process. Each additional hour that a plaintiffs' attorney invests in the litigation may have a higher

marginal payoff for higher stakes litigation. Defense attorneys may put in more resources when the stakes are higher, which in turn necessitates more work on the part of plaintiffs' attorneys.⁷⁴ If so, shareholders are losing twice because they are paying more for both the plaintiffs' firms and the defense firms.⁷⁵

Implications and Suggestions for Reform

Our study suggests that securities class actions resemble a lottery for plaintiffs' attorneys. These attorneys know from the outset that certain types of cases (i.e., those involving egregious frauds at large market capitalization, public corporations) have a much greater likelihood of ending with eye-popping settlements.

Appointment as lead counsel in these cases is therefore akin to receiving a winning lottery ticket, because those cases that result in settlement will almost certainly result in a large settlement and a correspondingly large attorneys' fee award.

At first glance, this may seem intuitive. If lead counsel invests the time and energy to get a \$100 million settlement against a company that committed fraud, then maybe they deserve the eight-figure fee that comes along with it. Yet the justification for contingency fees is premised on risk. The legal system rewards plaintiffs' attorneys in successful class actions because it recognizes that these attorneys do not receive any compensation if the case is dismissed. Contingency fees reward attorneys for making smart bets and

ferreting out the necessary evidence to prove their claims. Our study suggests that the risks in the most lucrative mega-cases are not that great. These attorneys can tell early on whether a given case is likely to end with a hefty settlement. Typically, much of the necessary evidence has already been made public. Plaintiffs' attorneys may also wait until after surviving the motion to dismiss (when the conditional probability of obtaining a settlement increases) to accelerate their investment of hours into the litigation, further diminishing their risk.

As a result, the legal system may overcompensate plaintiffs' attorneys in securities class actions with the largest settlements. The lottery aspect of these cases skews the selection of cases toward

“ Yet the justification for contingency fees is premised on risk. [...] Our study suggests that the risks in the most lucrative mega-cases are not that great. ”

larger companies and away from the most egregious frauds.

In addition, the lure of the jackpot settlement likely encourages attorneys to direct significant time and money to attracting institutional clients who will help them win the lead counsel fight. These fights do not benefit shareholders, but they are a predictable consequence of a winner-take-all scheme that gives total control of the case to the law firm with the largest shareholder claimant.

This section outlines three sets of possible reforms to address the lottery aspect of securities fraud class actions. First, it suggests changes to the way in which judges award fees in securities class actions. Second, it suggests crucial reforms to the lead plaintiff process. Finally, it proposes limiting damages in the largest cases to discourage the rent-seeking prevalent under the current regime.

Reforms to Contingency Fees

Lawmakers should consider reforms to the contingency fee method of awarding attorneys' fees. As explained previously, judges are charged with reviewing requests for attorneys' fees and ultimately deciding on the amount of these fees. Under the PSLRA, these fees cannot exceed "a reasonable percentage of the amount of any damages and prejudgment interest actually paid to the class."⁷⁶ Most courts purport to consider a variety of factors in setting these fees, including the time and labor expended by counsel, the magnitude and complexities of the litigation, and the risks inherent in the litigation.⁷⁷ Beyond these instructions, judges enjoy broad discretion in setting fee awards.⁷⁸

“ Judges should also probe the marginal contributions of the attorneys and the risk of non-settlement the attorneys faced at the time they actually worked on the matter.”

In practice, as others have noted,⁷⁹ judges typically rubber stamp the requests of plaintiffs' attorneys, rejecting them in just a handful of cases. This norm creates an incentive for plaintiffs' attorneys to request an inflated award, especially in the largest cases. Our study also suggests the possibility that some attorneys may support their claims for multi-million dollar fee awards by exaggerating the risk that they actually faced in the case (and thus the multiplier). Plaintiffs' attorneys may gloss over the fact that government investigators or the company itself provided the most salient evidence of fraud and that many hours, particularly for actions with larger market capitalization defendants, are expended only after the court rejects the final motion to dismiss, when the risk of non-settlement decreases.

Anecdotal evidence supports this conclusion. In a recent example, the law firm of Labaton Sucharow, LLP obtained a settlement of \$300 million in 2016 in a class action lawsuit filed against State Street Bank & Trust.⁸⁰ The court awarded these firms approximately \$75 million in

fees.⁸¹ Soon thereafter, following an investigation probing the settlement by the *Boston Globe*,⁸² the court ordered an inquiry into the fee award.⁸³ This investigation confirmed that, among several other issues, plaintiffs' counsel had double counted the hours of several attorneys.⁸⁴ As a result, according to case filings, these firms overstated the number of hours that the plaintiffs' firms had worked on the case by 9,322 hours, causing the firm to inflate its lodestar by more than \$4 million.⁸⁵

This case was not a securities class action; it was a consumer class action alleging unfair and deceptive practices by the bank. Nonetheless, the law firms involved are frequent filers of securities class actions,⁸⁶ and there is a concern that the firm uses the same cavalier attitude toward its billing practices in those cases as well. If judges simply rubber-stamp fee requests, they will not catch these types of errors. Nor will they notice more subtle practices of law firms performing unnecessary work, inflating billing rates, or staffing cases more heavily than necessary.

To curb these practices, judges should scrutinize fee requests far more carefully. Judges should either review the time records of the attorneys themselves, or better yet, refer them to a magistrate or special master familiar with law firm billing practices. They should also periodically request time sheets throughout the litigation, providing a watchful eye over the effort expended.

Judges should also probe the marginal contributions of the attorneys and the risk of non-settlement the attorneys faced at the time they actually worked on the matter. Did they uncover important evidence that other parallel investigations

had missed? Did they add value by advancing innovative legal or factual arguments? Conversely, did they simply repackage the same facts and basic legal claims found elsewhere and accelerate their hours after the final motion to dismiss decision? A higher level of scrutiny may be particularly appropriate in cases that attracted multiple lead plaintiff candidates at their inception; the plaintiffs' lawyers know which cases are low risk. If plaintiffs' attorneys know that their fee requests will be subject to more scrutiny at the back end, they may avoid inflating their hours or overstating their contributions and the risk they faced in the litigation.

Congress can also help curb exorbitant fee requests. The experience under the PSLRA has demonstrated that judges may be reluctant to play a greater role in supervising attorneys and/or reviewing their requests. Given this experience, Congress should set presumptive limits on fees in the largest cases in which exorbitant fees are common. In cases with settlements over \$100 million, Congress could impose a presumptive limit on fees of between 10 and 15 percent of the settlement award for lead counsel. The presiding judge could be authorized to depart upward if the court made specific findings that the case required extraordinary effort by lead counsel or that lead counsel exercised extraordinary skill and judgment in litigating the case.

Reforms to Lead Plaintiff Process

Lawmakers should also take a closer look at the lead plaintiff process. The data presented in this research suggest that the profits of plaintiffs' law firms depend less on the firms' skill and hard work and more

on their ability to amass a stable of institutional investors as clients. These clients provide the winning lottery ticket, giving the firms a high likelihood of substantial fees if they are appointed lead counsel in the high-profile cases. As a result, law firms spend vast amounts of time and energy trying to attract these clients. These expenditures offer no benefit to other class members, and they do nothing to promote deterrence.

The investigation in the State Street Bank case further illustrates this point. The investigation found that Labaton Sucharow paid an attorney named Damon Chargois to help it secure an Arkansas state teachers' pension fund as an institutional investor client.⁸⁷ Chargois did not perform any legal work on the State Street case.⁸⁸ His role was primarily arranging meetings between Labaton and the pension fund, and the firm rewarded him by paying him \$4.1 million, or 5.5 percent of the total fee award. This amount was more than double the amount received by several other plaintiffs' firms that performed actual legal work on the case.⁸⁹ The firm did not disclose the payment to the court or to the other members of the class.⁹⁰

Upon questioning by the federal judge overseeing the case, Labaton revealed that it had 150 open cases, and referral

arrangements in 48 of these cases.⁹¹ In other words, Labaton, and perhaps other plaintiffs' law firms, made a regular practice of rewarding law firms that brought them large institutional clients. These payments help ensure that the law firm is appointed lead counsel and receives the resulting spoils of any settlement.

This reality is not surprising given the incentives that the PSLRA creates. The winner-takes-all system for appointing lead plaintiff means that law firms face a tremendous financial incentive to attract institutional clients. Money spent attracting institutions is an investment by lawyers in securing the winning lottery ticket. Congress had the right idea when it placed these large institutional investors in charge of securities class actions, but the legislature dropped the ball when it failed to place any significant limits on law firms' ability to attract these clients.

Congress could rectify this oversight by enacting new ethical limits on the lead plaintiff process. Specifically, Congress should consider amending the PSLRA to prohibit lead counsel from sharing its fee with law firms that do not perform actual legal work in the case. In addition, Congress should also prohibit referral payments in securities fraud class actions. These "referrals" do not uncover cases;

“The data presented in this research suggest that the profits of plaintiffs' law firms depend less on the firms' skill and hard work and more on their ability to amass a stable of institutional investors as clients.”

they deliver plaintiffs to plaintiffs' attorneys that allow the lawyers to compete for cases that are generated through other avenues. Additionally, Congress should require lead counsel to disclose how the requested fee award will be distributed among the firms that worked on the case. Judges can also take the lead with these reforms. As part of their duty to set reasonable fees, judges could ask for specific information related to how the fee will be allocated among the various law firms and whether the allocation reflects a referral fee of any kind.

Reforms to Damage Awards

Our last proposed reform is a cap on damages to suppress the lottery ticket aspect of securities fraud class actions. As discussed above, compensation is not an important goal of securities fraud class actions as a theoretical matter, and in any event, is rarely if ever achieved in practice. Deterrence is the principal goal, and that goal should be the guidepost for the penalties inflicted on public corporations accused of fraud.

Our findings demonstrate that plaintiffs' attorneys can be induced to file suit even in cases where their expectations regarding fees are quite modest. And we saw that the expectation of large fees appears to correlate with some of the weaker cases—market capitalization appears to be at least as significant in targeting decisions as indicia of fraud. The significance of market capitalization suggests that plaintiffs' attorneys' incentives could be improved by reducing the effect of company size on settlement expectations.

The concern is that limiting damages in securities fraud class actions might also reduce their deterrent impact. Would a

“ *Money spent attracting institutions is an investment by lawyers in securing the winning lottery ticket.* ”

large capitalization company be deterred from engaging in fraud by a smaller potential damages number? This is a legitimate worry, and accordingly, we propose a damages cap tailored to a percentage of market capitalization, perhaps five percent. Insofar as the company has benefitted from the fraud (a rarity in current practice), disgorgement of the corporation's profit could be excluded from the damages cap. Also excluded from the cap would be individual defendants, giving the plaintiffs an incentive to pursue the actual wrongdoers responsible for the fraud, which would be an important step in promoting deterrence. These individuals would still be covered by D&O insurance, but in that scenario, the policy limits would set a hard cap on potential recovery.

To use a current example of how a damages cap would work, Tesla—which drew a dozen law firms to file suit against it in 2018—had a market capitalization of roughly \$50 billion in early 2019. A damages cap of five percent of market capitalization would still leave open the possibility of a damages award of up to \$2.5 billion. A hit that size would send a significant message to the Tesla board about the need for effective compliance systems. And from the perspective of the

plaintiffs' bar, even with uncertain recovery, the fees generated by a settlement in that range would still bring forth a healthy number of firms vying for lead counsel status. The goal is to deter fraud, not to

sanction the largest companies with the largest stock price drops. The litigation system should incentivize plaintiffs' lawyers to pursue the most egregious cases of fraud, not the biggest targets.

Conclusion

This study has looked at the business of securities fraud class actions, focusing on the risks and rewards that plaintiffs' lawyers face in bringing these cases. As expected, we found that dismissed cases, on average, alleged substantially less "hard evidence of fraud." By contrast, and somewhat surprisingly, the complaints that generated the smallest settlements did not have materially different allegations from other cases that produced settlements.

However, the largest settlements (the mega-cases) had substantially lower risks for the attorneys filing them.

Notwithstanding those substantially lower risks, the evidence presented here suggests that judges are quite generous in awarding fees to the lawyers who represent the shareholder classes.

That generosity skews the incentives of plaintiffs' lawyers in a way that appears to undermine deterrence—the principal goal of securities fraud class actions. We found

that the dismissal rate increases with the size of the defendant company, which suggests that plaintiffs' attorneys are willing to take greater chances on cases with weaker evidence if there is some chance of a fees jackpot if the case survives a motion to dismiss. The litigation resources devoted to meritless cases against larger companies that end in dismissal would be better devoted to cases with strong evidence of fraud against smaller companies.

“ [T]he dismissal rate increases with the size of the defendant company, which suggests that plaintiffs' attorneys are willing to take greater chances on cases with weaker evidence if there is some chance of a fees jackpot if the case survives a motion to dismiss. ”

We propose a number of potential reforms to reduce the lottery element of securities fraud class actions. First, we recommend that judges look more carefully at fee requests filed in connection with mega-settlements. Lawyers should be rewarded for their marginal contribution, not merely for winning the contest to attract the biggest loser among institutional investors vying for lead plaintiff status in cases against the largest issuers. Processing evidence of fraud produced by the SEC or auditors does not require particular skill and does not warrant extra compensation for the lawyers representing the class. Congress can also play a role by setting presumptive limits on fee percentages in the largest cases.

Congress should also consider reforms targeting the methods used by plaintiffs' lawyers to attract institutional investors. Specifically, Congress should prohibit referral fees paid to attorneys for delivering institutional investors as clients to plaintiffs' class action firms. These referral fees create an incentive to inflate hours and

billing rates to cover payments made to attorneys who do no work in the litigation. Shareholder class members do not benefit from the payment of these referral fees, and they do not enhance the deterrent effect of securities fraud class actions. The fact that plaintiffs' firms can afford to pay referral fees to lawyers who do no work on the case suggests that fee awards are greater than they need to be to attract competent counsel to work on securities class actions on a contingent basis.

Finally, we suggest that Congress should consider damages caps for securities fraud class actions in cases in which the public company has not been offering securities. The goal of securities fraud class actions is deterrence, not compensation, and deterrence can still be served with considerably lower potential damages (and correspondingly lower fee awards). Shareholders should not be on the hook for jackpot fee awards that make plaintiffs' lawyers rich without providing a corresponding deterrent benefit.

Endnotes

- 1 485 U.S. 224 (1988).
- 2 Private Securities Litigation Reform Act of 1995 § 101, 15 U.S.C. § 78u-4(b)(2) (2018).
- 3 15 U.S. Code § 78u-4(b).
- 4 15 U.S. Code § 78u-4(c).
- 5 15 U.S. Code § 78u-4(b)(3)(B).
- 6 See, e.g., Elisabeth Kempf & Oliver Spalt, *Litigating Innovation: Evidence from Securities Class Actions*, at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3143690 (finding that low-quality securities class action lawsuits disproportionately target firms with valuable innovation output, imposing a functional tax on these firms).
- 7 See Stefan Boettrich & Svetlana Starykh, NERA Economic Consulting, *Recent Trends in Securities Class Action Litigation: 2017 Full-Year Review*, at 3.
- 8 Michael Wursthorn & Gregory Zuckerman, *Fewer Listed Companies: Is That Good or Bad for Stock Markets?*, *Wall Street Journal* (Jan. 4, 2018).
- 9 Cornerstone Research, *Securities Class Action Filings: 2017 Year in Review*, at 10.
- 10 *Supra* note 7, at 22.
- 11 Lynn A. Baker, Michael A. Perino & Charles Silver, *Is the Price Right? An Empirical Study of Fee-Setting in Securities Class Actions*, 115 COLUM. L. REV. 1371, at 1385 (2015).
- 12 See *id.* at 1440.
- 13 In an earlier research paper, we examined political contributions by attorneys working at plaintiffs' law firms to key politicians in charge of litigation decisions on the part of certain public pension funds. See Stephen J. Choi, Jessica Erickson & Adam C. Pritchard, *Frequent Filers: The Problems of Shareholder Lawsuits and the Path to Reform* (U.S. Chamber Institute for Legal Reform) (2014).
- 14 See, e.g., John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation*, 106 COLUM. L. REV. 1534, at 1536 (2006).
- 15 John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?* 95 VA. L. REV. 707, at 762 (2009) ("In reality, compensation is only minimally achieved in today's enforcement and litigation world, and arguably properly so").
- 16 For example, NERA Consulting found that, in 2017, investors received only 2.6 percent of their possible losses in securities class action settlements. See Stefan Boettrich & Svetlana Starykh, NERA Economic Consulting, *Recent Trends in Securities Class Action Litigation: 2017 Full-Year Review*, at 38.
- 17 See James D. Cox & Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements*, 58 STAN. L. REV. 411, 413 (2005) (finding that "less than thirty percent of institutional investors with provable losses perfect their claims in [securities class action] settlements").
- 18 *Supra* note 14, at 1550.
- 19 See James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 509 (1997) ("[A] circularity problem arises for settlements of securities class actions ... [T]he plaintiffs necessarily provide, albeit indirectly, some portion of their own settlement recovery.")
- 20 *Supra* note 14 (arguing that compensation is "unobtainable" in securities class actions and that "deterrence ... is the only rationale that can justify the significant costs-both public and private-that securities class actions impose on investors and the judiciary").
- 21 See Elizabeth Chamblee Burch, *Securities Class Actions as Pragmatic Ex Post Regulation*, 43 GA. L. REV. 63, 89-90 (2008) (arguing that "class actions help produce a public good: regulation,

- which, in turn, creates positive externalities such as fostering corporate accountability, promoting deterrence, enforcing public norms, and circumnavigating potential SEC and exchange inaction”).
- 22 *Supra* note 14 (arguing that “the sum of these costs (of securities class actions) approaches and may exceed the aggregate recovery”).
 - 23 *See, e.g.,* Jessica M. Erickson, *Overlitigating Corporate Fraud: An Empirical Examination*, 97 IOWA L. REV. 49, 49 (2011) (“The legal system has developed a remarkable array of litigation options—shareholder derivative suits, securities class actions, SEC enforcement actions, even criminal prosecutions—all aimed at preventing the next corporate scandal.”).
 - 24 James D. Cox & Randall S. Thomas, *Corporate Darwinism: Disciplining Managers in a World with Weak Shareholder Litigation*, 95 N.C. L. REV. 19, 22 (2016) (“[T]he benefits created by [shareholder litigation] are qualified by the litigation agency costs that surround them.”).
 - 25 William P. Barrett, *I Have No Clients*, *Forbes*, Oct. 11, 1993, at 52 (quoting William S. Lerach).
 - 26 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, 232-33 (1983).
 - 27 *See* Jessica M. Erickson, *The Gatekeepers of Shareholder Litigation*, 70 OKLA. L. REV. 237, 242 (2017) (arguing that, as a result of litigation agency costs, “suits may be filed that have a positive value to their attorneys, but do not ultimately benefit the shareholders...”).
 - 28 *See, e.g.,* Renee M. Jones, *Law, Norms, and the Breakdown of the Board: Promoting Accountability in Corporate Governance*, 92 IOWA L. REV. 105 (2006); Lynn A. Stout, *On the Proper Motives for Corporate Directors (or, Why You Don’t Want to Invite Homo Economicus to Join Your Board)*, 28 DEL. J. CORP. L. 1, 7 (2003).
 - 29 *See* James D. Cox, *The Social Meaning of Shareholder Suits*, 65 BROOK. L. REV. 3, 6-7 (1999).
 - 30 S. Rep. No. 104-98, at 9 (1995).
 - 31 *See* President Bill Clinton, Private Securities Litigation Reform Act of 1995—Veto Message From the President of the United States, H.R. Doc. No. 104-150, reprinted in 141 Cong. Rec. H15215 (daily ed. Dec. 20, 1995).
 - 32 15 U.S. Code § 78u-4.
 - 33 *Supra* note 2.
 - 34 15 U.S. Code § 78u-4(b)(1).
 - 35 15 U.S. Code § 78u-4(b)(4).
 - 36 *Supra* note 5.
 - 37 Joint Explanatory Statement of the Committee of Conference, H.R. Rep. 104-369, Cong. 1st Sess. 31 (Nov. 28, 1995).
 - 38 15 U.S. Code § 78u-4(a)(3)(B)(iii).
 - 39 15 U.S. Code § 78u-4(a)(3)(B)(vi).
 - 40 H.R. Rep. No. 104-369, at 32.
 - 41 *Id.* at 36.
 - 42 15 U.S. Code § 78u-4(a)(6).
 - 43 *See, e.g., In re Citigroup Inc. Sec. Litig.*, 965 F. Supp. 2d 369, 388 (S.D.N.Y. 2013) (holding that a lodestar cross-check is “crucial because ‘economies of scale could cause windfalls in common fund cases’”).
 - 44 *Goldberger v. Integrated Res., Inc.*, 209 F.3d 43, 47 (2d Cir.2000) (“It bears emphasis that whether calculated pursuant to the lodestar or the percentage method, the fees awarded in common fund cases may not exceed what is ‘reasonable’ under the circumstances.”).
 - 45 S. Rep. No. 104-98, at 12 (1995) (stating that the lodestar method had led to attorneys’ fees that exceeded 50 percent or more of the total settlement).
 - 46 *Supra* note 9, at 5.
 - 47 *Id.*
 - 48 S. Rep. No. 104-98 (1995) (explaining that the legislation was prompted by testimony that “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”).
 - 49 *Supra* note 9, at 1.
 - 50 *See* Securities Class Action Services, *The Top 100 U.S. Class Action Settlements of All Time*, at 6-7 (2018). This report includes settlements that received court approval by the end of 2017. The report includes 13 settlements of more

than \$1 billion. In addition, a federal court in the Southern District of New York approved a \$3 billion settlement in mid-2018. *See* Stipulation of Settlement & Release, *In re Petrobras Secs. Litig.*, No. 14-cv-9662 (S.D.N.Y. Feb. 1, 2018); Opinion and Order, *In re Petrobras Secs. Litig.*, No. 14-cv-9662 (S.D.N.Y. June 25, 2018).

- 51 Securities Class Action Services, *The Top 100 U.S. Class Action Settlements of All Time*, at 7-9 (2018).
- 52 *See id.* at 6.
- 53 *See id.*
- 54 *See* Opinion and Order, *In re Petrobras Secs. Litig.*, No. 14-cv-9662 (S.D.N.Y. June 25, 2018).
- 55 James Park, *Securities class actions and severe frauds*, *Research Handbook on Representative Shareholder Litigation* (Edward Elgar Publishing, Sean Griffith, et al., eds. 2018), at 37.
- 56 Dean Seal, *12 Firms Vying To Lead 9 Tesla Take-Private Tweet Suits*, *Law360* (Oct. 10, 2018).
- 57 Stephen J. Choi, Jessica Erickson & Adam C. Pritchard, *Frequent Filers: The Problems of Shareholder Lawsuits and the Path to Reform* (U.S. Chamber Institute for Legal Reform) (2014).
- 58 Supplemental Opinion, Findings of Fact, and Order Re Award of Attorneys' Fees from Settlement Fund, *Newby, et al. v. Enron Corp.*, No. 4:01-cv-03624 (S.D. Tex. Sept. 8, 2018).
- 59 *Supra* note 54.
- 60 *Supra* note 11, at 1394-1395.
- 61 *See id.* at 1383-84.
- 62 *See* F.R.C.P. 23(h) (authorizing district court judges to award "reasonable" attorneys' fees in a federal class action).
- 63 *Supra* note 11, at 1380-81 (finding that "cases with ex ante fee agreements are the exception rather than the rule" and "the current system of ex post fee-setting in securities class actions is deeply flawed").
- 64 *Id.* at 1390.
- 65 *Id.* at 1403.
- 66 We obtained the list of disclosure related securities class actions from Mike Klausner at Stanford Law School.
- 67 The mention of a restatement in the complaint corresponds with an increased incidence of settlement. Among resolved actions with a complaint that mentions a restatement, 66.5 percent ended in a settlement. In contrast, among resolved actions with a complaint that does not mention a restatement, only 41.8 percent ended in a settlement (difference significant at the 1 percent confidence level).
- 68 The mention of either SEC Activity or Other Government Activity in the complaint corresponds with an increased incidence of settlement. Among resolved actions with a complaint that mentions either SEC Activity or Other Government Activity, 61.1 percent ended in a settlement. In contrast, among resolved actions with a complaint that does not mention either SEC Activity or Other Government Activity, only 40.3 percent ended in a settlement (difference significant at the 1 percent confidence level).
- 69 The mention of the termination or resignation of an officer in the complaint corresponds with an increased incidence of settlement. Among resolved actions with a complaint that mentions the termination or resignation of an officer, 59.4 percent ended in a settlement. In contrast, among resolved actions with a complaint that does not mention such a termination or resignation, only 38.0 percent ended in a settlement (difference significant at the 1 percent confidence level).
- 70 A higher Composite Score corresponds to an increased incidence of settlement. Among resolved actions with a complaint that receives a Composite Score above the median, 66.7 percent ended in a settlement. In contrast, among resolved actions with a complaint that receives a Composite Score at or below the median, only 38.8 percent ended in a settlement (difference significant at the 1 percent confidence level).
- 71 Federal district courts will record various litigation events, including the filing of a complaint, the filing of a court motion, and the issuance of a court order, among others, as entries in the docket for a particular lawsuit. Not all docket entries have the same importance. For example, some entries may simply record the appearance of a new attorney on behalf of a specific party in the matter. Nonetheless, to the extent the proportion of different types of docket entries (motions, court orders, new attorney appearances, etc.) are roughly similar across

- different cases, examining the relative number of docket entries for class actions involving companies with different market capitalization allows us to assess the relative amount of overall litigation activity for these actions.
- 72 The mean number of docket entries after the motion to dismiss for non-dismissed, resolved actions is 220.9 for Market Cap Decile 10 compared with an average of 79.3 docket entries for all the other Market Cap Deciles. The difference is significant at the 1 percent confidence level.
- 73 This difference is significant at the 1 percent confidence level. An alternate possibility is that even after the final motion to dismiss decision, defense counsel put in greater effort in the large market capitalization cases (filing more motions, bringing forward more expert witnesses, etc.), leading plaintiffs' attorneys to work more hours in response. In other work, we examine whether the large market capitalization cases result in the need for more work on the part of plaintiffs' attorneys as opposed to the manufacturing of more hours simply to justify higher fees in the large market capitalization cases.
- 74 We intend to explore the possibility of "make-work" in later research.
- 75 For the latter, the work done by the defense side will be reflected in D&O premia.
- 76 *Supra* note 42.
- 77 *See, e.g., In re IndyMac Mortgage Backed Sec. Litig.*, 94 F. Supp. 3d 517, 525 (S.D.N.Y. 2015) (listing six factors that district courts should take into account in approving a fee award in a securities class action).
- 78 *Supra* note 44 (holding that "what constitutes a reasonable fee is properly committed to the sound discretion of the district court").
- 79 *Supra* note 11, at 1403.
- 80 *See* Stipulation and Agreement of Settlement, *Arkansas Teacher Retirement System v. State Street Bank and Trust Co.*, No. 1:11-cv-10230 (D. Mass. Jul. 26, 2016).
- 81 *See* Order Awarding Attorneys' Fees, Payment of Litigation Expenses, and Payment of Service Awards to Plaintiffs, *Arkansas Teacher Retirement System v. State Street Bank and Trust Co.*, No. 1:11-cv-10230 (D. Mass. Nov. 2, 2016).
- 82 *See, e.g.,* Andrea Estes, *Critics hit law firms' bills after class-action lawsuits*, Boston Globe (Dec. 17, 2016).
- 83 *See* Memorandum and Order, *Arkansas Teacher Retirement System v. State Street Bank and Trust Co.*, No. 1:11-cv-10230 (D. Mass. Feb. 6, 2017); Memorandum and Order, *Arkansas Teacher Retirement System v. State Street Bank and Trust Co.*, No. 1:11-cv-10230 (D. Mass. Mar. 8, 2017).
- 84 *See* Special Master's Report and Recommendations, *Arkansas Teacher Retirement System v. State Street Bank and Trust Co.*, No. 1:11-cv-10230 (D. Mass. June 28, 2018), at 219.
- 85 *See id.*
- 86 *See, e.g.,* Securities Class Action Services, The Top 100 U.S. Class Action Settlements of All Time, at 22 (2018) (listing Labaton Sucharow as one of the most frequent lead/co-lead counsel in the largest securities class action settlements since 1995).
- 87 *Supra* note 84, at 96-125.
- 88 *See id.* at 125.
- 89 *See id.* at 311.
- 90 *See id.* at 309-314.
- 91 Declaration of Michael P. Canty, *Arkansas Teacher Retirement System v. State Street Bank and Trust Co.*, No. 1:11-cv-10230 (D. Mass. Oct. 18, 2018). In a more recent filing, Labaton Sucharow stated that its relationship with Damon Chargois and his firm was unique and the firm had not made "bare referral" payments to any other lawyer or law firm. *See* Phase I Report, *In Re: Labaton Sucharow, LLP*, Case No. 1:11-cv-10230 (D. Mass. Jan. 8, 2018).



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