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FTC Class Action Workshop
Panel Two: Tools for Ensuring that Settlements Are "Fair, Reasonable, and Adequate"

THE SETTLEMENT PROCESS IN SECURITIES CLASS ACTION SUITS

I. The Issue

A. In securities class action litigation, defendants have a strong incentive to settle even meritless suits. The threat of certification often forces corporate executives charged with protecting their company's assets "to stake their companies on the outcome of a single jury trial, or be forced by fear of the risk of bankruptcy to settle even if they have no legal liability." Defendants "may not wish to roll these dice."[1] As one observer has put it, "[f]or defendants, the risk of participating in a single trial [of all claims], and facing a once-and-for-all verdict is ordinarily intolerable."[2] As a result, the Supreme Court has long recognized that securities fraud actions present "a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general."[3]

1. The magnitude of the continuing pressure to settle even meritless strike suits is perhaps most clearly exposed by the fact that, since the passage of the Private Securities Litigation Reform Act of 1995, more than 2,000[4] securities fraud cases have been filed in federal court, yet defendants have taken less than 1% of these cases to trial.[5]

2. Even when defendants do succeed on the merits of the claim before a trial court, the risk of losing on appeal can *still* lead to substantial settlements. For instance, Bristol-Myers Squibb recently agreed to settle a pending class action for $300 million even after the suit was dismissed with prejudice at the trial court level.[6]

B. The same incentives that encourage defendants to settle strike suits means that members of the bar have strong reason to bring them. Members of the

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[1] In re Rhone-Poulenc Rorer, Inc., 51 F.3d 1293, 1299 (7th Cir.).

[2] Victor E. Schwartz, Federal Courts Should Decide Interstate Class Actions: A Call for Federal Class Action Diversity Jurisdiction Reform, 37 Harv. J. on Legis. 483, 490 (2000) (internal quotation mark omitted). See also H.R. Rep. No. 106-320, at 8 (1999).

[3] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739 (1975).

[4] http://securities.stanford.edu/companies.html.

[5] Richard Painter et al., Private Securities Litigation Reform Act: A Post-Enron Analysis 8 (2003).

[6] Jonathan Weil, Win Lawsuit – and Pay $300 Million, Wall St. J., Aug. 2, 2004, at C3.

Supreme Court have noted that class actions "have made more overnight millionaires than almost any other businesses," given "the perverse incentives" that make class action lawyers "business partners of plaintiffs in seeking large-dollar recoveries rather than act[ing] as objective servants of the law."[7]

1. As one commentator has noted, there is simply "*no appreciable risk* of nonrecovery" in securities class actions, because "virtually all cases are settled," regardless of their legal merits.[8] Merely "*[g]etting the claim into the legal system*, without more, sets in motion forces that ultimately compel a multi-million dollar payment."[9]

2. Illustrating how powerful the incentives can be to bring these suits, and to do so quickly before others can, one court found it "peculiar that four of the lawsuits consolidated in this action were filed around 10:00 a.m. on the first business day following [the defendant's] announcement" and that "[m]ost of the complaints are virtually identical (including typographical errors)."[10] At the hearing on the defendant's motion to dismiss, the judge inquired "[H]ow did you get to be so smart and to acquire all this knowledge about fraud from Friday to Tuesday? On Friday, afternoon, did your client suddenly appear at your doorstep and say 'My God, I just read in the Wall Street Journal about Travelers. They defrauded me,' and you agreed with them and you interviewed them and you determined that there was fraud and therefore you had a good lawsuit, so you filed it Tuesday morning, is that what happened?" The court noted that "[c]ounsel for the plaintiffs was not responsive to this line of inquiry."[11]

C. While plaintiffs' attorneys have a strong financial incentive to bring even meritless suits, and defendants have a strong incentive to settle them, neither has a particularly strong incentive to protect class members. For example:

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[7] Lisa L. Casey, *Reforming Securities Class Actions from the Bench: Judging Fiduciaries and Fiduciary Judging*, 2003 BYU L. Rev. 1239, 1255 n.67 (reprinting remarks of Justice O'Connor).
[8] Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 497, 578 (1991). As the Second Circuit has observed, "[a]necdotal evidence tends to confirm [Alexander's] conclusion. Indeed, [Melvyn I.] Weiss and his partner William S. Lerach of the Milberg firm have stated that losses in these cases are 'few and far between,' and that they achieve 'a significant settlement although not always a big legal fee, in 90% of the cases [they] file.'" *Goldberger v. Integrated Res., Inc.*, 209 F.3d 43, 52 (2d Cir. 2000) (quoting *In re Quantum Health Res., Inc. Secs. Litig.*, 962 F. Supp. 1254, 1258 (C.D. Cal. 1997)).
[9] Alexander, *supra* note 8, at 569. *Accord Hevesi v. Citigroup Inc.*, 366 F.3d 70, 80 (2d Cir. 2004) ("numerous courts and scholars have warned that settlements in large [securities] class actions can be divorced from the parties' underlying legal positions"); *Newton v. Merrill Lynch, Pierce, Fenner, & Smith, Inc.*, 259 F.3d 154, 164 (3d Cir. 2001) (discussing the "inordinate or hydraulic pressure on [securities fraud] defendants to settle, avoiding the risk, however small, of potentially ruinous liability").
[10] *Ferber v. Travelers Corp.*, 785 F. Supp. 1101, 1106 n.8 (D. Conn. 1991).
[11] *Id.*

1. Once the scope of the settlement fund is determined, defendants often have no particular concern in how that fund is divided between class members and plaintiffs' counsel, and no incentive to challenge fee requests. This regime can tempt plaintiffs' counsel and defendants to "structure a settlement such that the plaintiffs' attorneys' fees are disproportionate to any relief obtained for the corporation."[12] And settlement hearings frequently devolve into "jointly orchestrated" "pep rallies" in which no party questions the fairness of the settlement and "judges no longer have the full benefit of the adversarial process."[13]

2. In many settlements plaintiffs' attorneys are paid without respect to whether class members find the settlement of sufficient value to bother filing for their share.

a. For example, in 2002, AT&T and Lucent settled a class action suit alleging improper billing practices and established a $300 million settlement fund. Soon after, the lawyers for the class collected some $80 million in fees. Recently, however, the parties revealed that class members redeemed a mere $8 million from the settlement fund, meaning that the plaintiffs' lawyers earned *ten times* the amount of the injured consumers.[14]

3. Because payments come out of corporate coffers, securities fraud actions frequently involve only "a transfer of wealth from current shareholders to former shareholders."[15] Thus, to the extent that class members still own shares in the company at the time of the suit (as they often do), "payments by the corporation to settle a class action amount to transferring money from one pocket to the other, with about half of it dropping on the floor for lawyers to pick up."[16]

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[12] *Bell Atlantic v. Bolger*, 2 F.3d 1304, 1308-09 (3d Cir. 1993) (citing Richard A. Posner, *Economic Analysis of Law* § 21.9, at 570 (4th ed. 1992) (plaintiffs' attorneys "will be tempted to offer to settle with defendant for a small judgment and a large legal fee, and such an offer will be attractive to the defendant provided the sum of the two figures is less than the defendant's net expected loss from going to trial")).
[13] *Id.* at 1310. *See also Cohen v. Young*, 127 F.2d 721, 725 (6th Cir. 1942); *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 532 n.7 (1984).
[14] Editorial, *Fees Line Lawyers' Pockets*, USA Today, Apr. 6, 2004.
[15] Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 Stan. L. Rev. 1487, 1503 (1996). *See also* Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. Chi. L. Rev. 611, 638-39 (1985); Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. Ill. L. Rev. 691, 698-700; Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 Ariz. L. Rev. 639, 650 & n.48 (1996); Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. Ill. L. Rev. 913, 921-22.
[16] Alexander, *supra* note 15, at 1503.

4. Class counsel have virtually no one to answer to: as one prominent securities fraud attorney once boasted, "I have the greatest practice in the world because I have no clients. I bring the case. I hire the plaintiff. I do not have some client telling me what to do. I decide what to do."[17]

a. For example, in one recent case involving Qwest Communications, plaintiffs' lawyers sought to freeze approximately $400 million of potential proceeds from a planned sale of a Qwest business unit in order to place pressure on defendants to settle.[18] The court denied the motion, finding that Qwest badly needed the proceeds from the sale to avoid bankruptcy, and noting that the requested remedy would not benefit all plaintiffs or the company, but only former shareholders and the attorneys.[19] According to the court, entering the injunction sought would likely have bankrupted the company and rendered worthless the stock of thousands of class members who were still shareholders in Qwest.[20]

D. To be sure, Congress has sought to address some of these issues.[21] In 1995, Congress enacted the Private Securities Litigation Reform Act[22] (the "PSLRA").[23] It followed up in 1998 with the Securities Litigation Uniform Standards Act.[24] Despite these reforms, however, little has changed on the ground.[25] For example:

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[17] *In re Network Assocs. Inc. Sec. Litig.*, 76 F. Supp. 2d 1017, 1032 (N.D. Cal. 1999) (emphasis added).

[18] *In re Qwest Communications Int'l, Inc. Sec. Litig.*, 243 F. Supp. 2d 1179 (D. Colo. 2003).

[19] *Id.* at 1186-87.

[20] *Id.* at 1187.

[21] H.R. Conf. Rep. No. 104-369, at 31 (1995), *reprinted in* 1996 U.S.C.C.A.N. 730, 731. Congress explained that:

> The House and Senate Committees heard evidence that abusive practices committed in private securities litigation include: (1) the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action; (2) the targeting of deep pocket defendants, including accountants, underwriters, and individuals who may be covered by insurance, without regard to their actual culpability.

Id.

[22] 15 U.S.C. § 78u-4.

[23] Pub. L. No. 104-67, 109 Stat. 737, 15 U.S.C. §§ 77k *et seq.* (1995).

[24] Pub. L. No. 105-353, 112 Stat. 3227, 15 U.S.C. §§ 77b *et seq.* (1998).

[25] *See* Laura E. Simmons & Ellen M. Ryan, Cornerstone Research, *Post-Reform Act Securities Lawsuits: Settlements Reported Through December 2003* (May 2004) ("*Post-Reform Study*"), *available at* http://www.cornerstone.com/pdfs/2003_Settlements.pdf.

1. Overall, there has been a 32% nationwide increase in the mean number of securities fraud suits filed in the six years since the enactment of the PSLRA.[26] Indeed, according to one published report, public companies now face a nearly 60% greater chance of being sued by shareholders.[27]

2. Virtually all of these suits continue to be settled. One recent opinion quoted a statistic showing that the dismissal rate in the Ninth Circuit as *only 6%*[28] – and studies indicate that 83% of all securities fraud cases continue to be resolved through settlement.[29] As a result questionable suits continue to be brought, and settled, in ways that do not always benefit shareholders. Studies show that six years after the passage of the PSLRA, shareholders in class action suits collected, on average, just 6 cents for every dollar of claimed loss.[30]

> a. *In re PeopleSoft Securities Litigation* illustrates the sort of collusion that continues to appear in some securities class action settlements.[31] Immediately following a decline in the common stock of PeopleSoft, Inc., 19 complaints were filed alleging that top company executives had made materially false and misleading statements to inflate the stock price. At the onset of the action, counsel represented that the case was worth hundreds of millions of dollars in damages. Yet, one year later, the plaintiffs sought approval for a settlement of $15 million. In reviewing the proposed settlement, the district court concluded that counsel had engaged in "minimal" discovery, "on the borderline of acceptability" given the purported scope of the case. Although the district court concluded that "a substantial part of the allegations that led the court to sustain the complaint in the first place are untrue, were never true, and had, at most, razor-thin support," plaintiffs' counsel pocketed $2.5 million in fees and expenses, taken from the common fund.[32]

3. De facto control over these suits continues to remain in the hands of a small group of lawyers. Since the passage of the PSLRA, a single firm (recently split into two) has been responsible for filing 76% of all

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[26] Perino, *supra* note 15, at 930.
[27] *See* Todd S. Foster et al., National Economic Research Associates, *Trends in Securities Litigation and the Impact of PSLRA* 4 (2003).
[28] *In re Infospace, Inc. Secs. Litig.*, 2004 WL 1879013, at *4 (W.D. Wash. Aug. 5, 2004).
[29] *See* Woodruff-Sawyer & Co., A Study of Shareholder Class Action Litigation 25 (2002).
[30] Cornerstone Research, *Securities Class Action Case Filings 2002: Year in Review* (2003).
[31] *See* Order Certifying Settlement Class, Approving Class Settlement, and Awarding Fees and Expenses, *In re PeopleSoft, Inc. Sec. Litig.*, No. C 99-00472 WHA, at 9-10 (N.D. Cal. Aug. 24, 2001).
[32] *Id.* at 9-10.

federal securities class actions in California and 60% of all such suits in other states.[33]

a. A study by the Rand Institute for Civil Justice reveals that class counsel (in all class actions, not just securities cases) often receive fees approaching *or even exceeding* the total recovery by class members.[34] And one recent securities fraud case was described by a Florida court as "the class litigation equivalent of the 'Squeegee boys' who used to frequent major urban intersections and who would run up to a stopped car, splash soapy water on its perfectly clean windshield and expect payment for the uninvited service of wiping it off."[35]

II. What's the Solution To Ensure That Settlements Are Fair and Reasonable?

A. Some notable procedural reforms have been tried recently, and others have been suggested, including:

1. <u>Non-Party Objections</u>

a. The Supreme Court's decision in *Devlin v. Scardelletti*[36] provided an important step toward preserving the right of non-party objections to class action settlements. Prior to *Devlin*, a majority of circuit courts held that unnamed class members were forced to formally intervene in the litigation to have standing to appeal the class action settlement.[37] *Devlin* rejected these decisions and held that unnamed class members who objected to the settlement at the fairness hearing could maintain their own appeal to challenge the terms of the settlement. *Devlin* thus ensures that class members have some meaningful opportunity to challenge a class action settlement beyond the often-perfunctory fairness hearings that precede the approval of the settlement.[38]

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[33] Richard Painter, *supra* note 5, at 15-16.

[34] RAND Institute for Civil Justice, *Class Action Dilemmas, Pursuing Public Goals for the Private Gain – Executive Summary* 21 (1999).

[35] *Fruchter v. Florida Progress Corp.*, No. 99-6167CI-20, 2002 WL 1558220, at *10 (Fla. Cir. Ct. Mar. 20, 2002).

[36] 536 U.S. 1 (2002).

[37] *See, e.g., Shults v. Champion Int'l Corp.*, 35 F.3d 1056 (6th Cir. 1994); *Gottlieb v. Wiles*, 11 F.3d 1004 (10th Cir. 1993); *Croyden Assocs. v. Alleco, Inc.*, 969 F.2d 675 (8th Cir. 1992); *Walker v. City of Mesquite*, 858 F.2d 1071 (5th Cir. 1988); *Guthrie v. Evans*, 815 F.2d 626 (11th Cir. 1987).

[38] *Bell Atlantic*, 2 F.3d at 1310 (noting that settlement hearings frequently devolve into "jointly orchestrated" "pep rallies" for swift approval of the proposed settlement).

b. In fact, objectors often succeed in dramatically changing the posture of a class action settlement, achieving such results as extending the time available to class members to redeem their awards,[39] reducing plaintiffs' attorneys fees,[40] adding terms to the class notice,[41] and even increasing the amount of the settlement.[42] Courts routinely laud the participation of objectors for refining complex issues within the settlement, and "transform[ing] the settlement hearing into a truly adversarial proceeding."[43]

c. Meritorious objections are often difficult to file, however, given the lack of notice and the quick timetable frequently imposed for approving the parties' proffered settlement. In most cases, class members first become aware of the need to assert their interests only *after* a settlement has been struck and with just days or weeks before the court's fairness hearing.[44]

d. In addition, objectors generally receive no direct financial compensation for their activities, and no guarantee of attorneys' fee awards even if they succeed in convincing a court not to approve a settlement. Rather, they participate in class action proceedings only for whatever incremental *pro rata* value might accrue to them as a result of their efforts.[45] Meanwhile, objectors must shoulder the substantial costs of hiring counsel, analyzing settlement materials, filing written objections, and appearing in court, all within a matter of days or weeks. Given these costs, even the largest institutional investors only rarely have the incentive, and the means, to participate in class action hearings.[46]

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[39] *See Shaw v. Toshiba Am. Info. Sys., Inc.*, 91 F. Supp. 2d 942, 974 (E.D. Tex. 2000).

[40] *See In re Horizon/CMS Healthcare Corp. Sec. Litig.*, 3 F. Supp. 2d 1208, 1214 (D.N.M. 1998); *see also Uselton v. Commercial Lovelace Motor Freight, Inc.*, 9 F.3d 849, 854 (10th Cir. 1993).

[41] *See Duhaime v. John Hancock Mut. Life Ins. Co.* 2 F. Supp. 2d 175, 176 (D. Mass. 1998).

[42] *See Petruzzi's, Inc. v. Darling-Delaware Co.*, 983 F. Supp. 595, 599 (M.D. Pa. 1996).

[43] *See In re Domestic Air Transp. Antitrust Litig.*, 148 F.R.D. 297, 359 (N.D. Ga. 1993); *see also In re Ikon Office Solutions, Inc. Sec. Litig.*, 194 F.R.D. 166, 197 (E.D. Pa. 2000); *Howes v. Atkins*, 668 F. Supp. 1021, 1027 (E.D. Ky. 1987); *Frankenstein v. McCrory Corp.*, 425 F. Supp. 762, 767 (S.D.N.Y. 1977).

[44] Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. Chi. L. Rev. 1, 20 (1991) (class members receive little information about their case as it goes along).

[45] *Bell Atlantic Corp.*, 2 F.3d at 1309.

[46] *See* Remarks of District Judge Vaughn R. Walker, ABA National Securities Litigation Institute at 7-8 (June 5, 1998) ("[I]nstances of institutional investors actively leading a [securities class] litigation effort remain relatively rare. . . . This is no surprise. . . . [I]nstitutional investors have disincentives to becoming [parties]. . . . Lawsuits are costly in time, money and other resources.").

e. Finally, non-party objections are not without their own costs. Successful fee challenges have spawned a small cottage industry of professional objectors who seek to profit from regular challenges to fee requests by extracting settlements from the parties.[47]

2. <u>Notice to Government</u>

a. Participation by the appropriate state and federal agencies (such as the FTC) in reviewing and commenting on proposed settlements may also help expose and prevent collusive settlements.

b. For example, in *Erikson v. Ameritech Corporation*[48] the FTC entered an objection to a settlement providing one free month of Ameritech's speed-dial service not requested by class members. Worse still, unless class members expressly canceled the service, under the terms of the proposed settlement, they would continue to receive and *be charged for* the speed-dial programs they never ordered. Meanwhile, however, the attorneys sought nearly $1 million in fees. According to the FTC, the settlement was so bad that it was "perhaps even contrary to the interests of class members who fail[ed] to opt out of the settlement and as a result will not be able to pursue their individual claims against Ameritech."

c. Like private objectors, however, the government faces two primary hurdles: a lack of sufficient notice of settlements and their terms, and a lack of resources or incentive to pursue aggressively problematic settlements.

d. The FTC's comments on the proposed amendments to Rule 23 sought to address the first of these concerns. The FTC recommended that parties to a class action be required to notify the court of any related actions by government agencies, and to notify the government agencies involved in those actions of the related private class action.[49] The advisory committee, however, declined to adopt these suggestions. As a result, no procedure exists to ensure the timely participation of regulators or other government

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[47] *See* Edward Burnett, *Class Action Objectors: Extortionist Free Riders or Fairness Guarantors*, 2003 U. CHI. L. F. 403; Jathon Sapsford, *Lawyers Profit by Challenging Colleagues' Fees*, Wall St. J., May 7, 2004, at B1.

[48] Circuit Court of Cook County, Illinois, County Department, Chancery Division, No. 99 CH 18873 (consolidated with 99 CH 11536, 00 L 011474, 00 L 00500, 01 CH 3373).

[49] Federal Trade Commission, *Comments on Proposed Amendments to Rule 23 of the Federal Rules of Civil Procedure* (Feb. 15, 2002).

authorities, risking inefficient duplicative actions and omitting public participation by a neutral, independent authority.

e. Even if provided notice, governmental agencies frequently have no statutory directive to review settlements for fairness. The FTC has entered this field actively, but only as a result of the initiative of its recent leadership, not because of a statutory requirement. And other agencies that could play a role (e.g., the SEC, state Attorneys General) could do more.

3. <u>Second or Late Opt-Outs</u>

a. Until recently, when a Rule 23(b)(3) class was certified, the decision whether to opt out frequently had to be made early in the case, often before the nature and scope of liability and damages could be fully understood. Rule 23(e)(3) now permits courts to refuse to approve a settlement unless it affords a new opportunity to request exclusion at a time when class members can make an informed decision based on the proposed settlement terms.

b. Early experience, however, shows that few courts have permitted additional opt out periods following settlement approval.[50] A second opt out, moreover, offers no additional layer of protection where settlement occurs before a class is even certified, frequently the case in class action litigation.[51]

4. <u>Interlocutory Appeal</u>

a. Rule 23(f) allows a court of appeals to permit an appeal from an order of a district court granting or denying class action certification. Early reports indicate that Rule 23(f) has been used modestly, resulting in approximately nine published opinions per year since the rule was adopted in 1998.[52]

b. The discretionary nature of Rule 23(f), however, has led to a patchwork of standards and guidelines in the circuit courts, thus raising the possibility of inconsistent remedies depending on the

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[50] *See In re Auto. Refinishing Paint Antitrust Litig.*, MDL No. 1426, 2004 WL 1068807, at *3 (E.D. Pa. May 11, 2004) (finding "no significant developments since the original opt-out that would require . . . a second opt-out period"); *In re Visa Check/Mastermoney Antitrust Litigation*, 297 F. Supp. 2d 503, 518 (E.D.N.Y. 2003) (declining to offer the class a second opt-out opportunity "in light of the infinitesimal number of objections" by class members).
[51] *See* Lawrence J. Zweifach & Samuel L. Barkin, *Recent Developments in the Settlement of Securities Class Actions*, 1279 PLI/Corp. 1329, 1339 (2001).
[52] Brian Anderson & Patrick McLain, *A Progress Report on Rule 23(f): Five Years of Immediate Class Certification Appeals*, Washington Legal Foundation Legal Backgrounder (Mar. 19, 2004).

forum.[53] And, once again, Rule 23(f) provides little assistance in cases where settlement occurs before class certification, as is the dominant practice in securities class actions.[54]

5. Help Institutional Investors Do Their Job Under the PSLRA

a. In the PSLRA, Congress sought to reign in non-meritorious suits by expressing a strong preference for having institutional investors appointed as class representatives.[55] Congress, not unreasonably, believed that "increasing the role of institutional investors in class actions will ultimately benefit shareholders and assist courts by improving the quality of representation in securities class actions."[56]

b. Congress may have failed, however, to consider the task it asked these entities to assume. Although some investors are suitable candidates to lead class action litigation, many lack the staff, resources, funding, and experience to independently monitory the suits brought on their behalf.

c. For example, the trustees of the Louisiana Teachers' Retirement System recently brought a derivative suit against the majority shareholders of Regal Entertainment to stop the issuance of a $750 million dividend, despite holding only a $30,000 investment in the company. The court denied the Louisiana Teachers' application for a preliminary injunction, finding "'not a shred of evidence' that minority shareholder would be hurt," and the Teachers hastily dropped their claims.[57] Notably, the court found the claims so doubtful, that it asked plaintiffs' counsel "[t]o what extent has the plaintiff thought about the claims they're asserting and have they really studied them?"[58] Indeed, as it

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[53] *See* Aimee G. Mackay, Comment, *Appealability of Class Certification Orders Under Federal Rule of Civil Procedure 23(f): Toward a Principled Approach*, 96 Nw. U. L. Rev. 755 (2002) (collecting the various standards of the circuit courts).

[54] *See* Zweifach & Barkin, 1279 PLI/Corp. at 1339.

[55] The PSLRA requires courts to appoint as "lead plaintiff" the class member "that the court determines to be most capable of adequately representing the interests of class members." 15 U.S.C. § 78u-4(a)(3)(B)(i), and creates a rebuttable presumption that the most adequate plaintiff is the party with the "largest financial interest in the relief sought by the class." *Id.* § 78u-4(a)(3)(B)(iii)(I)(bb).

[56] H.R. Conf. Rep. No. 104-369, at 34., *reprinted in* 1996 U.S.C.C.A.N. at 733.

[57] Editorial, *Pension Fund Shenanigans*, Wall St. J., Aug. 20, 2004, at A12 ("[W]hat we have here is a public fund whose risky practices have cost the taxpayer billions throwing mud at a profitable company's management . . . a company. . . that was one of the fund's better-returning investments.").

[58] Transcript of Oral Argument Before the Hon. William B. Chandler, *Teachers' Retirement System of Louisiana v. Regal Entm't Group*, No. 444-N, at 156 (Del. Ch. June 1, 2004).

turned out, the Louisiana Teachers' Retirement System has been involved in 60 class action lawsuits in the last eight years.[59] Citing this substantial docket, one district court judge in the Eastern District of Tennessee declined to allow the Teachers' System to serve as a lead plaintiff in one of these class actions, concluding that "the Court cannot help but conclude the Louisiana Funds' resources are being spread too thin."[60]

d. To help institutional investors from becoming spread too thin, courts might consider greater enforcement of the PSLRA's "professional plaintiff" rule to bar actions repeating allegations already considered and rejected in a prior suit. The PSLRA prohibits a party from serving as lead plaintiff in more than five securities class actions brought during a three-year period.[61] Nonetheless, some courts have relied on commentary contained in the Conference Report accompanying the PSLRA to hold that institutional investors are not subject to this limitation.[62] As other courts have properly noted, however, the PSLRA "contains no express blanket exception for institutional investors" and automatically excusing institutional investors from the rule "would transform the preference for institutional investors into a monopolization of the PSLRA actions by institutional investors."[63]

e. Institutional investors themselves might consider the creation of neutral litigation committees to help them review solicitations made by plaintiffs' lawyers to ensure that the cases brought are meritorious and that any settlement benefits shareholders overall and does not, for example, simply result in a transfer of assets from current shareholders (frequently including institutional investors) to former shareholders.

B. While new procedural tools may help in assuring fairer settlements, it is unclear whether they are sufficient to the task when the underlying incentives encouraging (a) the filing of unmeritorious cases and (b) settlements that favor attorneys over class members remain unaddressed. What could be done to address these underlying incentive problems? Some ideas include:

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[59] *Pension Fund Shenanigans, supra* note 57.
[60] *In re Unumprovident Corp. Secs. Litig.*, MDL Case No. 03-1552, No. 03-CV-049 (E.D. Tenn. Nov. 6, 2003).
[61] 15 U.S.C. § 78u-4(a)(3)(B)(vi).
[62] *See* H.R. Conf. Rep. No. 104-369 at 35 (stating that "[i]nstitutional investors. . .may need to exceed this limitation and do not represent the type of professional plaintiff this legislation seeks to restrict").
[63] *In re Enron Corp. Sec. Litig.*, 206 F.R.D. 427, 443-44 (S.D. Tex. 2002); *see also In re Telxon Corp. Sec. Litig.*, 67 F. Supp. 2d 803, 821 (N.D. Ohio 1999).

1. <u>Enforce the causation requirement already codified in the PSLRA</u>

a. A majority of circuit courts have held that a securities fraud plaintiff must demonstrate that the price of the security at issue declined as the result of disclosure of previously concealed information, and then limited the plaintiff's damages to the amount of that decline.[64] In contrast, the Ninth Circuit has held that a securities fraud plaintiff need only argue that the price of a security was "inflated" when he bought shares.[65] Rather than holding companies liable for the damage they inflict, as reflected by actual market events, the Ninth Circuit's rule thus permits liability to be found and damages to be awarded even when the plaintiff can point to *no actual market price reaction to a corrective disclosure at all.* Under this regime, a plaintiff can bring a class action simply on the allegation that a company's share price was once "inflated" because of the undisclosed accounting issue – and do so without ever having to establish a causal link between any price decline and the alleged misrepresentation. The Ninth Circuit's approach, thus, allows recovery where investors are *never hurt* by the alleged fraud, including in cases where the plaintiff sold before the alleged misrepresentation was exposed; where the misrepresentation was never exposed at all; or where the misrepresentation exposed but the market did not respond negatively. This term, the Supreme Court will review the Ninth Circuit's decision and decide the appropriate loss causation pleading requirements under the PSLRA.[66]

i. An example illustrates the different outcomes under the conflicting approaches. Suppose plaintiff buys $100 of stock in the defendant corporation. As time passes, the value of plaintiff's investment declines to $10. *After* this decline, the defendant announces the restatement of an accounting item but plaintiff's shares remains at $10. In most circuits, any subsequent securities fraud case would be dismissed on a Rule 12(b)(6) motion. In contrast, under the Ninth Circuit's rule, a plaintiff could hire an expert to

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[64] *See Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189 (2d Cir. 2003); *Semerenko v. Cendant Corp.*, 223 F.3d 165 (3d Cir. 2000); *Robbins v. Koger Props., Inc.*, 116 F.3d 1441 (11th Cir. 1997); *Bastian v. Petren Res. Corp.*, 892 F.2d 680 (7th Cir. 1990).

[65] *Broudo v. Dura Pharms, Inc.*, 339 F.3d 933 (9th Cir. 2003); *see also Gebhardt* v. *ConAgra Foods, Inc.*, 335 F.3d 824, 831 (8th Cir. 2003).

[66] The Solicitor General had urged the Supreme Court to review the decision concluding that the Ninth Circuit's reasoning was "difficult to reconcile with the well-established principle that transaction causation and loss causation are distinct elements of a Rule 10b-5 cause of action." *See* Brief for the United States as Amicus Curiae at 12, *Dura Pharms., Inc. v. Broudo,* No. 03-932 (U.S. filed May 28, 2004).

opine on how much of the price plaintiff paid was "inflated" because of the undisclosed accounting issue. Having survived a motion the motion to dismiss, the case will proceed to discovery and, like the majority of all securities class actions, is likely to be settled.

2. Require defendants to pay class counsel fees from a separate fund

a. The practice of paying plaintiffs' attorney fees from the settlement fund, creates a powerful incentive to "structure a settlement such that the plaintiffs' attorneys' fees are disproportionate to any relief obtained for the corporation,"[67] and insulates the fee request from adversarial scrutiny. In essence, paying fees out of the common settlement fund reduces the recovery available to consumers, and shifts the burden of paying the class counsels' fees to class members. In contrast, forcing defendants to pay attorneys' fees outside of the class settlement increases the net amount of class recovery and avoids saddling class members with their attorneys' bills. Such fee shifting is, of course, highly undesirable from the settling defendant's standpoint because it increases the defendant's gross payment to settle the class action. That fact, however, provides a strong financial incentive for defendants to closely scrutinize the total proposed settlement, and to reject settlements that include attorneys' fees requests in the traditional 25% to 30%. In short, insisting on a separate fee awards would re-introduce the adversarial process into the settlement approval process by encouraging greater scrutiny of fee requests.

3. Employ the competitive bidding process first used by Judge Vaughn R. Walker as the basis for selecting class counsel

a. A bidding process to determine class counsel would employ market forces to constrain the supra-competitive prices often charged by plaintiffs' attorneys. Under one approach to competitive bidding, the district court solicits sealed bids from law firms seeking to represent the lead plaintiff, accompanied by a description of the firm's experience and qualifications in such actions. The court then selects the lead plaintiffs' lawyer from these submissions, and determines the attorneys' fees based on the

[67] *Bell Atlantic v. Bolger*, 2 F.3d 1304, 1308-09 (3d Cir. 1993) (citing Richard A. Posner, *Economic Analysis of Law* § 21.9, at 570 (4th ed. 1992) (plaintiffs' attorney "will be tempted to offer to settle with defendant for a small judgment and a large legal fee, and such an offer will be attractive to the defendant provided the sum of the two figures is less than the defendant's net expected loss from going to trial")).

firm's own bid.[68] In another approach to competitive bidding, the district court interviews each of the prospective class attorneys, and selects the lead plaintiffs' counsel based on the judge's independent analysis of the attorneys' ability to monitor and represent the interests of the class.[69]

4. Consider reviving the lodestar method as at least part of the fee review process

a. While the trend in federal courts has been towards using percentage of recovery methodology to determine fee awards, the lodestar method can provide a useful cross-check. The purpose behind any fee award from a common fund settlement is to compensate attorneys for the fair market value of their time in successfully prosecuting the class claims. While the lodestar method has been criticized as overly burdensome and fact intensive (and it is), such problems frequently arise because judges have to review the attorneys' submissions without the benefit of the adversarial process. If fee awards come from outside the settlement fund, defendants will have a stronger incentive to help the courts with the work of reviewing counsels' hours, rates, and other charges.

5. Calculate attorneys' fees on the actual benefit conferred, and not amount of the available settlement fund

a. Requiring reversionary settlements, where uncollected sums set-aside for the class are either returned to the defendants or distributed for the public good by way of a cy pres award, and basing class counsels' fees on the actual benefit conferred to class members, would more closely align attorneys' interests with those of their clients.

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[68] *In re Oracle Sec. Litig.*, 131 F.R.D. 688, 697 (N.D. Cal. 1990). Auctions for lead counsel have also been used in *In re Comdisco Sec. Litig.*, 141 F. Supp. 2d 951 (N.D. Ill. 2001); *In re Commtouch Software Sec. Litig.*, No. C 01-00719 2001 WL 34131835 (N.D. Cal. June 27, 2001); *In re Quintus Sec. Litig.*, 148 F. Supp. 2d 967 (N.D. Cal. 2001); *In re Auction Houses Antitrust Litig.*, 197 F.R.D. 71 (S.D.N.Y. 2000); *In re Bank One Holders Class Actions*, 96 F. Supp. 2d 780 (N.D. Ill. 2000); *In re Lucent Techs., Inc., Sec. Litig.*, 194 F.R.D. 137 (D.N.J. 2000); *Sherleigh Assocs., LLC v. Windmere-Durable Holdings, Inc.*, 184 F.R.D. 668 (S.D. Fl. 1999); *Wenderhold v. Cylink Corp.*, 188 F.R.D. 577 (N.D. Cal. 1999); *In re Network Assoc., Inc., Sec. Litig.*, 76 F. Supp. 2d 1017; *In re Cendant Corp. Litig.*, 182 F.R.D. 144 (D.N.J. 1998); and *In re California Micro Devices Sec.*, 168 F.R.D. 257 (N.D. Cal. 1996).

[68] John F. Grady, *Reasonable Fees: A Suggested Value-Based Approach Analysis for Judges*, 184 F.R.D. 131, 142 (1999).

[69] *See In re Quintus Sec. Litig.*, 201 F.R.D. 475 (N.D. Cal. 2001). The Ninth Circuit rejected this interview approach in *In re Cavanaugh*, 306 F.3d 726 (9th Cir. 2002).

i. Currently, without such limitations, lawyers are able to earn fees disproportionate to funds collected by their nominal clients, and have little incentive to structure settlements in ways class members find useful or attractive. By way of illustration, AT&T and Lucent in 2002 settled a class action suit alleging improper billing practices and established a $300 million settlement fund. Soon after, the lawyers for the class collected some $80 million in fees. Recently, however, the parties revealed that class members have found the settlement so unattractive that they have bothered to redeem a mere $8 million from the settlement fund, meaning that the plaintiffs' lawyers earned *ten times* the amount of the injured consumers.[70]

[70] Editorial, *Fees Line Lawyers' Pockets*, USA Today, Apr. 6, 2004.